COMMUNITY MORTGAGE LENDERS

TESTIMONY OF WES HUNT

COMMUNITY MORTGAGE LENDERS OF AMERICA

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON
“HOUSING FINANCE REFORM: MAINTAINING ACCESS FOR SMALL LENDERS”
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On behalf of the Community Mortgage Lenders of America (CMLA) I am pleased to submit testimony to the Senate Committee on Banking, Housing and Urban Affairs on Housing Finance Reform. CMLA is a trade group representing small lenders that serve the housing finance needs of their customers. CMLA's members, which include both mortgage companies and community banks, are active originators of loans that are sold to, and securitized by, both Fannie Mae and Freddie Mac (collectively the "GSEs").

None of CMLA's members received TARP bailout money and among our members there were very few loans from either GSE or FHA that they were required to repurchase.

CMLA is a member of the Main Street GSE Reform Coalition, which recently published a set of Common Principles for GSE reform. The Common Principles emphasize the need for strong capitalization of the GSEs, equal treatment and access for all lenders and fulfillment of the GSEs' affordable housing obligations.

<u>Summary of CMLA Housing Finance Reform Recommendation</u>

We are pleased that the Committee is moving forward on the subject of housing finance reform. Since the depths of the 2008 financial crisis, the U.S. mortgage market has made great strides in addressing the issues that created and drove the crisis. The last significant piece of unfinished business from the crisis is to resolve the status of Fannie Mae and Freddie Mac. In order to best serve the home finance needs of American consumers we need to allow these two vital sources of liquidity for the home mortgage market to emerge from their nearly nine year-long conservatorships. Listed below are CMLA's recommendations of how to accomplish the final steps in housing finance reform:

- The Housing and Economic Recovery Act of 2008 (HERA) addressed many of the shortcomings and lapses that led to the financial failure of Fannie and Freddie, and the Qualified Mortgage provision in Dodd Frank successfully addressed lax underwriting standards and poorly designed products. However, there are a few important steps left to be accomplished;
- The completion of housing finance reform includes both administrative actions and targeted, specific Congressional legislation;
- The Federal Housing Finance Agency (FHFA) must exercise its authority under HERA to set capital standards for the GSEs and oversee and approve the GSEs creating and executing a recapitalization plan to build a strong base of private capital to provide financial stability and reduce taxpayer risk;
- Congress should make permanent the mandate of equal fees for all lenders and the FHFA's authority to regulate the guaranty fees charged by the GSEs as well as extending these two safeguards to upfront risk sharing arrangements as well, in order to ensure a level playing field for America's homebuyers and all lenders, and
- Congress must also provide a federal backstop for the GSEs, so their MBS will continue to command strong prices in the marketplace, which translate to affordable interest rates for home buyers and continued availability of 30 year fixed rate loans

State of the Mortgage Market

The state of the mortgage market in the U.S. in 2017 is good with some improvements definitely required. Lenders are projected to originate approximately $1.6 trillion in single family mortgages this year. Home values are on a steadily upward trajectory and many individuals and families are able to obtain financing to purchase their home of choice. Interest rates for a 30-year fixed rate mortgage remain in the 4% range and the credit performance of existing loans is strong.

According to Core Logic, a California-based real estate data and analytics firm, delinquency and foreclosure rates among existing home loans are at quite moderate levels, and down from a comparable period in 2016. Both early (30 day) and late stage delinquencies (120 days+) are down .5% since the comparable period in 2016, while loans in foreclosure have declined from 1.0% in 2016 to 0.7% in 2017. All of these delinquency and foreclosure statistics are a fraction of the comparable numbers during the height of the financial crisis and its immediate aftermath in the 2008-2010 period.

Credit parameters have loosened somewhat in the past year, but remain more stringent than they were early in the century prior to the relaxation that led to the financial crisis. Fannie Mae, for example, recently announced that the maximum debt to income ratio they would accept on loans they purchase, would be 50%. Previously the maximum was 45%, with 50% acceptable only under certain qualifying circumstances.

