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GSE REFORM: IMMEDIATE STEPS TO PROTECT TAXPAYERS AND END THE BAILOUT

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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GSE REFORM: IMMEDIATE STEPS TO PROTECT TAXPAYERS AND END THE BAILOUT

Wednesday, February 9, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:12 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Schweikert, Royce, Lucas, Manzullo, Biggert, Hensarling, Neugebauer, Campbell, Marchant, McCotter, Pearce, Posey, Fitzpatrick, Hayworth, Hurt, Grimm, Stivers; Waters, Ackerman, Sherman, Miller of North Carolina, Maloney, Moore, Perlmutter, Donnelly, Carson, Himes, Peters, Green, and Ellison.

Ex officio present: Representative Frank.

Also present: Representatives Gary Miller of California and Carney.

Chairman GARRETT. Greetings. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises will now come to order.

And we have just conferred with the other side. Maxine is on her way, but we thought that since we have the panel here, and a number of esteemed Members from both sides of the aisle, we would begin the proceedings. So we will begin, without objection.

Also, without objection, all Members' opening statements will be made a part of the record.

And so we begin with opening statements.

It was on September 7, 2008, that Fannie Mae and Freddie Mac were put into conservatorship by the Federal Government. Over $150 billion and 885 days later, the government-backed mortgage twins remain in conservatorship. The Federal Government now underwrites 95 percent of the housing market. And still the American taxpayer continues to hemorrhage billions of dollars every quarter to keep them afloat.

So I am pleased to hear that the Department of the Treasury is getting closer with their much anticipated reform proposal, which I understand can be out here now. If I had known that simply scheduling a GSE reform hearing would facilitate such a swift response, we would have held one even sooner.

While I know a lot of attention has been given to the Treasury's proposal and what the future of U.S. housing finance will look like, I believe that there are other areas of this debate that we can focus on right now.

In particular, I believe the question we need to be asking ourselves is this: What are the immediate steps that Congress can take right now, this very instant, to protect taxpayers, to end the bailout, to get private capital off the sidelines, and to reduce the government exposures to the housing market? I believe it is these four objectives that should be the driving force behind our immediate reform efforts.

And so I look forward to discussing a number of reform proposals in greater detail with our esteemed panel. As I can see from their written testimony, there are many ways to protect taxpayers and begin the end of the bailouts.

Now, I say that on one hand. It is also unfortunate that some of my colleagues on the other side of the aisle have resisted any attempts, at least in the last Congress, to address the most expensive and explosive component of the Federal Government's intervention during the financial crisis. But I assure you, it will be a top priority of mine, as chairman of this subcommittee.

The Federal Government's housing policy has been a monumental disaster, and we must find new ways forward. Secretary Geithner said just the other day that the new policy should leave us with a system that will not be vulnerable to the really tragic colossal failures of the past. I couldn't agree with him more.

Even in The Washington Post, they are on board, too, with wholesale changes to Fannie Mae and Freddie Mac. In an editorial this Monday, the Post wrote, "Homeownership does help instill thrifty habits and solidify communities, but it can be taken too far." They said the national homeownership rate slipped back to 1998 levels, according to the Census Bureau.

So, in terms of building a community, etc., it is as if the last 13 years have never happened, except, of course, for the catastrophic losses to the taxpayers and also to the home buyers. They conclude by saying, "It might be more accurate to say that the Federal housing policy has helped to destroy communities."

It will be the goal of this subcommittee to ensure that we put an end to this destructive and costly housing finance policy and then replace it with a system, going forward, that protects taxpayers and actually strengthens communities instead of, as the Post says, destroying them.

I thank the witnesses for being here today, and I look forward to their testimony.

And, with that, I recognize Mr. Miller.

Mr. MILLER OF NORTH CAROLINA. I think Ms. Waters had allocated 2 minutes to me. So I will now take 2 minutes.

Thank you, Mr. Chairman.

The wrong lesson to draw from the financial crisis is that homeownership should not be a goal, a public policy goal. It undoubtedly can be taken too far, but the financial crisis was by no means caused by the goal of homeownership. Seventy percent of the people who got subprime mortgages were not getting those mortgages

to buy a home. They already owned their home, but they needed to borrow money.

More than half, well more than half—the Wall Street Journal estimated 55 percent; other estimates have been much higher than that—of the people who got subprime mortgages qualified for prime mortgages. So it was not about making mortgages available to people who would not have qualified in ordinary circumstances. It was entirely about making as much money as possible as quickly as possible without regard to the consequences.

Fannie and Freddie were certainly guilty of that, to some extent, but the private-label securitizers, their competitors, were also guilty of that and probably even more guilty of that.

We do need to recreate, to reinvent our housing finance system. But a principal goal should still be to make homeownership available, on reasonable terms, for middle-class families. We got away from that in the last decade. And as we reinvent our housing finance system, that is what we need to get back to.

I yield back my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from California, Mr. Royce, for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman.

It appears, after months of preparing, we finally got to the point here where Treasury is set to release their proposal for GSE reform. But I think, for us, the vexing part is, instead of coming out with one definitive plan, they are going to provide three options: no government role in the secondary mortgage market will be their first option; government support only sometimes looks like their second; and permanent government support as their third.

Unfortunately, three options doesn't equal one plan. And I think the time for debating the merits of options is long past. Now is the time to act.

A permanent government guarantee will inevitably lead to politicians and bureaucrats putting their proverbial thumb on the scale. Human nature is not going to change here. Politicians will insist that underwriting standards be relaxed, guaranteeing fees being lowered, and downpayments being waived, so just one more group can get into homes they otherwise could not afford if you were depending on the market.

So this scenario has happened before, and it will happen again. And when it does, we will again face a boom-bust cycle in our financial markets, followed by a massive taxpayer bailout.

I think we can do better. I think we should confront the reality of not putting in place that type of permanent government guarantee in the future.

I yield back.

Chairman GARRETT. The gentleman yields back.

And before I yield the microphone to the gentlelady from California, I am pleased to be joined by her today and pleased to see her beside me as a ranking member, and I look forward to working with her on so many very important issues, issues that we worked on collaboratively in the past, in the area of housing finance and the area of FHA reform. So, obviously, there are commonalities in our interest in making sure that we can get the economy back on

track again. I look forward to your comments, but also our collegiality moving forward, as well.

Ms. WATERS. Thank you very much, Mr. Chairman—

Chairman GARRETT. I yield you 4 minutes.

Ms. WATERS. —first, for organizing this first hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises for the 112th Congress. I, too, look forward to working with you. You are absolutely correct; we have worked together on issues in the past, and I think we can do that for the future.

Today's hearing is an opportunity to address one of the most critical questions facing our economy: How do we continue to move forward from the crisis and organize a secondary mortgage market that ensures access to sustainable homeownership at affordable rates for the American middle class? And how do we do this while protecting all taxpayers?

For many years, we did a fairly good job of providing the opportunity for homeownership to the average American who worked hard and acted responsibly. But over the course of the last decade, we saw the creation and evolution of toxic financial products that pulled Americans further and further away from the mortgages that we grew up with—30-year, fixed-rate loans with sensible downpayments for homes we could reasonably afford.

Now, what caused these products to develop was the subject of many fights in this committee during the last Congress. I continue to believe that an unregulated shadow banking system created the crisis and that casino-style betting magnified and lengthened it. Unfortunately, Fannie Mae and Freddie Mac, hungry for profits and market share, hopped on the bandwagon, albeit late. The result has been enormously consequential for American taxpayers.

Our objective, moving forward, should not be to continue arguing over the facts that led us to this point. I sincerely want to begin the next phase, negotiating a plan for the future.

I have not committed yet to any one proposal, and I am open to any plan coming from any Member or group or institution that can advance the following goals: Can the plan preserve the 30-year, fixed-rate mortgage, whose availability I believe is vital for American borrowers? Does the plan provide for stability and liquidity, particularly in times of severe credit constriction, as we experienced over the last few years? Are there features in the plan that allow for access for all qualified borrowers, as well as the small and community banks that seek liquidity? Does the plan ensure that there is a secondary market for multifamily loans and a market for individuals who seek affordable rental housing? Is there transparency for investors and regulators? Does the plan protect taxpayers and ensure that a small number of institutions don't again become "too-big-to-fail?"

So these are the criteria by which I will evaluate proposals, moving forward.

I understand that some details of the Administration's options paper were released to reporters last night. I am looking forward to reading the full report and studying the options they propose. But what I am more interested in hearing about are the principles the Administration thinks are important for GSE reform, such as

whether they think the preservation of the 30-year, fixed-rate mortgage is essential.

While it is important that we get the technical details right as we develop a new housing finance system, I think it is more important that we make clear what values underpin our vision for the future.

I look forward to working with the Administration and all of my colleagues in Congress on developing a plan that best meets the needs of all market participants. I believe that all of us need to seriously consider every option on the table.

And, Mr. Chairman, I do thank you. And I yield back the balance of my time.

Chairman GARRETT. I thank the gentlelady.

And now, I yield 1 minute to the gentleman from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman and fellow Members and, obviously, our witnesses.

I know there is a certain frustration here because the Administration had an obligation to provide us their proposal, what was it, last week, and something for to us discuss and build around, and here we are blind once again.

Having read much of the literature that is out there in regards to Fannie and Freddie and some of the distortions they may have created in the price of money and also the amount of debt and nonperforming assets they are currently holding, Mr. Chairman, witnesses, I desperately hope, as you testify, you give us some sense of how bad it is out there and how much we have in nonperforming assets that have to be unwound if we are ever going to see a recovery in our housing market.

Thank you, Mr. Chairman.

Chairman GARRETT. And the gentleman yields back.

I yield now to the gentleman from Connecticut, Mr. Himes.

Mr. HIMES. Thank you, Mr. Chairman. I join in welcoming our witnesses today.

I am grateful for the opportunity to finally begin examining reasonably and seriously the future role of the GSEs in our housing market. This has been the subject of much demagoguery for a long time. And while there is no question that the GSEs meaningfully contributed to our financial crisis through irresponsibility and the way they went in the years beginning in the 1990s, there are some things that we can't ignore.

First, they operated for decades safely and soundly and helped to really bulwark and assist the creation of an American middle class. Secondly, a 30-year, fixed-rate mortgage may not exist without them, or if it did exist, it could perhaps be priced out of the range of American middle-class families. And third, multifamily lending, which is so important to smart growth and creating vibrant cities, might be severely damaged were Fannie and Freddie to not exist in any form at all.

These are tough issues involving political decisions, and I hope that the panel today will address them and give us some guidance on how we can best secure our public policy goals without taking on the risks that were incurred in the 1990s.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. And I thank the gentleman.

The gentlelady from Illinois, Ms. Biggert, please, for 1 minute,

Mrs. BIGGERT. Thank you, Mr. Chairman.

Fannie Mae and Freddie Mac have received the largest taxpayer-backed bailout to date, over $150 billion. They are responsible for over $5.4 trillion in outstanding mortgage applications and were at the root of the greatest financial crisis since the Great Depression. And yet the Administration has failed to meet its deadline to produce a required report on reform. Moreover, GSE reform was intentionally omitted in the Dodd-Frank Act.

Fortunately, this is a new Congress, and housing finance reform is at the top of our agenda. Certainly, we must take care not to disrupt an already-fragile market. However, it is time to move toward a market with less reliance on government guarantees and more private-sector participation.

I thank Chairman Garrett for convening today's hearing, and next week, the Subcommittee on Insurance and Housing will hold a hearing to examine government barriers to the housing market recovery.

