Testimony of

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U.S. Senate Committee on Banking, Housing, and Urban Affairs

Hearing on:
"Principals of Housing Finance Reform"
Thursday, June 29, 2017

Chairman Crapo, Ranking Member Brown and Members of the Committee, thank you for the invitation to be here today. It is an honor to be back before this Committee, this time in my new capacity as the President of the Housing Policy Council (HPC, or the Council), a division of the Financial Services Roundtable. The Council's 32 member firms are among the nation's leading mortgage originators, servicers, insurers and mortgage data service and settlement providers. They operate in the mortgage market every day and they want it to be strong and stable for the future to serve their customers – current and future homeowners.

The topic of this hearing – housing finance reform – is a top priority for the Housing Policy Council. While the housing finance system continues to function with Fannie Mae and Freddie Mac in conservatorships, the status quo is untenable for many reasons and only Congress has the authority to make the permanent changes needed to put the system on a sound footing for the long term. The good news is that much progress has been made since I last appeared before this Committee in 2013 as the Acting Director of the Federal Housing Finance Agency and since this Committee approved reform legislation in 2014.

In these prepared remarks, I will review that progress and its importance to this effort. I will also describe the strides made since 2013 in developing a broad consensus not just on the need for legislation but, in many ways, on such legislation's content. While significant differences of opinion remain on some key aspects of housing finance reform, they are relatively few and in some instances, multiple approaches may be workable and acceptable. The critical point is that reform cannot be completed without Congress. Your leadership in this effort is much appreciated and HPC's members stand ready to help you forge the bipartisan consensus needed to get this legislation to the finish line.

Enacting comprehensive housing finance reform will put the country on a better course to ensure future homebuyers have broad access to credit and that our financial system can deliver this credit with much less systemic risk than in the past. Comprehensive housing finance reform can also ensure that taxpayers are protected and that Congress will not need to consider 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 review of housing finance should include the Federal Housing Administration (FHA) program as a critical component of the housing finance system.

Principles for Housing Finance Reform

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:

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.
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.

Fixing What is Broken

Among the many things broken in the current system are: the burden the system places on taxpayers for the bulk of the capital needed to backstop mortgage credit risk; the lack of meaningful market forces in evaluating mortgage credit risk; persistent concerns about access to and affordability of credit for consumers despite the enormous subsidies inherent in the current system; the barriers to entry inherent in a system structured around two government-sponsored enterprises (GSEs); and the systemic risk that results from concentrating most mortgage credit risk on two balance sheets. As we have seen, this systemic risk leaves taxpayers exposed to emergency bailouts when the system fails. All these flaws need to be fixed.

At the same time, we need to preserve the features of the system that are working well, some of which have been greatly strengthened since the crisis. We should preserve: the efficient forward market that allows borrowers to lock in rates before settlement (known as the To-Be-Announced, or TBA market); the standardization of data and reporting; transparent and consistent reps and warrants; attracting private capital from mortgage insurers and a range of other capital providers; and the ongoing, nationwide access to the secondary mortgage market by lenders of all sizes and types, which benefits consumers and all participants in the mortgage market.

Ensuring a Smooth Transition

The pathway to the new system should be constructed with care. Hasty or ill-conceived transitions can disrupt markets, add risk, and limit credit availability. By the same token, an excessively drawn out transition can also be disruptive, especially if it leads to more interim measures that add costs and risks. Legislative reform can and should continue the gradual transition process that has been underway for several years. Such an approach allows new infrastructures and business arrangements to form around the new system before the old system is ended. A thoughtful transition also protects the value of $5 trillion in mortgage securities already trading today and the new securities that will be issued during the transition period.

Private Capital Should Bear Mortgage Credit Risk

As the crisis demonstrated, the GSE-duopoly system created immense systemic risk and the imminent collapse of the housing finance market forced Congress to pass emergency legislation bailing out investors in the GSEs' mortgage-backed securities (MBS). Since then, progress has been made in drawing private capital back into a meaningful first-loss position, but more progress is needed. Housing finance reform should continue that gradual transition away from taxpayer capital support to a system based upon private capital that protects taxpayers and restores market discipline on risk-taking. The heads-shareholders-win, tails-taxpayers-lose construct must be banished. Instead, as described below, a new system should encourage multiple channels for bringing private capital to this market, including bank balance sheets, mortgage insurance, various capital market structures, equity markets, and reinsurance.