However, there has been little to no increase in mortgage risk as a result of these modest loosening in credit parameters. As measured by Core Logic's Housing Credit Index, which tracks the risk inherent in mortgages being currently originated, the risk in mortgage being originated today is equivalent to the risk inherent in mortgages originated early in this century, which was a period of low risk and robust credit performance for single family mortgages in the U.S. By comparison the Housing Credit Index in the first quarter of 2007, at the height of the pre-crisis relaxation of underwriting standards and origination of exotic mortgage products, was more than double what it is today.

To be sure, there are some issues in today's market that need to be addressed. Credit parameters, while having loosened somewhat, are still stricter than they were in the 2000-2003-time period. That early 21st century time period is seen as having had the optimum balance between ample credit availability and strong underwriting standards. In addition, the supply of homes, both existing and new, is quite restricted in many major markets. Overhanging all of this is the continued low rate of homeownership, which in turn has contributed to sharp increases in rents as potential buyers remain as tenants and compete for rental housing with new entrants.

A significant, and from the standpoint of small lenders, beneficial change in the mortgage marketplace since the immediate aftermath of the financial crisis has been the lessening of market share concentration among the big bank lenders. In 2011 three big bank lenders accounted for 50% of all residential mortgages in the U.S. Today the market share held by those three same banks is just above 20%. What has changed is the market share of small and mid-sized independent lenders, which has grown to 40%+ in 2016 and the first half of 2017.

1629 K Street, NW, Suite 300, Washington, DC 20006

The growth in the independent lender segment has translated into more choices for consumers and less risk concentration among a few large lenders, both positives for the marketplace and for borrowers.

State of Mortgage Market Reform

The shortcomings that led to the GSEs' conservatorship are well known. Too little capital, a weak and ineffective regulator, executive compensation that encouraged excessive risk taking and discounted guaranty fees to large lenders that led to a concentration of risk, were the four primary causes. Fortunately, HERA corrected three of these issues and legislative action by Congress in 2011 corrected the fourth, at least temporarily.

HERA created FHFA as a robust regulator, armed with sufficient authority to oversee the operations of the GSEs. The legislative change in 2011 authorized FHFA to regulate the guaranty fee charged by the GSEs and mandated equal guaranty fees for all lenders for a ten-year period ending in October, 2021.

FHFA's actions, as both regulator and conservator we believe, have fulfilled the expectations of HERA's drafters. Under FHFA's direction and control Fannie Mae and Freddie Mac have been steady, dependable and significant sources of liquidity for the conventional mortgage market. The credit quality of the mortgages purchased and securitized by the duo have been outstanding, as has the performance of the mortgages backing the GSE-issued securities. Fannie Mae and Freddie Mac are once again the linchpins of the conventional mortgage market in the U.S.

FHFA has also moved to address some issues that have made the mortgage market less efficient and more expensive for consumers – notably the price difference between Freddie Mac and Fannie Mae securities. As noted recently by the Urban Institute, the price gap between the Freddie Mac and Fannie Mae mortgage backed securities has largely disappeared. This price gap, with Freddie Mac securities commanding a lower price in the capital markets, had persisted for many years, well prior to conservatorship. Now with the product uniformity and other operational efficiencies introduced by FHFA, as well as the promise of a common securitization platform and a single security, have led to the market pricing the securities on a relatively equal basis.

The other major shortcoming that FHFA has not addressed, though HERA provided it with ample authority to do so, is the inadequate capitalization of Fannie Mae and Freddie Mac. HERA authorizes the FHFA Director to set both minimum capital standards and risk-based capital standards, "…to the extent needed to ensure that the regulated entities operate in a safe and sound manner."

Unfortunately, with Fannie Mae and Freddie Mac in conservatorship, FHFA has chosen to not exercise its capital authority under HERA. In fact, the Preferred Stock Purchase Agreements (PSPAs) between the U.S. Treasury and each GSE specifically ignore the capital provisions of HERA and require each entity to reduce its capital level each quarter until it reaches zero in January 2018. We find this to be a reckless and ill-advised action put in place by the former administration and we shall address this issue further, later in this testimony.