The bottom line is that never again should taxpayers be on the hook for risky housing finance policies. I look forward to working with my colleagues to examine the future of housing finance.

I yield back.

Chairman GARRETT. I thank the gentlelady for yielding back.

Two minutes to the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. And I thank the witnesses, as well.

This is about homeownership, it is about the American dream, but it is also about the economy. It is about what happens once we start to build housing and we have buyers. Because, once you lay that foundation, you know that at some point you will sell carpet or you will sell a washer, a dryer.

This economy has been driven in great part due to the success of our housing market. So, as we move forward, we want to make sure that market is still in place such that we can utilize it to again help us with our economic recovery.

I think that if we don't consider the impact on the economy, we are making a mistake. So let's be sure that, as we move forward, we don't develop unintended consequences associated with our desire to make things right.

I thank you for the time, Mr. Chairman. And I yield back.

Chairman GARRETT. And I thank you.

And the other gentleman from Texas, Mr. Hensarling, for 1 minute, please.

Mr. HENSARLING. Thank you, Mr. Chairman.

We all know that the classic definition of "insanity" is doing the same thing over and over and expecting a different result. Those who want to foster a system of continuing government guarantees in the secondary mortgage market certainly bear the burden of persuasion that somehow we can expect a different result—a different result than $150 billion of taxpayer bailout money, $8 trillion of debt that ultimately the taxpayer is responsible for. That is a strong burden of persuasion.

For 2 years now, we have had the Administration, which has discussed, studied, ruminated, cogitated, and done everything but

acted upon the GSEs. I hope that very soon, they will release a plan.

But I think the real question is, how do we transition to a competitive market without taxpayer guarantees and how soon can we get there? It is time for us, at three trillion-plus deficits in our Nation's history in a row, to end the taxpayer bailouts.

I yield back.

Chairman GARRETT. Mr. Frank?

Mr. FRANK. Thank you, Mr. Chairman.

I have, actually, a question which will be addressed.

Chairman GARRETT. For 2 minutes.

Mr. FRANK. I have heard criticism of the Administration for missing its deadline. And I must say, this is a newly discovered attitude of deference towards the Obama Administration on these matters. I had not previously thought that the Majority was waiting around for the President to suggest to them what to do. I had thought that, frankly, the Majority knew what it wanted to do.

Last year, in July, in the conference, an amendment was offered to the conference report that we were told, as I recall, resolved this problem, got rid of them. And I didn't think it was germane; we ruled it was not germane. But when the election happened, I had assumed—in fact, I am surprised that we are now having a hearing on what the Administration hasn't done. I assumed this would be a hearing on the amendment Mr. Hensarling offered last year.

It did seem to me that the Majority knew what it wanted to do in July when it was in the Minority. And, apparently, there was something about transitioning from the Minority to the Majority that induces a kind of legislative amnesia.

People on the Majority side were very sure what we should do. So I had expected to be coming to a hearing in which we would be considering the amendment. There was a great deal of unhappiness on the Minority side that we couldn't vote on the amendment. The Majority is in charge of that, so I assumed we would go forward. And, again, I had not expected them to wait for the Administration.

So my question is, why are we not—and I know it has been introduced as part of the RSC package, the amendment of the gentleman of Texas. So can we anticipate a legislative hearing on this and a markup of that legislation? And if not, what impediment intervened? Why was this a very good idea in July and not in February?

Chairman GARRETT. Would the gentleman yield?

Mr. FRANK. Yes.

Chairman GARRETT. I appreciate that, and I appreciate the gentleman's recollection of the history of what we had proposed in the past. And I assume the gentleman also remembers, as well, that we had also called on the Majority at that time to do what we are doing right now, and that is to call in the interested parties, call in the academics, call in the stakeholders to elaborate, to elucidate, and to explain what some of the ramifications of these proposals are.

That was never done. And now we have a whole slew of new freshmen from—actually, we only have one freshmen new—

Mr. FRANK. I take back my time to say, no, these aren't new questions. There is nothing new here that wasn't known then. In

July, people said, "Adopt this amendment. We know what to do." And I am surprised that there was a certainty then and such uncertainty now. There aren't any new questions about this. At least, there aren't questions that weren't there before.

So, again, I am struck by the contrast between the certainty that was expressed when the Majority was the Minority and the uncertainty that has overtaken them in the Majority.

And I yield back.

Chairman GARRETT. And the gentleman yields back. I assume the gentleman will be interested in the contrast as we go ahead in the next 2 years, as well.

And, with that, I yield to the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. And thank you for holding this very important meeting. As has been said, we have been waiting for 2 years for some action to happen on this issue, and finally we are about to start down that road.

One of the things that concerns me is, while we are in this very hearing today, Freddie and Fannie will take on additional taxpayer liability. And so, the time to act is not later but is now. We need to start to make sure that we are doing everything we can and the conservator is doing everything they can to minimize additional exposure while, at the same time, making space for private securitization to begin to take place immediately so that we can begin to reduce that exposure.

There are a lot of things that should be discussed today, and I look forward to this important dialogue.

Chairman GARRETT. And now for 2 minutes, the gentleman from Minnesota, Mr. Ellison.

Mr. ELLISON. Thank you, Mr. Chairman and also Ranking Member Waters, for this important hearing. I am looking forward to this dialogue, and I would like to express a few ideas as we go forward.

First of all, I think it is important to learn the right lessons from the recent housing market crisis. And these lessons point to the private sector's role in creating private-label mortgage-backed securities as we start this new Congress. Let's not forget that the subprime mortgage securities were created by Wall Street firms, not Fannie and Freddie.

Now, I am not advocating that Fannie and Freddie were perfect actors during the housing bubble, but let's be clear; Fannie and Freddie did not start this crisis, and Fannie and Freddie's affordable housing mission did not cause the collapse.

Let's also be clear that the Community Reinvestment Act did not cause the housing collapse either.

Reforming mortgage finance systems is a big responsibility because homeownership has sustained the middle class of this country. Calls to eliminate all government involvement in the secondary mortgage market are not responsible. We can't go back to the predepression housing market when government played no role in housing finance and homeownership was restricted to the very wealthy.

As this subcommittee addresses the important work of GSE reform, I also hope that equal attention is given to the important role

that Fannie and Freddie have played in the affordable rental housing market.

So I look forward to the testimony of the witnesses here, and I thank all of you.

I yield back.

Chairman GARRETT. I thank the gentleman for yielding back.

And now the gentleman from Illinois, Mr. Manzullo, for 1 minute.

Mr. MANZULLO. Thank you.

It is very simple. Whoever came up with the great idea to allow people who couldn't make the first mortgage payment to buy a house made the mistake. It took the Fed until, I believe, October of last year to come up with a simple rule that said, whenever you apply for a home mortgage, you must have written proof of what your earnings are.

That is how we got in this mess. People bought homes, couldn't make the first mortgage payment, everything got behind, and derivatives were soured because of the underlying securities on it.

So now, we need to find our way out of this mess. Fannie Mae and Freddie Mac could have done it a long time ago. They simply could have passed a rule that said, we will not accept any loan unless there is written proof of what a person earns.

I look forward to hearing from the witnesses.

Chairman GARRETT. The gentleman from New Mexico, Mr. Pearce, for 1 minute.

Mr. PEARCE. Thank you, Mr. Chairman.

I appreciate the opportunity to take a little closer look at Fannie Mae and Freddie Mac. I hope that we are taking the first step today towards significant reform of these failed institutions.

We are titling the hearing, "Immediate Steps to Protect Taxpayers and End the Bailout." And it is time for someone to speak up for the taxpayers, who have now dished out $150 billion to save these institutions which were declared "too-big-to-fail." It is reason enough to put the country on notice that servicing foreign obligations over obligations to American citizens will not be the norm any longer.

While the priority of this committee is to protect taxpayers, the conservatorship that took over Fannie and Freddie created several other victims whose investments and, in some cases, financial health were destroyed by the manner in which the mortgage giants were seized. Prior to the conservatorship, about 1,000 community banks held an estimated $15 billion to $25 billion in Fannie and Freddie preferred stock. That stock was wiped out by the government when the GSEs were taken over and placed in conservatorship.

Former Secretary of the Treasury Hank Paulson acknowledged in his book on the crisis, "On the Brink," that the action constituted an ambush. More concerning, Secretary Paulson also mentioned in his book that the decision to wipe out preferred stockholders in this country was done in part to satisfy America's debt obligations to the Chinese.

As we move forward with proposals to reform the GSEs, it is time for Congress to do the right thing and prioritize the Federal Government's obligations to the citizens in this country.

I look forward to the panel. Thank you, Mr. Chairman.

Chairman GARRETT. And I thank the gentleman.

The gentlelady from New York, Ms. Hayworth, for 1 minute.

Dr. HAYWORTH. Thank you, Mr. Chairman.

The figures we are dealing with are stunning because, to date, the GSEs have consumed approximately $150 billion from our taxpayers, and most experts believe these losses will be much higher. The CBO says that if we do nothing to stem the lawsuits, the taxpayers will end up paying nearly $400 billion to bail out Fannie Mae and Freddie Mac.

And as we wait for the Administration to come up with a plan to wind down the GSEs, and protect our taxpayers, we know that it becomes ever more urgent. So I want to commend our chairman for holding this hearing, and I look forward to hearing what you have to say.

I can tell you that my constituents in the Hudson Valley of New York have become convinced that the more government intervenes, the less common sense prevails. So I submit that the task before us is to return common sense, in the form of free enterprise principles, to the mortgage and housing marketplaces.

I yield back the remainder of my time.

Chairman GARRETT. I thank the gentlelady.

The gentleman from Virginia, Mr. Hurt, please.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Chairman, thank you for holding this subcommittee hearing on this important issue. With $150 billion in taxpayer funds already spent propping up Fannie Mae and Freddie Mac, and hundreds of billions more a possibility, it is clear that this will be the most expensive Federal bailout in response to the financial crisis.

As it has been said, we must end the limitless bailouts of Fannie and Freddie and effectively reform them in order to protect the American taxpayer and give true stability to the marketplace.

The previous Congress failed to address GSE reform while passing one of the most sweeping regulatory overhauls of the financial services industry. Today's hearing makes it clear that this committee and this new Congress are prepared to act.

I look forward to hearing from the witnesses, and I thank them for their appearance.

Thank you, Mr. Chairman. I yield back my time.

Chairman GARRETT. I thank the gentleman.

The gentleman from New York, Mr. Grimm, for 1 minute.

Mr. GRIMM. Thank you, Chairman Garrett. Thank you for calling this hearing.

And thank you to those testifying.

This is obviously one of the most important issues facing this committee and our entire Nation. Ending the enormous and ongoing taxpayer bailout of Fannie Mae and Freddie Mac is, in my opinion, an absolute must.

And this conservatorship started in September 2008. These two failed firms have cost the American people over $150 billion. And this sum is almost guaranteed to go higher in the coming months and years. And, shockingly, the recently-passed 2,300-page Dodd-Frank financial reform bill did not address these two firms, and they are continuing to hemorrhage money.

So, as we move forward on deciding what the future of housing finance will look like in the United States, there are certain points that we should keep in the forefront of our discussion.

For many years, homeownership has been considered the cornerstone of the American dream and has led Congress to support homeownership through various initiatives. I know that back in my district in Staten Island in Brooklyn, the ability to own your own home is unbelievably important to my constituents for them to build a strong financial foundation to improve the lives of their families.

And with that being said, we must give serious consideration as to how to continue to make homeownership affordable to middle-class Americans while, at the same time, ensuring that the American taxpayer is never again left to shoulder a burden the size of Fannie Mae and Freddie Mac.