Regulation Should be Consistent and Transparent

Today's mortgage market has thousands of firms engaged in the origination and servicing of mortgages. Some are large and operate nationwide, some are small and operate in a single community. Some are regulated as insured depository institutions, often with multiple federal and state financial institution regulators overseeing their operations. Others are not subject to oversight by banking regulators, but have multiple federal and state agencies monitoring their activities. This leads to duplication of regulatory effort and inevitable inconsistencies in the interpretation and application of rules, which drives up costs and ultimately limits credit access. We can do better. An improved regulatory framework should promote consistency and efficiency, which would lower costs to consumers while delivering more consistent and equitable outcomes for firms and consumers alike. Supervisory and other enforcement mechanisms should be consistent and transparent. Penalties should be commensurate with the harm and the intent of the violation. As in other areas of financial regulation, we need to return to an environment in which regulators seek first to encourage correction of errors rather than to immediately punish and penalize. But if egregious or persistent patterns of neglectful or willfully wrong activity exists, appropriate enforcement should follow. In sum, greater regulatory transparency and consistency are needed, across all types and sizes of firms and regulators.

Competition Promotes Superior Outcomes

We should not lose sight of the numerous benefits that competitive markets deliver to consumers. Reform should establish a market structure that removes barriers to entry while fostering competition and innovation. Competition benefits consumers by driving down costs. Innovation benefits consumers by adding new products and making the delivery of existing products more efficient and consumer-friendly. Appropriate standard-setting promotes healthy market competition by establishing rules of the road for all competitors. Standard setting may include data and disclosure standards, servicing rules, basic borrower eligibility rules, and standards around acceptable credit enhancement. Clear and enforceable standards, in turn, give market participants a more equitable basis to resolve disputes than what we have experienced since the financial crisis.

Desired Outcomes

Given these principles, HPC supports comprehensive housing finance reform that leads to the following outcomes:

1. A deep and liquid mortgage-backed securities market for multiple mortgage products, including 30-year, fixed-rate mortgages, that gives eligible borrowers access to credit throughout the business cycle and removes barriers to entry in the secondary market.

2. A TBA market with a means to normalize around loan delivery and performance standards that allows borrowers to lock interest rates when they apply for a mortgage.
3. A level playing field for secondary market access across charter type, size of lender, and source of credit enhancement giving homebuyers choices among mortgage originators.
4. Competition and market efficiency in lending, credit risk syndication, and mortgage servicing to keep mortgage rates low and give consumers choice among lenders and mortgage products.
5. Replacing the separate Fannie Mae and Freddie Mac MBS with a single deep, liquid MBS security with multiple issuers, backed by private capital and wrapped with a government guarantee to broaden the investor pool for U.S. mortgage assets, thereby keeping mortgage rates low.
6. A common securitization infrastructure that operates with a uniform set of standards for mortgage servicing, investor disclosure, and dispute resolution.
7. A better approach to meeting affordable housing needs that may include elements such as a duty to serve, a dedicated funding stream, a modernized FHA, and/or other means to create *sustainable* mortgage loans for low- and moderate-income borrowers and communities.
8. Consistency in regulation and enforcement to reduce unnecessary compliance costs and provide certainty to lenders, servicers and their customers.

Restarting the Legislative Process to Achieve Housing Finance Reform

Since this Committee approved the Johnson-Crapo bill in 2014, administrative and marketplace actions, and additional policy analysis have improved the foundation for reform legislation. Those developments should make your legislative effort easier because reform concepts have been getting a real-life market test, and continued policy analysis is helping build a consensus among stakeholders.

In this section, I will review this progress and its implications for legislation. I also will highlight the numerous common elements across most, if not all, reform proposals before assessing the critical things left to be decided.

The Threshold Question – Should There be a Government Guarantee of MBS?

The approach to reform that HPC supports, and that is reflected across most reform proposals, provides for a single MBS that has an explicit catastrophic backstop federal guarantee to replace the separate MBS issued by Fannie Mae and Freddie Mac that carried an “implied” guarantee. A common platform would be used to issue these securities and place the federal guarantee. Multiple private entities would be able to add loans to the common pool. This is how the Ginnie Mae securitization process works today.