FHFA has also acted to ensure that executive compensation provides the appropriate incentives to keep GSE management focused on fulfilling their mission of providing ample liquidity to the mortgage market and a flow of affordable housing finance for lenders to make available to consumers.

The fourth shortcoming, the discounting of guaranty fees tied to lending volume, was a serious misstep by Fannie and Freddie. The combination of a 10-year grant of statutory authority to FHFA and strong, effective administrative action, have eliminated this issue.

In the pre-crisis era both Fannie Mae and Freddie Mac utilized the technique of discounted guaranty fees in return for exclusive business arrangements with large lenders as a competitive tool to garner larger loan volumes.

This discounting of guaranty fees to large lenders had several detrimental effects on the financial stability of the GSEs and the mortgage market. Through the discounts the large lender recipients were able to translate their favorable pricing into a competitive advantage in the primary mortgage market that allowed them to underprice small lenders and gain larger market share for themselves. As pointed out above these larger market shares led to a dangerous concentration of mortgage originations among a handful of lenders. As we pointed our earlier in the testimony, in 2011 three big bank lenders commanded a combined market share of 50%.

Smaller lenders were not offered the same pricing by either Fannie Mae or Freddie Mac and thus could not offer these lower prices to the consumers whose financing needs they served. Small lenders could obtain not-quite-as-favorable pricing by agreeing to sell their closed loans to one of the large lenders who enjoyed the discounted guaranty fees. The downside for small lenders was that large lenders would only purchase loans from small lenders bundled with the loan servicing rights. So, small lenders forfeited the opportunity to establish a long-term customer relationship. Small lenders also were deprived of the opportunity to build additional financial stability for their companies through the ongoing income stream from loan servicing fees.

The situation is very different today for small lenders. With the equal pricing policy mandated by Congress and implemented by FHFA, small lenders pay the same guaranty fees as large lenders. Small lenders can compete on an equal pricing basis with large lenders in the primary mortgage market with the option of selling the loan directly to Fannie Mae or Freddie Mac and retaining the servicing rights to the loan. Retaining the loan servicing rights allows small lenders to build a long-term relationship with their customers and to create greater financial stability for their company with the ongoing income from loan servicing fees.

Since the major shortcomings that led to the GSEs' conservatorship have been addressed through legislative action by Congress and administrative action by FHFA, what remains to be done? What can be accomplished administratively, by FHFA and/or other agencies or departments in the executive branch and what further action do small lenders believe Congress needs to take?

Scope of GSE Reform that Remains to Be Accomplished

There are several critical and specific actions that remain to be taken in order to complete housing finance reform. Some of these actions can be accomplished administratively and some require targeted, narrowly-scoped Congressional legislation. Among the required actions are the following:

- Congress must make permanent FHFA's authority to regulate the guaranty fees charged by Fannie Mae and Freddie Mac; continue the prohibition on discriminatory or unequal pricing and extend that administrative authority and prohibition to upfront risk sharing transactions and all other actions that may foster or encourage vertical integration of the primary and secondary mortgage markets;
- Congress should make permanent the current PSPAs as an explicit federal backstop support for the GSEs with two important changes - eliminate the capital reduction and profit sweep provisions and mandate payment of an ongoing fee by the GSEs for the backstop;
- FHFA must exercise their existing statutory authority to draw up both minimum and risk-based capital standards for Fannie Mae and Freddie Mac;
- FHFA must require Fannie Mae and Freddie Mac to draw up plans to meet both the risk-based and minimum capital standards. As mandated by HERA the GSE capital plans are then subject to approval by FHFA
- Once each GSE has an approved plan to meet the risk-based and minimum capital standards FHFA should oversee the implementation of those plans by the GSEs; and
- Once the GSEs have met the capital standards FHFA should release them from conservatorship.