Thank you, Mr. Chairman, for holding this hearing.

I yield back the remainder of my time.

Chairman GARRETT. I thank the gentleman.

The gentleman from Ohio, Mr. Stivers.

Mr. STIVERS. Thank you, Mr. Chairman. I would like to thank the chairman for calling this hearing today.

The gentleman from New Mexico focused his comments on the American taxpayer, and I think that is appropriate because these GSEs should be an issue for all American taxpayers across the country. The gentlelady from New York mentioned that the taxpayers are already on the hook for $150 billion and counting.

So finding a solution where the American taxpayer is not left holding the bag for these gigantic losses while, at the same time, continuing to ensure that home loans are still available and accessible is a priority for me. I hope we act quickly and prudently as we propose and implement reforms.

I look forward to hearing the panel discuss ideas on the way forward for GSE reform. I would like to thank the chairman, and I yield back the balance of my time.

Ms. WATERS. Mr. Chairman, I have an unanimous consent request.

Chairman GARRETT. What is your request?

Ms. WATERS. I request that Mr. Carney be allowed to participate, to sit in on the subcommittee hearing today.

Chairman GARRETT. Without objection, it is so ordered.

Ms. WATERS. Thank you.

Chairman GARRETT. Mr. Miller from California?

Mr. GARY MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

Over 10 years ago, we tried to reform Freddie and Fannie. We worked on it for years. We tried to put a strong regulator in place. We tried to create strong underwriting standards. And, as you know, it all got killed in the Senate.

I have read some of the testimony, and I agree we all need to protect taxpayers, and a $150 billion loss is outrageous. There is just no excuse for that. But 66.5 percent of the families in this country own their homes, and many of those are two-taxpayer homes also.

So we need to look and say, what do we have to do? And when we look at the overall marketplace, I think we need to look at the

marketplace and say, what is wrong with the marketplace and how do we reform everything?

If you look at the default rates on subprime loans, it is 38.7 percent—38.7 percent. The default rate on Fannie and Freddie is 3.1 percent. If you look at the default rate on subprimes, it is 26.5 percent. The all-loan seriously delinquent rate is at 8 percent and Fannie Mae is at 4.2 percent. So are the default rates on Fannie and Freddie high at 3.1 and 4.2 percent? They are high, but they are better than the private sector.

So how do we address that? And we need to get to the bottom of it. We can't put taxpayers at risk. I am not arguing with that. But what is wrong with the overall marketplace?

I know some data says we need to eliminate high-cost areas. But they are the best-performing loans with Fannie and Freddie. If there is data other than that, I would like to see it, because I have just not seen that.

So I look forward to the testimony. And, Mr. Chairman, I thank you for the time.

Chairman GARRETT. And I thank the gentleman.

And, finally, Mr. Fitzpatrick from Pennsylvania for 1 minute.

Mr. FITZPATRICK. Thank you, Mr. Chairman.

I believe the government has a role to play in encouraging homeownership, but this laudable goal has led to interference in the market, and now the taxpayers are writing checks to the tune of hundreds of billions of dollars.

I believe that the government has overstepped its bounds, Mr. Chairman. The United States Government went from being a facilitator to now backing over 90 percent of all the loans in the United States. There is no question that Fannie Mae and Freddie Mac must be weaned off the government in a responsible way that protects our economy but gets the American taxpayer out of the bailout business.

We can argue about how we got here, but the fact remains that Fannie and Freddie are now bloated with bad loans and toxic assets. And while too fast of a wind-down could damage our housing economy, we cannot allow prudence to be the enemy of progress. The system must be reformed, the system must be stabilized, American families protected, and the government be relegated back to its proper role.

The path forward will not be easy, but we were sent to Congress to fix the system and to fight for the taxpayers. I look forward to the testimony and the solutions.

And, Mr. Chairman, I yield back the balance of my time.

Chairman GARRETT. I thank the gentleman.

And I thank all of the witnesses. As you heard, we are all very much looking forward to your testimony.

And we do have a great panel of esteemed witnesses, so let me just run through them. And then I will refer to each of you for 5 minutes.

On our left, Mr. Mark Calabria, director, financial regulation studies at the Cato Institute. Next to him, Anthony Randazzo, director of economic research at the Reason Foundation. Next, Alex Pollock, resident fellow of AEI, American Enterprise Institute. Fol-

lowing, last but certainly not least, Ms. Sarah Wartell, executive vice president of the Center for American Progress.

I welcome you all here today for our very first hearing. And I do, indeed, look forward to your testimony and your ideas and your expertise to help us solve this problem.

Sir, 5 minutes.

STATEMENT OF MARK A. CALABRIA, DIRECTOR OF FINANCIAL REGULATION STUDIES, CATO INSTITUTE

Mr. CALABRIA. Chairman Garrett, Ranking Member Waters, full committee Ranking Member Frank, and distinguished members of the subcommittee, I thank you for the invitation to be here at today's hearing.

Given the central role of Fannie Mae and Freddie Mac in the financial crisis, the need for reform is beyond dispute. While I believe a major overhaul of our Federal mortgage policy should happen sooner rather than later, reform should be done in a deliberate and thoughtful matter. The need for deliberate and thoughtful process, however, does not preclude the necessity of taking immediate steps to protect the taxpayer.

The most immediate and important step that can be taken to protect the taxpayer is to change the role of the Federal Housing Finance Agency from that of conservator to receiver. The Housing and Economic Recovery Act of 2008 establishes a resolution or reorganization process for the GSEs.

It should be noted that there is little, if anything, that a conservator can do that a receiver cannot. There is, however, a considerable amount that a receiver can do which a conservator cannot, the most important difference being that a receiver can impose losses on creditors.

Some might object to receivership on the basis that it would end the GSEs. Such a position would be mistaken. HERA specifically prohibits the receiver from revoking, annulling, or terminating the charters of an Enterprise. Quite simply, the charters of Fannie Mae and Freddie Mac would remain in place under receivership.

Another potential objection to receivership would be that it forces a solution upon Congress before it has had sufficient time to deliberate. Such an objection would also be false. Again, under HERA, a limited-life regulated entity, essentially a bridge bank for the GSEs, has an initial life of 2 years, which can be extended by FHFA for 3 additional 1-year periods. This would give Congress and the Administration 5 years to arrive at a suitable solution to Fannie Mae and Freddie Mac.

Another important feature of receivership is that it would help lessen the perception that certain entities, including our largest banks, are "too-big-to-fail." The Dodd-Frank Act establishes a resolution process for both non-banks and bank holding companies. This resolution process mirrors, in many ways, the receivership provisions of HERA.

Market participants have questioned whether the resolution powers of Dodd-Frank would ever be used to impose losses on creditors. Quite simply, if we are unwilling to take Fannie Mae into receivership, then most market participants will conclude that we are also unwilling to take Citibank or Goldman into a receivership. Moving

Fannie and Freddie into receivership adds credibility to the resolution process established in Dodd-Frank.

In transitioning from a government-dominated to a market-driven mortgage system, we face the choice of either a gradual transition or a big bang. While I am comfortable with believing that the remainder of the financial services industry could assume the functions of Fannie and Freddie, I recognize this is a Minority viewpoint. Practical concerns as to the state of the housing market point toward a gradual transition. The question is then, what form should this transition take?

One element of this transition should be a gradual step-rise reduction in the maximum loan limits for the GSEs. I would recommend an immediate reduction of the loan limit to $500,000, followed by annual decreases of $50,000. Of course, the details can differ.

The hallmark of a private corporation is that its owners bear the benefits and costs of its activities. This situation no longer holds for Fannie Mae and Freddie Mac. Any revenue going forward will help reduce the size of the hole, while expenses will dig it deeper.

Given that the taxpayer is now the residual claimant to these entities, it should be clear that the employees of Fannie Mae and Freddie Mac are working not on behalf of the shareholders but on behalf of the taxpayers. Accordingly, they should be paid like other government employees. I recommend that all GSE employees be transitioned to the GS pay scale as soon as possible. This should also include the executive officers. Quite simply, if FHA can adequately manage its mortgage risk by paying its employees on the GS scale, then I see no reason that Fannie Mae and Freddie Mac cannot do the same.

Credit losses suffered by Fannie Mae and Freddie Mac have, in some instances, been caused by the violation of representations and warranties by the originating lender. While the GSEs have made some efforts to recover losses from the originating lenders, there is simply not enough public information to gauge the aggressiveness of these efforts. Congress should examine in detail the agreements reached between the GSEs and the banks in regard to loan repurchase and recovery for losses, both on private-label securities and on mortgages bought from these lenders by the GSEs.

I believe a GAO audit of these agreements, along with detailed information by lenders, would help stem some of the losses.

The TARP directed the President to submit a plan to Congress for recoupment of any shortfalls experienced under the TARP. Unfortunately, assistance to the GSEs lacked a similar requirement. Now is the time to rectify that oversight. Congress should establish a recoupment fee on all mortgages purchased by Fannie Mae and Freddie Mac. Such a fee could be used to directly reduce the deficit and structured to recoup as much of the losses as possible. I believe a reasonable starting point would be 1 percentage point per unpaid principal balance of loans purchased.

It is important to note that the structural flaws in our mortgage finance system were not limited to Fannie Mae and Freddie Mac, but also included the treatment of GSE debt within the bank capital standards. One of the rationales for the rescue of Fannie Mae and Freddie Mac was the concern over the impact their failure

would have on the rest of the financial system. I believe we need to change the bank capital standards away from encouraging the holding of GSE securities over mortgages. So I believe Congress should direct the regulators to end this preferential treatment.

Lastly, the bulk of losses suffered by Fannie Mae and Freddie Mac were the direct result of declines in credit quality. In order to limit future losses, Fannie Mae and Freddie Mac should be restricted to the quality of loans they can purchase. Under current law, Fannie Mae and Freddie Mac essentially set their own credit standards. Going forward, the GSEs should be limited to purchasing only those mortgages that meet the definition of a qualified residential mortgage as will be determined by regulations promulgated under Dodd-Frank.

Each of these recommendations, as well as others, is detailed in my written testimony. I again thank the committee for holding this important hearing and look forward to your questions.

[The prepared statement of Dr. Calabria can be found on page 56 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

And, Mr. Randazzo, you are recognized for 5 minutes.

I should also add that, without objection, the written testimony of all of the witnesses will be added to the record as well.

STATEMENT OF ANTHONY RANDAZZO, DIRECTOR OF ECONOMIC RESEARCH, REASON FOUNDATION

Mr. RANDAZZO. Thank you. Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee, thank you for the opportunity to join you in discussing the important matter of reforming the Nation's mortgage finance system.

My name is Anthony Randazzo, and I am director of economic research at Reason Foundation.

It is important at the outset of this debate to frame the issue properly. Mortgage finance policy and affordable housing policy are two different things. Whether we should or how we should subsidize low-income Americans' putting a roof over their heads must not cloud the analysis and the debate about the consequences of government policy distorting mortgage prices for nearly the entire housing market.

That being said, now is the time for major reform of the government's role in the mortgage finance market. Ideally, a fully reformed system would have no explicit or implicit government guarantee for mortgage finance. Such financial support only subjects taxpayers to high risks and eventual losses.

Ultimately, the goal of housing finance reform should be to allow private investors to replace the government, i.e., taxpayers, as financers in the housing market while ensuring that any subsidies remaining in the system are explicit, direct, narrow, on-budget, and properly accounted for.