But why any federal guarantee at all? The simple answer is that an explicit, federal guarantee to cover catastrophic credit risk is needed to ensure a steady flow of mortgage credit in all economic cycles. Housing finance, however, is far from simple, so I will provide a little more context for this important issue.

Consider how the Fannie, Freddie, and Ginnie MBS work today. In each case, securitizing a pool of mortgages in a MBS separates the two essential risks in mortgage lending – credit risk and interest rate risk. Credit risk is the risk that the borrower is unable to make their payments and defaults on the loan. Interest rate risk is the risk that interest rates move up or down over time, while the investors are holding long-term, fixed-rate mortgages. Interest rate movements also influence borrower's likelihood of refinancing, which alters the expected time to maturity and creates reinvestment risk for investors.

In a Ginnie Mae MBS, the credit risk remains with the government insurance program (chiefly FHA and VA) with some residual risk to servicers. Interest rate risk goes to the private investors in the Ginnie Mae MBS. In the GSE world pre-conservatorships, beyond traditional mortgage insurance coverage, all mortgage credit risk on mortgages placed in Fannie Mae and Freddie Mac MBS resided on the balance sheets of those two companies. This was a recipe for systemic risk - $5 trillion in mortgage credit risk on two balance sheets (and those balance sheets had capital requirements for that risk that were a fraction of the capital required for other regulated entities). The interest rate risk on those MBS went to the private MBS investors. So, in the process of securitization, Ginnie, Fannie, and Freddie effectively separate credit risk from interest rate risk. Private capital retains the interest rate risk and government capital retains the credit risk (in the case of Ginnie) and GSE shareholders retained the credit risk (in the case of Fannie and Freddie).

Of course, market participants believed that the GSE shareholders were not alone in this process. They looked at the GSEs' federal charters, subsidies, protected duopoly status, and weak capital standards together as indicating the government would not let Fannie and Freddie default. This was the frequently discussed and officially denied implicit guarantee of the GSEs. Investors believed, rightly as it turned out, that the U.S. government would not permit a global financial market disruption resulting from a default on Fannie and Freddie MBS.

It is also important to understand how other significant elements of our current housing finance system grew out of this structure. The development of a TBA market rested on the proposition that MBS investors faced no credit risk and the MBS issuers' exemptions from certain securities laws. Thus, investors in MBS could buy and trade contracts for delivery of mortgages not yet originated. The TBA market does two important things – it adds substantial liquidity to the mortgage market, assuring lenders in the process of originating mortgages that investors are ready to buy and it assures borrowers that they can lock in today's interest rates even though it could be weeks before settlement.

It is conceivable that, in the absence of a government guarantee of MBS, the market would develop methods of separating credit risk from interest rate risk and create a hedging mechanism to replace the TBA market. Yet the experience of the private label MBS market should give us pause. That market, operating without the clarity of a government guarantee, imperfectly separated credit risk from interest rate risk via complex security structures that parsed mortgage payment streams across multiple security tranches. There was no equivalent of TBA and the private label market was heterogeneous, which limited investor participation.

In the context of housing finance reform, we envision a new secondary mortgage market in which multiple sources of stable private capital bears all but catastrophic mortgage credit risk on mortgages placed into this new MBS. We believe it is the responsibility of private market participants to bear this risk. But ensuring the liquidity of some $5 trillion in mortgages – the size of the Fannie and Freddie market today – requires more than that. To ensure that families get the benefit of deep and continued investor interest in MBS to finance long-term, fixed-rate mortgages, the consistency of the loan pools and the absence of credit risk in those pools needs to be protected. A meaningful segment of MBS investors today would not continue to invest in this market if they had to also manage credit risk. Fewer investors means higher rates for consumers.

In all reform proposals that include a government guarantee, that guarantee is limited to catastrophic or so-called tail risk; that is, private capital would directly bear all credit losses except losses caused by catastrophic economic circumstances (that is, the tail of the distribution of possible economic outcomes). Private market participants face several huge obstacles in managing mortgage tail risk. The frequency of a catastrophic event is rare. At most we have seen such events only twice in the past hundred years. The severity of the outcome is also extreme – losses far greater than in normal circumstances.