Permanent FHFA Authority – Vertical Integration

For small lenders, this is the paramount issue within housing finance reform. As detailed earlier in this testimony, discriminatory pricing of guaranty fees by Fannie Mae and Freddie Mac in favor of the large lenders in the pre-crisis era led to both market distortions as well as a concentration of risk for the GSEs. The statutory prohibition of such discriminatory pricing, and the authority of the regulator to oversee and control the GSEs' guaranty fees is an essential cornerstone of housing finance reform and must be made permanent by Congress.

In addition, the extension of this prohibition to upfront risk sharing is equally essential, as is the authority for FHFA to regulate such activities. Our concern is that upfront risk sharing, while potentially an important technique for the GSEs to control their risk, also offers the same opportunities for discriminatory action favoring one group of lenders over another. So, an amendment to current law to accomplish these dual objectives is important.

Finally, we also believe that an amendment should extend the prohibition, and grant of FHFA regulatory authority, to any and all other techniques, transactions or actions by the GSEs that could provide great marketplace leverage, or lead to vertical integration of the primary and secondary markets, to any group of lenders at the expense of all other lenders. Congressional policy should be a strong endorsement and affirmation of equal pricing and equal treatment for all lenders that do business with the GSEs.

Permanent Federal Backstop

The national and international capital markets have accepted the PSPAs as proof of a federal backstop to Fannie Mae and Freddie Mac, that has led to favorable pricing for both their debt and the mortgage-backed securities that they issue. Such favorable pricing has led directly to benefits for home buyers, who continue to enjoy an adequate supply of conventional mortgage financing at affordable rates. In addition, this market acceptance of Fannie Mae and Freddie Mac mortgage-backed securities is directly linked to the continued availability of the 30-year fixed rate mortgage for American home buyers.

In the interests of keeping legislative action by Congress to complete housing finance reform as specific and targeted as possible, while preserving all the benefits to home buyers that flow from the current system, we believe the best course of action for Congress would be to make the PSPAs a permanent federal backstop for the GSEs with a couple of important changes. The first would be to eliminate the capital reduction requirements currently built into the PSPAs.

As referenced above, we believe it is a reckless and ill-advised policy to run two organizations that are so vital to the smooth functioning of the U.S. mortgage market on a thin and rapidly diminishing capital level, as required by the current provisions of the PSPAs. As we have stated publicly, FHFA has the authority, as conservator, to suspend the dividend payments under the PSPAs, to allow the GSEs to build a capital buffer. Such a capital buffer is important to reduce the possibility that either of the GSEs may experience a quarterly accounting-driven loss due to their hedging activities, which in turn could require another draw under the PSPA. Such a draw could lead to market disruption or turmoil, which is entirely avoidable if the GSEs have a capital buffer, rather than a thin to nonexistent capitalization as they have now.

We would support administrative action now, or in the immediate future, by FHFA to address this situation, either through a suspension of the dividends or other means to allow the GSEs to build a capital buffer. The smooth functioning of the GSEs is too important to the housing finance needs of American consumers to allow an entirely avoidable quarterly fluctuation to disrupt their operations.

Capital Standards

Under existing law (12 U.S.C. 4611 et. seq.) the FHFA Director is authorized by Congress to establish and enforce both risk-based and minimum capital standards for Fannie Mae and Freddie Mac. Regrettably FHFA has failed to exercise this authority while the GSEs have been in conservatorship.

We believe a vital part of housing finance reform is for FHFA to immediately begin exercising its statutory authority to set both risk-based and minimum capital standards that "…ensure that the enterprises operate in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in the operations and management of the enterprises." (12 U.S.C. 4611)

The single more important lesson from the '08 financial crisis is that capital is key. Those institutions that were well capitalized survived, those that were not, failed, or were bailed out. There will inevitably be another financial crisis at some point in the future. How it will come about, and how it will either resemble, or be starkly different, from the 2008 financial crisis is impossible to know today. But what we do know is that strong capitalization will be a decisive factor, as it has been in every financial crisis in the past 100+ years.