Now, realistically, a robust overhaul of the housing finance sector will take time to accomplish. And in the near term, there is still a need to protect taxpayers from additional future losses while ending the ongoing bailout of the GSEs. The government's role in housing must be reduced, and private capital must be allowed to return.

The following are 10 ideas that will help achieve these goals. And while they are focused on addressing short-term needs, they can also be extended beyond the near term as the basis for a robust overhaul.

One, lower all conforming loan limits for Fannie Mae and Freddie Mac by 20 percent by the end of September 2011. A 20 percent reduction would still leave conforming loan limits above national average and median housing prices. And this would be a very modest reform to create room for private lenders and investors to begin re-entering the mortgage market as Congress debates how to reform the system as a whole.

Two, increasing downpayment requirements for mortgages backed by government agencies to 20 percent over the next 3 years. This would decrease government, i.e., taxpayer, exposure to risky mortgages and prevent the government from supporting mortgages for those without the resources to become a homeowner right now. Both those who want to prevent future bailouts and those who are looking to protect consumers from loans that would hurt them in the future should support this idea. And Fannie and Freddie should also be prevented from buying or guaranteeing any loan originated outside the yet-to-be-established qualified residential mortgage guidelines.

Three, instruct FHFA to begin slowly increasing the guarantee fee charged by Fannie Mae and Freddie Mac. Over time, this would increase the cost of doing business with the GSEs and create room for private capital to be more competitive with government agencies. And, in the meantime, the GSEs would be collecting more revenue to put back towards the cost of bailing them out.

Four, end all affordable housing goals. Again, mortgage finance policy should not be considered the same as affordable housing policy. And as I outlined in my written testimony, while I would argue that we should have no subsidies for mortgages at all, it is possible that aid for low-income families can be pursued in more effective ways than affordable housing goals which distort the entire mortgage market.

Five, raise capital requirements for Fannie and Freddie.

Six, create a legal framework for covered bonds.

Seven, cap expansion of Fannie and Freddie's portfolios at a certain date and have the Treasury Department buy the combined portfolio to be run off over time. And having the GSE portfolios run down on the government's balance sheet would allow Treasury to take advantage of Uncle Sam's debt funding advantage and save the taxpayers money.

Eight, p'ut the staffs of Fannie Mae and Freddie Mac on the Federal pay scale.

Nine, require the Treasury Department to formally approve new debt issuance by Fannie Mae and Freddie Mac. And this would help protect taxpayers by providing more accountability and transparency to the GSEs while their fate is being further considered.

And, 10, wipe out the remaining stock of Fannie Mae and Freddie Mac. And it is also critical that mortgage finance reform be paralleled by FHA reform.

To close, these 10 ideas should not be considered an adequate fix of Fannie Mae and Freddie Mac or as sufficient to reform the hous-

ing market. They are merely a starting point, a first step towards a robust overhaul, and should open the door to further mortgage finance reform discussion.

Thank you for the opportunity to discuss this important issue with you, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Randazzo can be found on page 70 of the appendix.]

Chairman GARRETT. I thank you for your testimony.

Mr. Pollock for 5 minutes. Thank you.

STATEMENT OF ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Waters, and members of the subcommittee.

In the same lead editorial cited by the chairman, The Washington Post recently wrote about Fannie and Freddie, "Advertised as a new way to stabilize the housing market, the government-backed mortgage securitization ended up distorting and destabilizing the market." The Washington Post is absolutely right about this.

To avoid this distortion and destabilization, we should aim in the long run for a housing finance sector in which you can be either a private company or you can be a government agency, but you can't be both. In other words, in the long run, there should be no GSEs.

This is consistent with the GSE reform bill introduced by Congressman Hensarling in the last Congress, and also with the AEI White Paper recently published by Peter Wallison, Ed Pinto, and me.

May I just remind us that the old GSE charters meant not only that Fannie and Freddie had a taxpayer guarantee, but also that they were granted many privileges and large economic subsidies. They were highly politicized, exercised duopoly market power, discriminated against small lenders, and transferred a portion of their taxpayer subsidies without appropriation to politically directed housing programs.

They were accurately described as "masters of Beltway capitalism." Fannie, in particular, was genuinely feared as a hardball political operator. Fannie and Freddie had especially low capital ratios because their real capital was known by the bond market to be the credit card of the U.S. Treasury. We certainly don't want those GSEs back.

My view is that, in the long run, Fannie and Freddie need to be restructured into a private company, a government agency and a liquidating trust, but this can't be done just yet. There are, nonetheless, a number of focused, specific actions we could take now consistent with our long-term aim. My written testimony suggests a dozen of them, and I will touch on a number of these briefly.

We should enable covered bonds as an alternate long-term mortgage funding option. A lesson everybody has learned from the bubble is the importance of whether mortgage lenders retain "skin in the game" for mortgage credit. With covered bonds, the issuing bank has 100 percent skin in the game for their credit responsi-

bility, and this is a major advantage over the GSE originate-and-sell model.

Granting perpetual charters to GSEs was a major historical mistake. We should set a 5-year sunset on Fannie and Freddie's charters, thus having them expire in 2016. Before then, we will be ready for their long-term restructuring.

Congress should instruct the GSE regulator to set Fannie and Freddie's capital requirements at no less than those applied to national banks for the same assets and the same risks.

We should mandate the runoff of the GSE's investment portfolios, both loans and securities. As these assets run off, GSE unsecured debt will be correspondingly reduced, as will the complex derivatives activity and portfolios associated with these assets.

As my colleagues on the panel have recommended, we should set a regular, predictable reduction in GSE conforming loan limits.

We should mandate clear Federal budget accounting for Fannie and Freddie, as proposed in the Accurate Accounting of Fannie Mae and Freddie Mac bill introduced in 2010.

We should eliminate all GSE affordable housing goals and transfer such goals to HUD. Public subsidies for affordable housing and non-market, higher-risk lending should be explicitly governmental activities. So all affordable housing goals, assets, and related funding should be ended for the GSEs and, as appropriate, become the responsibility of the housing finance operations of the Department of Housing and Urban Development.

One of the big mistakes made by bank regulation was to encourage the banking system to increase the systemic risk of the GSEs. Congressman Pearce previously raised the issue of the preferred stock of Fannie and Freddie held by banks. It is essential for us to understand and to correct the risk interaction between the GSEs and the banking system. This interaction caused a hyper-leveraging of mortgage risk for the financial system as a whole, as discussed in my written testimony.

Something everyone agrees on is the need to provide clear, simply stated, straightforward key information to prospective mortgage borrowers. We should mandate that no loan can be guaranteed by Fannie or Freddie which has not provided the borrower with the appropriate one-page information form.

And, finally, an outrageous part of the GSE bailout was the full protection, so far, at the expense of the taxpayers, of the holders of Fannie and Freddie's subordinated debt. The investors in this subordinated debt should be put on a path toward market discipline.

In sum, Mr. Chairman, there is a lot we could do now to move in the right direction. Thank you again for the opportunity to share these views.

[The prepared statement of Mr. Pollock can be found on page 63 of the appendix.]

Chairman GARRETT. Thank you.

And finally, Ms. Wartell for 5 minutes.

STATEMENT OF SARAH ROSEN WARTELL, EXECUTIVE VICE PRESIDENT, CENTER FOR AMERICAN PROGRESS ACTION FUND

Ms. WARTELL. Thank you very much, Mr. Chairman, and thank you, Ranking Member Waters, and all of you, for the opportunity to share my thoughts on reform of housing finance.

We all agree today that we find ourselves in an unsustainable situation. Government now bears the credit risk on the bulk of residential mortgage loans, and private capital must be attracted back into the market to bear as much of the load as possible in our housing finance system going forward.

That said, our housing policy should have other goals, as well: decent and affordable housing rental options and homeownership so that American families have appropriate choices; access to homeownership for creditworthy borrowers who are ready to sustain the responsibilities of a mortgage; equitable and nondiscriminatory access to credit; the opportunity to rebuild, based on sound and sustainable lending principles, communities hard hit by the foreclosure crisis; and a diverse system not dependent on a handful of large financial institutions, but which includes local institutions that can meet the needs of the communities they know best.

Those are all part of our goals. Thoughtful evolution, not overnight revolution, is the best way to reform the housing finance system, provide stability, and protect the taxpayers. So let me touch on just three topics that I mention in my written testimony.

First, there are important conditions that must be in place if we are going to pull back government support from parts of the housing market in an attempt to try to crowd in private capital.

Investors won't return unless the rules of the game are clear. And given the mess that the private-label securities market made in the past, we shouldn't want them to. Most will wait to see what regulators do in implementing the provisions of the Dodd-Frank Act regarding mortgages. And those who would delay these regulatory efforts undermine the certainty that they claim private markets need for investment.

The return of private securitization also requires restoring confidence in servicing. Investors, as well as consumers, are deeply frustrated by the servicing standards of the lenders. A new servicing standard process is just beginning, and it should be a priority also for those who want to see private at-risk capital return.

Withdrawing the GSEs from market segments before these steps, such as through loan-limit increases, risks a shock to the housing market already struggling from an inventory overhang and weak employment. We must ensure the private market is ready to pick up the slack or risk restarting the vicious cycle of falling home values, a shrinking economy, which would also leave taxpayer losses for its GSE obligations larger than is required.

Second, I have concerns that accelerating the liquidation of the GSE portfolio may be directly counter to the taxpayers' interest. Asset sales can sometimes yield higher returns, but it also can allow buyers to benefit from market recoveries, rather than the taxpayer, who is currently backing the GSEs. The sales should be dictated by maximizing expected recoveries and not a mandated schedule of sales.

Finally, a few quick reactions to some of the more radical privatization proposals that have been advanced about the end-state. These would take us to unchartered territories—truly unchartered—because, despite assertions to the contrary, no developed country has a purely private housing finance market without some government support in one form or the other. Moody's Mark Zandi made this point in a paper that he released this week, as well.

The oft-cited Canadian market has significant government insurance and support. In any event that purely private intermediaries were able to finance all of the U.S. mortgage market debt, their obligations would surely be considered systemically important, given the high degree of concentration in U.S. mortgage activity in a few financial institutions.

So instead of a private system, we might create a new set of implicit but unmonitored and unpriced government guarantees—exactly the opposite of the solution that any of us seek.

These problems would be exacerbated if we relied entirely on the covered bond model. While a useful product as a replacement for a mortgage finance system, covered bonds encourage the dominance of a few institutions, which receive the benefit of implicit government guarantees in Europe. I talk a little bit more about this in my written statement.

While these privatization schemes are unlikely to protect the taxpayers and avoid moral hazard, they would result in some stark consequences for American households. The availability of mortgage finance would be sharply reduced, and middle-income households would be shut out of homeownership. To the extent that mortgage finance remained available for working households, it would be directed into loans of shorter durations, higher costs, and very high downpayments. Products that help families fix their housing costs over time like the long-term, fixed-rate mortgage would not be available at prices affordable to most families.

Lack of long-term private finance would reduce the availability and raise the costs of rental housing, even as constrained homeownership access would create greater demand for rental units and upward pressure on rents.

Finally, fewer families would have access to the forced savings that homeownership represents and the opportunity for economic mobility that is the American dream. After the sorry consequences of private-market innovation over the previous decade, we should think carefully before going down that path again, leaving American families who have already suffered the worst economy in our lifetime to once again pay the price. Thank you.

[The prepared statement of Ms. Wartell can be found on page 86 of the appendix.]

Chairman GARRETT. Thank you.