Under corporate tax and accounting rules, it is difficult and expensive for private firms to price and hold reserves for such large and rare contingencies. So, in the absence of a catastrophic backstop, the cost of mortgages would go up and the supply would become more limited (for instance, down payment requirements would be greater).

Looked at this way, a government guarantee is a way to enhance market performance by ensuring that credit risk is kept separate from interest rate risk in all economic environments. But we also believe that the system should have a pre-established system to fully repay taxpayers for any support provided as a result of the government guarantee.

HPC supports proposals for the government establishing a Mortgage Insurance Fund and charging a fee for the government's catastrophic guarantee on all government-backed MBS replacing the Fannie and Freddie market. The government would manage the Mortgage Insurance Fund and use it to pay MBS holders if we ever encountered a catastrophic market outcome that wiped out the private capital support.

Importantly, though, this would not be the end of the story. Just as with federal deposit insurance, any taxpayer advances to the Fund would be fully repaid over time through premiums assessed on future mortgages. The role of the government's guarantee would be to more efficiently distribute catastrophic losses over time. As a pre-established system, the Fund would also serve as an automatic economic stabilizer; Congress and market participants alike could count on this mechanism to keep liquidity and confidence in housing finance through a catastrophic storm and any funds taxpayers lent into this system would have a built-in repayment mechanism.

To make the likelihood of activating the government backstop remote, there needs to be robust and reliable private capital standing ahead of the Mortgage Insurance Fund. Rather than the 45 basis points of capital required of Fannie Mae and Freddie Mac, first loss capital should be at least as great as what banks would be required to hold if the mortgages were on their books rather than placed into MBS.

In sum, the future system must be properly structured and capitalized both to absorb even catastrophic losses and to provide counter-cyclical support. We view a government guarantee as enabling markets to work more efficiently, making more mortgage credit available consistently and at lower cost to consumers. Since private capital would bear a substantial first-loss position, private capital would be incented to keep mortgage credit risk at prudent levels. And since the government backstop for catastrophic losses would be pre-funded and have an *ex post* repayment mechanism already in place, taxpayers would not be bailing out the system but rather stabilizing it and enhancing the distribution of rare but substantial credit losses across time in a way private markets cannot.

Building on Progress Made

As the Committee restarts its legislative efforts, we believe there is a lot of common ground across legislative, industry, think tank, and other stakeholder proposals on which to build. Most, if not all, of the leading reform plans have the following elements:

- 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 and Freddie 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 provided.
- Fannie Mae and Freddie Mac would be wound down and then ended as GSEs and their GSE charters would be extinguished. 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.

This extensive amount of common ground provides a strong foundation on which to legislate. Importantly, relative to 2013-2014, the uncertainty associated with change is much less. For example, work on a common securitization platform, which was first announced in 2012, now has five years of thought and development and is partially operational today. Another example:

the idea that private capital can be raised to back mortgage credit risk via risk syndication has moved from theory to practice. The first transaction was completed in 2013. Today, FHFA reports that the GSEs have transferred risk on more than $1.4 trillion of MBS, with nearly $50 billion in capital support raised through this process. Moreover, this capital support has been raised through multiple channels and structures, ranging from lender recourse and deeper private mortgage insurance to reinsurance and structured capital market transactions. This is a very encouraging development as it shows both the interest of private capital in this emerging asset class and the multiple ways in which the capital can be raised and the multiple sources of that capital. By establishing post-conservatorship secondary market entities, Congress would be completing the development of this market. Secondary market entities engaged in this credit risk syndication should give lenders and investors alike confidence in this credit intermediation process.

Key Issues Still to Resolve

While important issues remain unresolved, these are not insurmountable challenges and in many cases, the range of differences has shrunk over time. Among the key issues left to be resolved are the following:

- Who owns and who may access the common securitization infrastructure? May it be used to issue private label MBS? What is the source of the government guarantee – a new federal entity, Ginnie Mae, or some other approach?
- How will legislation ensure consistent national servicing standards and other forms of standardization such as mortgage data standards, disclosure standards, and so on?
- Assuming multiple forms and channels for bringing private capital to back all but catastrophic credit loss on mortgages, how would FHFA (or some other regulator) ensure equivalency of these various credit enhancement structures in front of any government guarantee? Should legislation direct bank regulators to update bank capital and liquidity rules for this new system? Whatever the approach, clearly the movement from a GSE-dominated secondary market to a post-conservatorship market will require a holistic review of capital, liquidity, and disclosure rules.
- How does this new regime ensure equitable access to the secondary market for loan originators of all size and charter?
- What requirements should be placed on secondary market entities to ensure they strive to reach traditionally underserved markets and borrowers?
- May lenders credit enhance their own mortgage production if they meet the same standards as guarantors must meet?
- What other legal changes are needed to make the new system work (for example, amendments to securities and tax laws would enable mortgage real estate investment trusts to more readily be a source of private capital in this new market)?
- What is the role of the Federal Home Loan Bank System in this new regime? Should their mission or membership change?