Capital Plans

Current law (12 U.S.C. 4622) grants the FHFA Director the authority to require a GSE that does not meet the minimum or risk-based capital standards to submit a capital restoration plan. Once FHFA has established minimum and risk-based capital standards for the GSEs, it should utilize this authority to require submission of capital restoration plans by Fannie Mae and Freddie Mac.

These plans are subject to FHFA's approval and must meet the following standards:

> "Each capital restoration plan submitted under this subchapter shall set forth a feasible plan for restoring the core capital of the regulated entity subject to the plan to an amount not less than the minimum capital level for the regulated entity and for restoring the total capital of the regulated entity to an amount not less than the risk-based capital level for the regulated entity. Each capital restoration plan shall-
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> (1) specify the level of capital the regulated entity will achieve and maintain;
> (2) describe the actions that the regulated entity will take to become classified as adequately capitalized;
> (3) establish a schedule for completing the actions set forth in the plan;
> (4) specify the types and levels of activities (including existing and new programs) in which the regulated entity will engage during the term of the plan; and
> (5) describe the actions that the regulated entity will take to comply with any mandatory and discretionary requirements imposed under this subchapter."

Release from Conservatorship

Once FHFA approves these plans the GSEs should remain in conservatorship until they have met the minimum capital standards set by FHFA. Once they have met the minimum capital standards, and any other conditions set by FHFA, the GSE should be released from conservatorship.

What Small Lenders and their Consumers Do Not Need from Housing Finance Reform

There are a number of items that small lenders and the consumers whose housing finance needs they serve, do not need or want from any housing finance reform effort. Chief among those are the following:

- Massive, complex legislation to create someone's vision of what the U.S. housing finance system should look like if we were designing it from scratch today;
- Creating avenues or loopholes that could be exploited by the large banks and their Wall Street enablers to re-establish the un-level, concentrated mortgage market that existed in the pre-crisis era, with dominant positions for the large banks in both the primary mortgage origination and secondary capital markets;
- Examples of such avenues or loopholes would include –
    - Advocacy of incomplete or limited prohibitions on unequal pricing and risk sharing
    - Proposals to either break up Fannie Mae and Freddie Mac, remove the Common Securitization Platform (CPS) from GSE ownership, or permitting the chartering of additional GSEs
    - Permitting ownership of such "new" GSEs by large lenders, consortiums of large lenders or Wall Street investment banks; and
    - Coupling such ownership with a proposal to establish a federal guaranty on the MBS issued by each chartered GSE.

Massive Complex Legislation

As we have stated previously in this testimony – we know the causes of the GSEs financial failures in 2008 and we know how to remedy those failures. As we have demonstrated in this testimony, such remedies do not require broad, sweeping remakes of the entire housing finance system in this country.

Such proposal for broad, sweeping remakes either from think tanks, consultants or financial trade associations representing large lender and/or Wall Street interests primarily exist for two reasons. They satisfy the ego needs of their author(s) and seek to advance the financial interests of those who funded the creation of the proposal. Neither reason is sufficient to justify the scrapping or replacement of a housing finance system that has provided affordable mortgage finance for millions of Americans and has worked reasonably well in the post-crisis era.

We know what went wrong and how to fix it. That is what we should do.

Avenues or Loopholes

As small lenders, we have noted the consistent theme of the debate over housing finance reform and the various proposals that have been put forth to address the issue. Restoration of the primary role of the large lenders has been the overriding objective of most of the players, and many of the proposals, that have been put forth.

Initially in the immediate wake of the crisis, with the GSE conservatorships in their infancy, the debate and proposals did little to cloak the primary objective of restoration of the large lender roles.

As the debate has gone on the various players have perceived that many in Congress, as well as small lender, consumer and other interest groups are either unsupportive, or actively opposed, to the restoration of the large lenders in their pre-crisis dominant roles. In recognition of this development the large lender proponents have shifted their tactics.