This is very interesting, so I will begin with the questioning for 5 minutes. Mr. Pollock, you use the expression in your written testimony about double leveraging of the GSEs by the banking system.

Could you give me just briefly, in about a minute or less, a little more detail on this and discuss what steps? You sort of touched on how we could curtail that double leveraging.

Mr. POLLOCK. Yes. Thank you, Mr. Chairman.

As I mentioned, the interaction between the way that lending money and investing in the GSEs was encouraged by regulation in the banking system and the GSEs themselves resulted in double leverage or hyper-leverage. One example is with preferred stock. A large amount of the capital of the GSEs was in the form of preferred stock. Preferred stock could get leveraged 60 to 1, 60 in debt to 1 in stock by the GSEs.

Among the biggest buyers of the preferred stock, and encouraged by regulation, were commercial banks. And the banks themselves owned that stock on a leveraged basis, or a margin basis, with a risk-based capital requirement of only 20 percent risk weighting, which is equivalent to 1.6 percent capital. In other words, they owned the equity of the GSEs on a 98 percent margined basis, like buying stock on 98 percent margin.

So if you combine the banking system with the GSEs and think about that as a total system, there was virtually no real equity. You had a leverage of 60 squared, or over 3,000 to 1. That thinking about the interaction between the banks and the GSEs is, I think, critical. I will just mention quickly, if I may, that banks were also encouraged to hold GSE debt and mortgage-backed securities without limit, so that you got over-concentration in GSE risk by the banks.

Chairman GARRETT. Thank you.

And Ms. Wartell, right now we are trying to take actions. What can we do today? Looking at the GSEs today, they are in conservatorship, lots of money going out the door. A couple of things are going to be coming up. The FHFA is soon to announce that executive compensation is going to be due with the executives of Fannie and Freddie.

What is your position on exec compensation packages that we have seen over there? Should the taxpayer basically be funding these quite high compensation packages in your view?

Ms. WARTELL. I think what is important for the GSEs is that because they do represent a significant contingent liability, potential liability for the taxpayers, it is very important that they be able to continue to attract the talent to manage their obligations. And I do in their current situation believe that it is difficult for them—they are seeing a great deal of runoff already of their senior leadership into private institutions—and the ability to attract people, for example, to manage servicing and retain assets. So I don't have a position particularly on the current compensation packages. I understand the difficulty that they present. I also think it is really important that we don't let them lose talent to manage and protect the taxpayers' ultimate outcomes.

Chairman GARRETT. We have to be careful of that because over at Ginnie Mae and FHA, they are having to deal with the same problems over there, and they are not getting the same compensation package. So we may be getting a call for giving them bonuses if we are not willing do it here.

Let me just ask you one other question. With them in conservatorship right now, is now a good time to address the issue or have them issuing affordable housing goals? Do you think that should be something they should be doing right now?

Ms. WARTELL. I think what is important, and what we would suggest for both the near term and the long term, is that the secondary market serve what the primary market is doing.

Chairman GARRETT. How much is the near term? Because I am looking at what we could do for them.

Ms. WARTELL. In the near term, the affordable housing goals, as written in the statute that the conservator is now still implementing, require the GSEs to lead the market. The rulemaking by the Bush Administration that really forced them to stretch out ahead of the market is where I think the goals really got out of bounds. Requiring the secondary market to continue to serve the primary market, the loans that lenders are making, and not cherry-pick those loans so that we end up with communities without access to capital, communities that are effectively credit deserts, seems to me an important ongoing obligation. We just don't want to make them stretch in ways that have them make unsafe loans.

Chairman GARRETT. Okay. And in my 30 seconds' time, because someone is trying to keep the time here, Mr. Randazzo, Mr. Calabria, you both discussed variations of how to treat their outstanding debt.

Mr. Randazzo, could you expound on your idea to bring that debt online with the Treasury and Treasury's balance sheet, and the potential taxpayers' savings there? Have you had any discussions, I should say, also with Treasury on this as well?

Mr. RANDAZZO. You are speaking specifically to how to bring the debt of the GSEs in line?

Chairman GARRETT. Right. And onto the Treasury's balance sheet, and then the tax savings that results there—in 15 seconds.

Mr. RANDAZZO. Sure. In short, the GSEs, because they are not technically government agencies right now, pay more to issue debt than the Treasury Department does. By bringing those portfolios onto the Treasury's debt, you would have roughly 25 basis points cheaper borrowing when you reissue short-term debt. And given that over the next year, about 40 percent of their debt is going to come up for renewal, that has potential savings of anywhere between $4 billion and $12 billion for taxpayers just by having those portfolios run off on the Treasury's balance sheet as opposed to in a separate holding company.

Chairman GARRETT. My time has expired. Ms. Waters for 5 minutes.

Ms. WATERS. Thank you very much. Let me direct my first question to, I believe, Mr. Pollock, of American Enterprise Institute. Could there be a 30-year fixed-rate mortgage product available on the market for the median-income family without any government involvement in the housing finance system? If so, how many basis points more expensive would it be compared to what borrowers pay now?

Mr. POLLOCK. Congresswoman, there could certainly be one and would certainly be one. I guess it would be somewhat more expensive. I doubt that it would be very much more expensive. It is hard to say until we run the market experiment, of course. But that it would be available, I think is beyond doubt.

Ms. WATERS. I would like to ask Ms. Wartell that same question.

Ms. WARTELL. I agree that it would probably be available. But I disagree that it would be available at a rate that would be competitive in the marketplace and that would be able to attract middle-income families. I think the reality is with the economic uncertainty people have, they are not going to pay one dime more than they can for their housing costs. And the reality is that we are adding economic volatility into the system by moving people to adjustable rate mortgages, as we saw during the crisis. And you are also I think putting limitations on central bank regulators' capacity to manage interest rates if we know that so many families' housing costs will vary up and down with adjustable rate mortgages.

Ms. WATERS. Mr. Calabria, what do you make of the fact that William Gross, the co-founder and managing director of the investment firm Pimco, has said his funds wouldn't buy pools of private label mortgages unless homeowners made a downpayment of at least 30 percent? I know that as an investor, he is not exactly an impartial party. He has an interest in there being a government guarantee. Do you think he is bluffing, or do you think his statement is an accurate picture of what investment firms would actually do?

Mr. CALABRIA. I think he is doing what they call on Wall Street "talking your book." As you mention, Pimco is a very large holder of GSE securities. Were a government guarantee to end, his book of business would take a very large loss. I can't blame him for trying to protect that. I think his statement as to the effect of 3 percentage points strikes me as absolutely ridiculous. I think that is outside of the realm of reason.

We don't see that kind of difference between—I think a more reasonable—I will be willing to guess, where Alex would not, and put an estimate, which is, I think, if we were to move our conforming mortgage market to resemble our jumbo mortgage market, we would see interest rates increase somewhere on the range of 30 to 40 basis points at most, which I will note is not large enough to impact the homeownership rate. And while that might make mortgages more affordable, I think a constant theme that we need to keep in mind is that homeowners are also taxpayers. So taking a dollar out of one pocket just to put 90 cents back in the other does not make someone better off, and we need to look at the whole picture.

Ms. WATERS. Thank you very much.

Mr. Randazzo, I don't know if your expertise extends to servicing. But given all of the expertise we have had over the past year or so in housing finance, can you explain why we are seeing a breakdown in the mortgage servicing industry? Today, the Veterans Affairs Committee is holding a hearing on improper military foreclosures by JPMorgan Chase. Do we need national standards for mortgage servicing? If so, what should be included in these standards?

Mr. RANDAZZO. Thank you for the question. I will say my expertise is not mainly focused in the servicing market. I would say that there are a number of outside factors that have impacted the way that banks have put together their own specific servicing standards. Without the right incentives for private companies to track

their risk, things can get out of whack. And I think that has happened with a lot of these companies.

I don't know that national servicing standards are necessarily needed. But as long as there are misaligned incentives in the marketplace, it would be natural that that would be the route to go. I would say that—

Ms. WATERS. Ms. Wartell, on the same issue of servicers, there is a big problem—robo signing, all of this we are coming up with. What happened? Do we need national standards?

Ms. WARTELL. I think we absolutely need it, not only because consumers don't have the ability to be dealt with fairly, but also because investors need to know how servicers are going to act and whether they are going to have an incentive to act in the investors' best interests in trying to maximize returns in the mortgage. And they are, I think, without that confidence today. There are multiple ways of getting to an effective set of best practices that are applied across the entire market, either voluntarily or through legislation. But if we don't see it happen voluntarily, then it needs to happen in another way.

Ms. WATERS. Anyone else on servicing? Yes, Mr. Calabria?

Mr. CALABRIA. I will make a comment and show that there are certainly some issues on which Sarah and I agree. And I think, given that the taxpayer is on the hook for much of the servicing industry, there certainly is a national interest. I would say the place to start is certainly with Freddie and Fannie's book. They have a large amount that they are servicing. So there is definitely a Federal interest. There is definitely a reason do this. The details will differ, but I do think it is something worth looking at.

Ms. WATERS. Thank you. I yield back.

Chairman GARRETT. Thank you. The gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman.

I think I would go to Mr. Randazzo first. When we consider the preferred stocks that were basically allowed to not be exercised, do you know what the process was in which these were suspended? The banks were being encouraged to buy the stock; isn't that correct? Do you know anything about that? Do you know anything about the process?

Mr. RANDAZZO. In 2008, when the—

Mr. PEARCE. Yes. In other words, prior to the government taking conservatorship, banks were encouraged to buy these—if it is not something you are familiar with, you can yield to Mr. Pollock. I think he might have—

Mr. RANDAZZO. I think Mr. Pollock and Mr. Calabria could speak more to this.

Mr. PEARCE. Okay.

Mr. POLLOCK. Thanks, Congressman. I would be glad to address that.

By the regulatory capital treatment, banks were certainly given an incentive to own this equity on a highly leveraged basis. And when the GSEs were put into conservatorship, the dividends on the preferred stock were suspended. That strikes me as an appropriate thing to do under the circumstances. But the valuation then of the stocks, looking forward to how much could be recovered ever, of

course, was extremely low. And the write-offs were very high. It troubled many banks and it put several banks into failure.

The fault, as I see it, is the design of the system in the beginning, which encouraged the banking system running on what you might think of as double-dipping of the government guarantee. That is to say, you took government-guaranteed deposits and used them to leverage investments in equity of the GSE. That, in my view, was a big mistake.

Mr. PEARCE. The term "preferred stock" means basically just that. Were there lower-level creditors who were given their value while preferred stockholders lost theirs?

Mr. POLLOCK. No. There were common shareholders, of course. There still are legally common shareholders who saw the price of their stock go down more than 99 percent to pennies on a share. Then you have the preferred. Above the preferred you have the subordinated debt, which I mentioned in my testimony, which has been protected. And that is something I believe we need to fix going forward; that the subordinated debt holders should share in the realization of the risks which they knowingly undertook by buying subordinated debt.

Mr. PEARCE. Ms. Wartell, you mentioned on page 17 that we need to bring people and families and home back into the conversation about housing finance reform. Would you kind of elaborate on that? In other words, when I hear that—I am not saying that everybody who took out a subprime mortgage knew that they could never pay a payment on it and they were being encouraged into it, but also they were willing participants. So when I hear that, I kind of hear that we need some personal accountability and responsibility.

Is that what you intended in your comment, or did you have a different direction? I would like for you to expand on that just a bit.

Ms. WARTELL. Sure. That was not what I intended by my comment, but I certainly agree with that.

Mr. PEARCE. You would agree with it?