Other Issues and Opportunities

Beyond all the plumbing and market structure issues just reviewed, comprehensive housing finance legislation needs to concern itself with how our housing finance system serves the needs of all Americans.

The Rental Market

My testimony to this point has focused largely on the ownership market. Yet, today the country's greatest housing challenges are in the rental market. While the CFPB's Qualified Mortgage rule generally requires household total debt (including mortgage payment) to be no more than 43 percent of a family's monthly income, we have more than 11 million renter families spending more than 50 percent of their monthly income just on rent. The waiting list for rental vouchers in many communities is years long. Moreover, local zoning, land use ordinances, and building requirements drive up the cost of new construction and rehabilitation, thereby limiting supply. While better education, jobs, and wages are the best solution, these supply constraints remain critical obstacles in many communities.

FHA

Few reform proposals deal with FHA, which is ironic since this agency offers the government's flagship program for encouraging homeownership and because it is in such need of repair and modernization. While some of FHA's many challenges may be handled administratively, and HPC appreciates HUD Secretary Carson's openness to stakeholder input for improving the program, there can be a role for Congress here as well. At a fundamental level, Congress could give FHA a clear mission for serving 21st century borrowers and markets and ensure FHA has the resources to fulfill that mission.

In my short time at HPC, I have been struck by the deep concern our membership has for the FHA program and its future. HPC members see great value in the program as a means for the federal government to target subsidies that promote home ownership opportunities. In that way, FHA should complement private sector efforts rather than using those subsidies, and FHA's thin capital base, to compete away business that the private market already is serving. There is enough need for access to credit for low- and moderate-income homebuyers that both FHA and private lenders should be actively and fully engaged.

Yet, trends in the FHA program are troubling. Its market share in 2016 grew to 17 percent yet participation by depository institutions has been declining. Former Ginnie Mae President Ted Tozer frequently remarked on the risks this combination was creating for taxpayers. Neither FHA nor Ginnie Mae has the staff nor the resources to manage the evolving risk profile in the FHA program, which risks its long-term ability to serve its customers.

Earlier this month, HPC submitted a public comment letter to HUD outlining our concerns about the program as currently administered. From operational issues like property conveyance rules and weak quality control practices to legal requirements such as certifications to the use of enforcement tools such as the False Claims Act, these features of the FHA program as administered today are counter-productive to serving borrowers. As the Committee weighs housing finance reform, HPC respectively urges you to also consider the FHA program, its role in our housing finance system, and the potential to address pressing FHA issues as part of reform.

Preparing Borrowers to Become Sustainable Homeowners

A common element across many housing finance proposals is a goal of making mortgage lending more 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, low-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 needs to become more attuned to this challenge so better solutions may be found.

Loan qualification standards also need to evolve and improve. For instance, greater competition has already led to more innovative approaches to credit scoring. With greater market transparency around mortgage performance and a competitive market for private capital risk-bearing, these developments will be more likely to get adopted, resulting in more consumers qualifying for mortgages.

Conclusion

In the nine years since Fannie Mae and Freddie Mac were placed into government conservatorships, the market has evolved substantially away from the failed system of the past. That process cannot be completed absent bipartisan legislation that deals with the status and charters of the GSEs and addresses related issues such as the role and health of FHA. The good news is that there are numerous common elements across the leading reform proposals. HPC is supportive of this consensus, which forms a solid foundation for legislation. While differences remain to be worked out, we are encouraged that compromise solutions are within reach. We stand ready to support this Committee as it crafts legislation that will set the country's housing finance system on a more market-based and competitive path because we believe this is the way to best serve the housing finance needs of our nation's families. Thank you for inviting me here today.