Their proposals now cloak their objective more carefully, but create avenues or loopholes that are designed to facilitate the efforts of the large lenders to regain their dominant role. Such avenues include a number of different items:

Limited prohibitions on unequal pricing – Various proposals seemingly embrace the current prohibition on unequal pricing and requirement of equal pricing for all lenders, but do not advocate extending that pricing to unequal risk sharing terms, or other means to favor large lenders over small lenders

Proposals to break up the GSEs or Remove CSP – As currently constituted the GSEs are coherent, well-functioning entities that are serving the needs of the marketplace. As outlined previously in this testimony this current state of affairs can be transitioned to a post-conservatorship era with modest legislative action and appropriate regulatory action by FHFA. Breaking up the GSEs and/or removing a vital component of their ability to create a mortgage-back security to access the capital markets (the Common Securitization Platform (CSP)), serves no good purpose except to create opportunities for Wall Street and the large banks to regain their dominant positions, which they previously demonstrated they use to favor their financial interests and disadvantage small lenders and the consumers they serve.

Proposals to charter new GSEs – The U.S. housing finance system previously had hundreds of GSEs. They were called savings & loans (S&Ls) and either through direct experience, or by reading our history books, we all know how well that turned out for our country. In addition, these proposals to charter new GSEs do not contain an absolute prohibition on ownership of the newly chartered GSEs by consortiums of big banks and/or Wall Street investment banks. Thus, creating an avenue for attainment of the principal objective outlined above. The ability of small lenders to establish a mutually-owned GSE is not an effective counter to this situation. The capital to establish a new GSE will be a large sum, well beyond the ability of small lenders, who constantly work to ensure the adequacy of their own capitalization, to free up cash to invest.

Proposals to Federally Guarantee GSE-MBS - On the surface proposals to establish a federal guarantee for MBS issued by the GSEs appear worth considering. With an explicit federal guarantee investors could feel secure that principal and interest on their MBS would be paid no matter what turmoil engulfs the marketplace. However, a closer examination of the issue reveals several troubling facets:

- Securities carrying the full faith and credit guarantee of the U.S. government would permit banks, particularly large banks, to own such securities without holding any capital against them. The capital free nature of such securities would give large banks an advantage not enjoyed by other investors, which in turn could lead to ownership concentrations, that in turn could grant undue leverage and influence to the large banks.

- If this capital-free securities status for large banks were coupled with the ability of large bank consortiums to establish and own a GSE, you could easily see how this would facilitating the re-establishment of the dominant role for large banks in the mortgage marketplace and extend that dominant role to the secondary market as well
- Currently the only mortgage security that has a full faith and credit federal guaranty is the Ginnie Mae mortgage-backed security, which is the financing vehicle for FHA-insured, VA-guaranteed and Rural Housing loans. Each of these loan programs serves groups for whom the lower interest rates afforded by the federal guaranty is critical: first time buyers, low and moderate income buyers, veterans and rural borrowers. What impact will there be on the GNMA program and the borrowers it serves, if GSE MBS received the same guaranty? We believe this issue merits further exploration and discussion, at the very least.

Conclusion

We would ask members of the Senate Banking Committee to note the contrasts between the testimony you are hearing today, from groups whose membership consists solely of small lenders, and previous testimony from groups whose membership includes large lenders.

Hopefully you have noted the consistent message from small lenders, simply asking Congress for limited action sufficient to address the well-known reasons why the GSEs entered conservatorship. Further that Congress should take legislative action that contains specific provisions to address those issues, without upending the current mortgage market. We would ask the Committee to remember that the organizations that have testified before you today do not need to take into account, or negotiate the views they have expressed to you today with the large lenders, many of whom were responsible for much of what led to the 2008 financial crisis. Our views are the distillation of the observations and beliefs of our members, small lenders all, who have faithfully served the mortgage finance needs of their communities through thick and thin and were not responsible for the actions and conditions that led to the 2008 financial crisis.

Thank you for this opportunity to present out testimony. Please contact us with any questions and if you desire additional detail.