Ms. WARTELL. I certainly agree that individuals who take out loans should have the ability to repay them. And I think we have a responsibility as individuals and as a society to ensure that lenders are making loans available to people who have the ability to repay them. Some of them were lured or tricked through predatory practices into taking on obligations they didn't have the capacity to pay, and others were simply part of a crowd that—kind of a crazy frenzy.

But what I had in mind by my comment was that I think there are serious economic consequences for American families if we don't care about the stability of the housing market and the role that the housing market plays in creating economic opportunity and mobility for families.

Mr. PEARCE. Okay. That is fair enough, as long as we take both sides of the equation. I mean that seems reasonable enough.

Mr. Calabria, you mentioned on page, I think it is 3, that you do not think there is much—that we have experienced most of the risk in the financial sector; that if we start bringing accountability

in the system, there is not much downside risk. Am I reading that correctly?

Mr. CALABRIA. For starters, yes, I believe we are past the point where you could say we are in a financial panic. And my point about I think it is time to consider start imposing losses on creditors. Now, the concern about, I think during the crisis the Treasury had, was there would be a run in these markets. And of course the bazooka that Secretary Paulson was given to back up Freddie and Fannie was to calm those markets and provide liquidity. We are past that point.

We are at a point where I think we can start thinking about where should we allocate the losses. And in my opinion, they should be allocated on creditors. I do believe that creditors can bear those losses. As I indicated in my testimony, I think creditors would get at least 94, 95 cents on the dollar, which if the Chinese central bank is not happy with that, they can go invest somewhere else in my opinion.

Mr. PEARCE. So all the instruments of risk, the MBS, CDOs, whatever you are talking about, you are saying that a large percent now resides in the U.S. Government to where there is not much left out there. We have bought most of the bad assets. Is that right?

Mr. CALABRIA. There are still a number of bad assets. The concern is really if you start with the observation that 80 percent of the funding for Freddie and Fannie comes from the rest of the U.S. financial services system, so about a trillion of that, a little more than a trillion, trillion and a half of that is in the commercial banking system, so we do need to be concerned that if you impose losses such as were imposed on the preferred shares, what would happen to the banking system.

Now, the FDIC has looked at this. And the number of banks that would actually fail is quite small. You have other things. The money market mutual fund system holds about a trillion in unsecured debt. We have to remember the priorities would be preferred shareholders get hit, subordinated debt would essentially get wiped out, and the unsecured debt would take a significant haircut. The MBS would largely, in my opinion, be whole. That would pose significant risk I think to the money market mutual fund. You would see dozens probably break the buck.

We still at post-crisis do not have a solution, in my opinion, into the issue of money market mutual funds, even post-reserves primary. So I think that issue needs to be directly addressed, but I think we can allocate those losses.

Mr. PEARCE. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you. The gentleman from Massachusetts for 5 minutes.

Mr. FRANK. Thank you, Mr. Chairman.

I would like to ask all the witnesses if they have views on H.R. 4889. That is the comprehensive bill for phasing out and reforming and then phasing out Fannie Mae and Freddie Mac. It was introduced by the gentleman from Texas, Mr. Hensarling, about a year ago. It has been offered on the Floor in the committee. And again, I had assumed that from what I had heard my Republican colleagues say, that they were ready to deal with legislation. They

had a fairly well-developed bill. It is been reintroduced this year, I understand, as part of the Republican Study Committee package.

So I am wondering, the Majority having invited these witnesses, if they called your attention to H.R. 4889, to establish a term certain for the conservatorships of Fannie Mae and Freddie Mac, to provide conditions for continued operation and the wind-down, etc.; do any of the witnesses have views on this?

Mr. CALABRIA. I will preface by saying I haven't read the bill, but I understand—

Mr. FRANK. You haven't read it?

Mr. CALABRIA. I haven't read the bill.

Mr. FRANK. Were you asked when the Majority invited you on this topic? Did they call your attention to the bill?

Mr. CALABRIA. I was not asked.

Mr. FRANK. Next. Did they ask you to read the bill and give your opinions on it?

Mr. RANDAZZO. I have read the bill. And I read the bill when it was introduced last year. I think that it is a good basis for where we need to go in terms of comprehensive reform. I think that it is going to be difficult to get that specific piece of legislation passed through both Houses of Congress immediately, and so this hearing does have some value.

Mr. FRANK. Okay. But let me ask you—I appreciate your view on the strategy. It sounds like you not only read the bill, but might even have been involved in it. You say it would be difficult. But do you think, would you urge us to pass this bill right now? The Majority controls the House. So would you urge that this 4889 be passed right now?

Mr. RANDAZZO. I would not urge that the bill as it is currently written be passed.

Mr. FRANK. Why not?

Mr. RANDAZZO. I think that there are certain things that can be adjusted. I think that there needs to be a more comprehensive approach. I think that—

Mr. FRANK. Can you tell me specifically? You obviously are familiar with this. Again, we were asked to pass it. If the Majority had its way, it would have been part of the financial reform law as is. But since they didn't have their way, we have a chance.

What changes would you make in this bill? You say it is a good general framework but not ready to be passed. What changes would you recommend in it? Because I like to think in legislative terms.

Mr. RANDAZZO. I think the biggest thing that can be added to the bill, or can be an additional piece of legislation, is reform for rules with FHA. If we were to lower conforming loan limits by 20 percent over, say, 5 years—

Mr. FRANK. I appreciate that. But that is the FHA. With regard to Fannie and Freddie, do you think it is ready to be passed now with regard to Fannie Mae and Freddie Mac?

Mr. RANDAZZO. I think that the principal underlying issue of beginning a process of winding down Fannie Mae and Freddie Mac through all of the different pieces that are in there should be pursued.

Mr. FRANK. Okay. But that is not what I asked you. I appreciate that. Again, we were told, we were criticized for not passing this into law. And I just wonder why, if that was something that we should have done last year, the Majority wouldn't do it now. So we can't vote on—we don't vote on general principles here, we vote on legislation.

Would you recommend that with regard—you said separate stuff on FHA. I understand that. I hope we will get to that. We have some pending—in fact, Ms. Capito and Ms. Waters, they came to some good agreements on FHA. I hope we will pass the rest of that. So I agree with that.

But with regard to Fannie Mae and Freddie Mac, do you think the bill as it now stands is ready to be passed? And if not, what changes would you recommend?

Mr. RANDAZZO. Once again, I think that there are pieces and minutia that maybe we don't want to spend 5 minutes to an hour going through and nitpicking.

Mr. FRANK. Be my guest. I have nothing else to do this afternoon. There are no more votes. I appreciate your concern for my time.

Mr. RANDAZZO. I was not a part of putting the bill together, so that I have a particular way that I think would be best to—

Mr. FRANK. So you would not recommend that we pass this bill, as is, with regard to Fannie and Freddie?

Mr. RANDAZZO. I would say not immediately. I think that there are some things that can be changed. It is a good base.

Mr. FRANK. Thank you. Mr. Pollock?

Mr. POLLOCK. Congressman, I did read the bill when it was introduced. I supported it then. As I said in my testimony, all of the points in my testimony are consistent with Congressman Hensarling's bill. And when reintroduced, I will support it.

Mr. FRANK. It has been reintroduced. Would you urge the committee then to just have a markup and vote on it fairly soon?

Mr. POLLOCK. I think that would be a good idea.

Mr. FRANK. Okay. Thank you. Mr. Hensarling is back in minority status on the panel of his invitees. It is one to two. But one out of three I suppose ain't bad.

Let me just—one other thing to say, and I do appreciate the point that was made about separating mortgages and affordable housing. And in my case, in my view what we ought to be doing is affordable rental housing primarily. The great mistake, I have consistently felt, was pushing people into homeownership when they weren't ready. So I appreciate that separation. And I hope as we go forward, what I would hope would be we would find a way to get a revenue stream for affordable rental housing and separate that out from the decisions made on mortgages.

So I appreciate that separation. Thank you, Mr. Chairman.

Chairman GARRETT. And I appreciate those comments. Now for the rest of the story, the gentleman from Texas.

Mr. HENSARLING. Thank you, Mr. Chairman. And I certainly am fascinated by the ranking member's fascination with my particular bill. I would wonder where the fascination was when he was committee chairman. He certainly had the ability to give a vote on the bill. I think I heard the gentleman say the bill has been reintro-

duced. As the author of the bill, I can say it has not been reintroduced. As with many pieces of legislation, it is being refined through the process. I do intend to reintroduce the bill. It will be quite similar to the one that was introduced in the last Congress. But at least, there will be a bill.

I recall on September 29th, during a full committee hearing, where the now-ranking member, then-chairman, told us that he was disappointed that we were not dealing with, quote, a piece of legislation, but there is no point in rushing that pace. It is not going to be possible now, I know, until November when we come back, because we lost 7 days. Apparently, we are now in the process of losing 133 days. I don't think I have seen the gentleman from Massachusetts introduce the bill that was committed in September.

Mr. FRANK. Would the gentleman yield?

Mr. HENSARLING. I would yield to the gentleman from Massachusetts.

Mr. FRANK. The gentleman is not accurately representing me. I was not for passing it. I agreed with that. The gentleman said it needs to be refined. You know how important refinement is to me. I wouldn't have wanted to pass something that was unrefined.

Mr. HENSARLING. Reclaiming my time for one point, did the gentleman make a commitment that he was going to introduce legislation in the last Congress or have I been given an incorrect record?

Mr. FRANK. I thank the gentleman for yielding.

Chairman GARRETT. It is the gentleman from Texas's time.

Mr. FRANK. I thank the gentleman. I would ask unanimous consent that the gentleman have an additional minute since I have taken his time, Mr. Chairman.

I would just say after the election, when control changed hands, it didn't seem to me that there would be any chance of getting that done in the lame duck session. So I just want to say, no, I was not for passing this bill last year. I was being criticized for not being for passing it last year. And I am very sensitive, so I was just glad to have some support for my position for last year from your witnesses from this year.

Mr. HENSARLING. Reclaiming my time, I am not sure I heard the answer on where the gentleman from Massachusetts' bill is.

Mr. FRANK. Would the gentleman yield 30 seconds? The answer is, I have not filed one because it is not my expectation that the Majority would pay any attention to it. And if I wanted to do academic exercises, I would go back to school.

Mr. HENSARLING. Reclaiming my time, I appreciate that sentiment. I would note again, the gentleman certainly had time on his shift to introduce a bill before the House switched.

Let me take time now to speak to the members of the panel. I think I heard Mr. Randazzo—maybe it was in your testimony, I am not sure. Let me ask the question this way. Do any of you believe, as we know what has happened to home price values, we know about the cratering, you can look at the Case-Schiller index, did Fannie and Freddie play a role in the housing bubble, in the housing price inflation? Mr. Pollock, do you agree with that?

Mr. POLLOCK. Without question, they played a significant role in inflating housing prices, inflating the bubble, and therefore in making the collapse worse.

Mr. HENSARLING. Do others agree? Perhaps just a show of hands. At least, I see two nodding heads with Mr. Calabria and Mr. Randazzo. I don't know about Ms. Wartell.

Ms. WARTELL. Only a very small and—

Mr. HENSARLING. Okay. All the panelists agree that Fannie and Freddie played some role in price inflation. So when I write out my mortgage check each month, I have principal, I have interest. In the studies that I have seen, the GSEs may have helped on the interest side anywhere from 7 basis points to 30 basis points. Now, granted, I think the 7 basis points is a several-year-old study from the Federal Reserve. I have seen a number of academic studies. I don't know, maybe the median is 15 basis points, 20, I don't know. So they helped me on the one hand by, say, a median of 15 basis points; but on the other hand, is my principal perhaps not higher because of the artificial demand? Meaning at the end of the day, as a consumer, was I really better off? Can we make the case? Can we make the case that I was better off? We know the taxpayer wasn't better off. So Mr. Calabria, do you have a comment?

Mr. CALABRIA. To start with, the outcome of any price is clearly the interaction of supply and demand. And what you are referring to are the demand factors. So my answer would be it really depends on the housing market. I think in housing markets with relatively tight supply, places like California, you ended up running up the house price. The seller was better off in those instances.

Mr. HENSARLING. So the consumer, maybe he benefited, maybe he didn't benefit. We know the taxpayer did not benefit. We have heard some discussion of the fact, or some have made the assertion that there would no longer be a 30-year fixed-rate mortgage in America without Fannie and Freddie. Yet were there not 30-year fixed-rate mortgages in subprime? Were there not 30-year fixed-rate mortgages in jumbo? You gentlemen and lady have researched the market. Am I correct in that assertion?

Mr. POLLOCK. You are correct, there were 30-year, fixed-rate mortgages without Fannie and Freddie in the parts of the market where they don't exist.

Mr. HENSARLING. So they have existed in America in parts of the market where Fannie and Freddie didn't exist. Isn't it also true, perhaps not common, but in OECD nations in Europe you can also find 30-year fixed? At least I think in Sweden and Denmark? I have tripped across a few other countries. Is it also true you can find examples of 30-year fixed overseas?

Mr. POLLOCK. You certainly find it in Denmark.

Ms. WARTELL. I think Denmark.

Mr. HENSARLING. I see my time has expired. I thank the chairman.

Chairman GARRETT. I thank the gentleman from Texas. The gentleman from California for 5 minutes.

Mr. SHERMAN. Just responding to the gentleman from Texas, I think 3 to 30 basis points is absurd. The fact is that if you try to get a loan today that barely qualifies, and then you say, what is a loan going to cost that Fannie and Freddie won't touch because

it is a little over that amount, the difference is hundreds of basis points, if it is available at all.

The fact is that we would see a collapse in home prices if it wasn't for Fannie and Freddie. And that means a collapse of our economy. We already had one mortgage/home value collapse of our economy. I am not looking for a second. And to say that in 2012, non-GSE financing is going to be just as available as it was in 2002 assumes that all the lenders have been asleep with Rip Van Winkle over the last decade. The fact is almost nobody is willing to lend money to middle-class home buyers except if it qualifies for Fannie, Freddie, or FHA.

The banks are not lending now because the future of mortgage financing is uncertain. Home buyers need a reliable flow of mortgage financing. GSE reform is needed. But eliminating all Federal involvement would harm this economic recovery, put the housing market at risk, and put the economy at risk.

Today, private capital is nonexistent outside the GSE mortgage financing limits. And to assume that it will suddenly become available if we eliminate the GSEs because everybody will go back and do what they did in 2005 assumes a level of amnesia among investors that I don't see.

What we don't need is a precipitous decline in housing prices. That is how we got the first dip. That would give us a second, or double-dip recession, if not a depression. And it is particularly important in regions like mine, where middle-class homes go for $600,000 to $800,000. Certainly, all the upper middle-class homes do. And without GSE financing, you would see not only a collapse of home values, but a collapse of the local economy.

Ms. Wartell, under Dodd-Frank, when defining a qualified residential mortgage which is exempt from the Act's risk retention requirements, regulators must take into account consideration, underwriting criteria that historically indicates a lower profile of risk and default such as mortgage insurance. To the extent that such insurance reduces the risk of default, the data seems clear that loans with PMI have lower default rates.

Do you agree that mortgages should not have to meet the risk retention requirements in Dodd-Frank as long as they meet other underwriting criteria and PMI is also part of the loan?

Ms. WARTELL. Congressman, I want to be careful not to speak to the precise regulatory question today. And if I could send you written comments on this, because I don't have all the details in front of me. But I would agree with your general proposition that there are many ways to ensure that the borrower has adequate equity to protect the investors. And PMI is certainly one of the ways to do that.

Mr. SHERMAN. Okay. We have Bill Gross, the co-founder of Pimco, saying that without a government guarantee, if he was going to invest in mortgages, he would demand a 30 percent downpayment. There are proposals to go for a 20 percent downpayment. Wouldn't such a requirement push more business to FHA, further constraining that agency's resources? And wouldn't it have a dramatic impact on the ability of the average family to buy a home in many regions of the country?

Ms. WARTELL. Yes. I completely agree with you. And to your FHA point, I think it is important to understand that in the case of the GSEs when they were functioning, or some future system, it is possible to put private capital at risk ahead of the taxpayer. In FHA, we do not have that. So when you shift market to FHA by imposing high downpayment requirements like that, you actually are having the taxpayer stand at a much more extensive risk position than they would otherwise.

Mr. SHERMAN. So it is worse for home buyers, worse for home sellers, worse for communities, and worse for the taxpayer.

Ms. WARTELL. And unnecessary for us to take risks that the private sector could take on their own.

Mr. SHERMAN. I yield back.

Chairman GARRETT. All right. Thank you. The gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you. I think one of the vexing things for us is that the Federal Reserve has come to us in the past with concerns about the model that we have set up, especially since 1992, the GSE Act that passed the Congress here. Under that model, they were able to dive into the junk mortgage market, and they purchased over $1 trillion worth. They wracked up leverage of 100 to 1. Part of the concern here is that once you establish a GSE, you have established a huge quasi-governmental monopoly that comes in and lobbies the Members.

So the Fed came to us, they asked us to take some action in the Congress. I offered an amendment, endorsed by the Fed, that would authorize the regulator to rein in Fannie and Freddie on these mortgage portfolios based on the systemic risk that they posed. That was opposed by Fannie and Freddie, and of course it was defeated, as was Jim Leach's amendment.

Jim Leach, the former chairman of this committee, offered an amendment to strengthen the minimum capital requirements for Fannie and Freddie. And Ron Paul offered an amendment to eliminate the ability of Fannie and Freddie to borrow from the Treasury. Any one of these the Fed recognized would have helped the situation.

But once we create these entities, they come in, they lobby against those kinds of reforms. And indeed, the only reform we ever passed out of the House is one that was opposed by the Treasury and the Fed. Why? Because it made the situation worse. It tied the hands of the regulators even more.

So here is the problem. We now have the president of the Richmond Federal Reserve—and Mr. Calabria, I will ask you about this—he comes to us and he says, "We should phase out government guarantees for home mortgage debt." Clearly, he doesn't mean tomorrow. He means phasing it out over a long period of time in order to make sure that we bring private capital back into the market. And he says otherwise, financial stability will be elusive, and fiscal balance will be threatened by repeated boom-bust cycles in housing.

I was going to ask you, do you think government guarantees on mortgages exacerbate or mitigate the boom-bust cycle that we have experienced in the market?

Mr. CALABRIA. I would 100 percent agree with the remarks of President Lacker. I think that our current system of mortgage finance is procyclical rather than countercyclical. And I think the point that you make, and I say this from having spent 7 years working on staff in the other body, I think any system we set up will erode over time. The reality is there will be another housing boom at some point in the future. We will all again think that housing is the best thing since sliced bread, and we will want to get everybody in, and we will push underwriting standards again down. It has happened time and time again. So I would 100 percent agree with that.

While you could design a system today that, if it just stayed that way, might reduce the risk, I have very little confidence that it would stay that way over time.

Mr. ROYCE. Let me ask you another question. In your testimony, you call for shifting the FHFA from conservator to receiver for the GSEs. Right?

Mr. CALABRIA. Yes.

Mr. ROYCE. And I think among the points that you make, your argument is that it could be an instrumental step in combating the perception that other entities out there are "too-big-to-fail." I know some think we have solved the "too-big-to-fail" problem with the legislation passed last year, but a lot of economists think otherwise. And I would ask you to expand on that point and maybe explain to us how that transition process might occur, how you would envision us getting from point A to point B.

Mr. CALABRIA. Sure. Let me start with a broader point about "too-big-to-fail." We have to recall that essentially every financial institution, whether it is Fannie Mae or Citibank, is primarily funded with debt. Ninety percent-plus of their funding is debt. And so it is all good and well to fire management and wipe out shareholders, but you will not have sufficient market discipline in that absence.

So to me, to end "too-big-to-fail," again whether it is Citi or whether it is Fannie, you have to set up a process where creditors take haircuts. And I think because we have not done that, and because in the last crisis under this Administration and the last Administration, the proposal was always to protect creditors, I think that has been a mistake.

While you can argue maybe in a panic, I think going forward post-panic creditors need to take losses. And why? That is because as companies begin to take risk, whether it is incompetent management, whether it is a business strategy, those who provide funding will raise the cost of that funding and constrain them. I was always puzzled, working on GSE issues, that the more debt Fannie and Freddie issued, the lower their funding costs were. It is certainly contrary to—

Mr. ROYCE. The bigger the share of the market they would take—

Mr. CALABRIA. Exactly.

Mr. ROYCE. And I would argue—during the conference, I actually had an amendment to sort of guarantee a larger haircut. That was defeated in the markup in the conference committee. I think we need to revisit that issue on the "too-big-to-fail" front.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. I thank the gentleman from California. The gentleman from North Carolina, Mr. Miller, please, for 5 minutes.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. There is no doubt that we would not have much of a mortgage market now without Fannie and Freddie. They are buying, the vast, vast majority, well more than 90 percent of mortgages. Five years ago, they certainly were not in a duopoly position. In fact, they were rapidly losing market share.

What the three of you seem to imply is that the reason their market share is now so enormous is that they are crowding out the private securitization market somehow. I have talked to mortgage investors, and they don't say that at all. The pension funds, the insurance companies that bought the private-label mortgage-backed securities 5 years ago, say there is no way they are going to buy that stuff again unless there is a serious reform of the private securitization market. They are not going to buy mortgages based on a AAA rating from a rating agency. Unless there is the kind of disclosure that an investor in a new stock issue gets, so they can actually do due diligence themselves and figure out what they are buying, they are not touching that stuff again.

Do any of you have any basis, any evidence for the idea that the private-label securitization market is going to come back without reforms if we simply hobble Freddie and Fannie, limit what they can do, but don't reform the private-label securitization market?

Mr. CALABRIA. If I could touch on this, and this might be where I differ from some of my colleagues, while I would like to see the private securitization market come back, I don't think that should be the ultimate objective. The vast majority of mortgage lending in this country can be funded by a portfolio of various financial services institutions, whether it is banks or insurance companies. And it is important to keep in mind, as I mentioned earlier, 80 percent of the funding for Freddie and Fannie—so when people ask me, if Freddie and Fannie aren't going to fund it, who is? The parties that fund Freddie and Fannie. If the banking system can hold a trillion and a half in Freddie and Fannie securities, then the banking system can certainly hold a trillion and a half in mortgages.

So it is just moving it around from different institutions. Are there problems with those other institutions? Absolutely. And we should address those problems. But I don't think our objective should simply be let's bring back the private securitization. I think it should be how do we set up a system that has substantially more capital? And it is important to remember the very existence of Freddie and Fannie is to a large degree a capital arbitrage, it is a massive subsidy for lenders.

Mr. MILLER OF NORTH CAROLINA. My understanding is about half of all lending 5 years ago was the securitization market. And you are saying if we simply let that go away, it would be replaced by portfolio mortgages.

Mr. CALABRIA. First, we need to remember that in 2005, 2006, 40 percent of private-label mortgage-backed securities were bought by Freddie and Fannie. So if you add what they bought, what they originated, they maintained a majority of the market share, which was still very close to—they dominate what they can do. And if you

look at it today in terms of how much the housing stock is next to the jumbo market, they dominate what they can do.

Mr. MILLER OF NORTH CAROLINA. That strikes me as a remarkable leap of faith upon which the entire economy depends.

Mr. CALABRIA. I would be happy to sit down with you at any time.

Mr. MILLER OF NORTH CAROLINA. Ms. Wartell?

Ms. WARTELL. I would agree with you. I think that the capacity of our financial institutions, which right now with the new capital standards are already severely undercapitalized, to provide the kind of ongoing support for the housing market in the near term is an enormous leap of faith.

I would also note that the durations that those—the big thing that the secondary market provided, by creating a market that was liquid, was it allowed longer term obligations to be made available into the capital markets. If you don't have that mechanism, banks will not make long-term mortgages available, and we will have driven the entire housing market to an adjustable rate regime in which you will see people's economic costs of living varying with interest rates. And that, in and of itself, will limit the ability of central bankers to be able to adjust interest rates as they need to for monetary policy purposes.

Mr. MILLER OF NORTH CAROLINA. Let me move on to another topic. I am sorry. You certainly can supplement your answers. You are more than welcome to do that.

I have raised many questions before about the conflicts of interest of having the servicers be affiliated with the securitizers. And I have talked to investors who say that the barriers they now face in pursuing their legal claims against the securitizers is like doing business in Russia and trying to bring a lawsuit against an oligarch. And they will not play unless that is reformed as well.

I have talked to the small banks and the credit unions, and they say one of the reasons they did business with Freddie and Fannie, and not Wall Street, is they knew that their mortgages would end up being serviced by a big bank, and the big bank would try to use that relationship to steal their customers.

When the servicers sat there a month or two ago, I asked them why on Earth, what is the reason for having a servicer be affiliated with a securitizer? And they said, "cross-marketing." Which seems to support the concerns about the small banks. What possible reason should servicers—should they not be separate entities not affiliated with a bank? Is there a reason that has not occurred to me? Because I have been thinking a lot about it and been drawing a blank.

Chairman GARRETT. I think what we will on that is do just what you said, to ask them to provide that answer in more detail not only to Mr. Miller, but to all of us as well. It would be interesting to see the answer to that.

With that, I yield to the gentleman from Texas.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Again, thank you for having this hearing. One of the things I think we need to point out is that, prior to securitization, as Mr. Calabria said, is there were people who bought mortgages that didn't go through Freddie and Fannie. In fact, I originated and actually was in the banking

business for a while, and we sold those loans to other financial institutions, the insurance companies.

But securitization does provide a certain amount of liquidity opportunity for investors to hold those mortgages and some other ability to manage interest rate risk. And so, certainly, we don't want to do away with securitization.

Back to what I think Mr. Pollock has said and maybe Mr. Randazzo has said and the other panelists, probably where the big mistake is here is we have had the government setting the risk premium. And the government doesn't have a very good record on setting the risk premium. All you have to do is look at our National Flood Insurance Program and realize we haven't been charging the appropriate amount of money for the risk that the government is taking.

And so there is really not much space for private market right now because the risk premium is so low that getting these loans sanitized by Freddie and Fannie makes more sense than doing it outside.

So, isn't it a way to make some space for private securitization or for private investment—I don't want to get—is to lower these conforming loan limits and, at the same time, increase the risk premium that Freddie and Fannie are charging for buying those loans and securitizing them?

At some point in time, the private market is going to say, I am not willing to give up 50, 75, 100 basis points, whatever that is; I would rather have that yield than go through that. If I knew that those loans were being underwritten in a fashion that gave me some sense that these are good-quality residential loans, good old underwritten residential loans is a good investment.

Is there consensus that that has to be some of the initial steps if you are going to bring the private market in, is you have to take away the competitive advantage of Freddie and Fannie?

Mr. Calabria?

Mr. CALABRIA. I would say, absolutely. And, as I mentioned in my testimony, I do think you need to institute a fee to try to recoup some of the money we have put in. Obviously, one benefit of that is you recoup some taxpayer money. The other benefit is you reduce the competitive advantage that Freddie and Fannie have.

I would also emphasize—and I know Alex has made this point—we really do need to change the incentives facing the banking industry. If you hold a Fannie Mae security, it is only a 20 percent risk rating, where if you are holding a whole loan, it is 50 percent. So, to some extent, the existence of Freddie and Fannie has reduced the capital behind mortgages by about 60 percent of the system.

I don't think a public policy objective should be how do we get less capital into the system behind mortgages. So making that a little more equal and treating Freddie and Fannie securities as if they were any other corporate securities, I think, would shift the incentives of banks.

Mr. NEUGEBAUER. Mr. Pollock?

Mr. POLLOCK. I think you make a very good point, Congressman. We might ask, looking back historically, why did a private securitization market for middle-class prime loans not develop? It

is a natural market. It doesn't need a government guarantee. The reason it didn't was because nobody could compete with subsidized providers, namely Fannie and Freddie, who effectively enjoyed tens of billions of dollars of taxpayer subsidy.

And so, one way I have thought about the question of how could you make that move with guarantee fees is to consider that Fannie and Freddie, historically, had much lower capital than other people. Now they have no capital at all, literally zero, counting the government's capital, and their own capital is very negative.

So one might do a calculation and say, if Fannie and Freddie had to have the same capital as everybody else for a risk and they had to have a reasonable return on that capital, what would their price have to be?

You remember, with the Federal Reserve some years ago, the Congress put in what they called the "private-sector adjustment factor" for the Fed (the Fed is kind of a GSE) in order to take away the Fed's pricing advantage. You might think about that same kind of calculation for Fannie and Freddie.

Mr. NEUGEBAUER. Kind of risk-based pricing basically is what you are saying?

Mr. POLLOCK. Yes.

Mr. NEUGEBAUER. And I think I agree totally, is that whatever we do over at Freddie and Fannie, we can't make FHA the new subprime lender. And so we are going to have to go over there and determine what the lending limits and the credit underwriting standards are going to be over there, as well. Otherwise, we just move that market.

Mr. Randazzo?

Mr. RANDAZZO. The one thing I would add to what my colleagues have said is I think the approach that you mentioned, with a few other steps, addresses the concerns on the other side of the aisle that this is not jumping into privatization. You are not ending Fannie Mae and Freddie Mac tomorrow. You are incrementally dropping the conforming loan levels, and you are raising your G fees to let private capital begin to step in slowly over time.

It is not this leap of faith and just trusting that capital is going to be there from the private sector. It is, we are going to take these short-term steps, and, along the way, the private sector can adjust, can look at the new rules of the game, and we can begin to back the government out slowly.

Mr. NEUGEBAUER. Thank you.

Thank you, Mr. Chairman.

Chairman GARRETT. I thank you.

And now, my good friend from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you. And I yield 30 seconds to the ranking member.

Mr. FRANK. I thank the gentlewoman.

I want to make it very clear, I did not think that we were ready to pass the bill last year, including the one, 4889, the Republicans offered. I thought it needed more time. My Republican colleagues said, "No, it is taking too long to get to it. We are ready. Here is the bill."

I mentioned earlier that it had been introduced this year and I was surprised that the witnesses weren't asked to talk about it.

The gentleman from Texas said it hadn't been introduced, but I was not hallucinating. It was introduced. It was introduced as part of a package, the Spending Reduction Act of 2011, introduced by the prime sponsor, Mr. Jordan. The chairman of the subcommittee was a cosponsor.

So 4889, the late, lamented 4899, which was so popular last year but has withered on the vine of popularity, was, in fact, introduced.

And I only stress that to say, yes, I did think it was more complicated and needed more time. It was my Republican colleagues who were very critical of that, said, "No, let's move now; we can't wait." And I am, therefore, surprised at this change of heart and their lack of enthusiasm for the bill they were ready to have enacted last year.

I thank the gentlewoman.

Chairman GARRETT. Mrs. Maloney?

Mrs. MALONEY. Reclaiming my time, we have been discussing how to restructure, what to do in the future. But irrespective of any future policy, how should we address the literally trillions of dollars of existing debt from the GSEs that are in the mortgage-backed securities and in corporate bonds that were purchased with the expectation that there was an implicit government guarantee?

Much of this debt is now in pension funds, it is in 401(k)s, it is in assets that benefit the overall American public. And I have read in some press reports that many central banks across the world are also holding large packages of these mortgage-backed securities.

So my question, really, to Ms. Wartell and then to Mr. Pollock and just down the line is, how do we address what is there now? And are these bonds government-guaranteed, at this point? It is always an implicit guarantee? Are they guaranteed or not?

Many of my constituents are holding them in their 401(k)s, and they are very anxious to find out what the future holds for them.

Ms. Wartell?

Ms. WARTELL. I understand that the Treasury Department has been very careful not to say that they are a full-faith-and-credit obligation of the United States Treasury. That said, I believe it has been the policy of this Administration and the former to treat them as if they were—that the outstanding debt—many of us talk about that, in a system in the future when we have a new design, most of us would agree that the debt of any future institutions should not be guaranteed, that any liquidity backstop ought to be on the MBS.

But for the outstanding obligations, much like our discussion about the debt ceiling in this country, it seems to us very important that we give investors here at home and around the world confidence that the United States stands behind those obligations.

Mrs. MALONEY. Mr. Pollock?

Mr. POLLOCK. Congresswoman, the question you raised focuses on an essential point. Bond salesmen all over the world, when they sold Fannie and Freddie unsecured debt and Fannie and Freddie mortgage-backed securities, said to the investors something along these lines: "You have nothing to worry about. This is a government debt. But it has a higher yield, it has more spread, as we say. But it is a government credit. Don't worry."

Legally, as a technicality, that wasn't true, but, in fact, the bond salesmen were absolutely right. It always was really guaranteed, and it is guaranteed. Many of us could agree in a theoretical world it shouldn't be. But I think we are stuck with that on the existing debt.

In my view, that existing debt should, on the restructuring of Fannie and Freddie, go into a liquidating trust, in a very similar way as to what was done with the privatization of Sallie Mae, and that debt be honored by the U.S. Government as it runs off.

Mrs. MALONEY. Mr. Randazzo?

Mr. RANDAZZO. This is where I disagree with one of my colleagues, is technically, legally, this debt was not guaranteed by the U.S. Government. And just as there has been a lot of discussion in this Chamber and previous Congresses about the importance for institutions that take on too much risk to be able to fail, I believe that investors should also be able to fail.

They knew, or they should have known, that, by law, they were not explicitly guaranteed by the U.S. Government. And we should not extend this explicit guarantee to honor what was an implicit guarantee. It would be bad for the taxpayers.

Mrs. MALONEY. Mr. Calabria?

Mr. CALABRIA. I would also add, I think an important part is, not only by statute—and this was not changed in HERA—that not only is it not guaranteed, it is explicitly rejected. The Federal law says, you will not be paid.

And so, any commitments that Treasury Secretaries, previous or current, or that bond managers or that GSE CEOs made, they had no authority to. And they were making those commitments in contradiction of statute.

And so, to me, a very important principle we should always carry with us is the rule of law. It is not what a Treasury Secretary says; it is what the statute says that should be important and that should govern here.

Mrs. MALONEY. Thank you.

My time has expired.

Chairman GARRETT. Thank you.

I yield now to the vice chair of the subcommittee, the gentleman from Arizona.

Mr. SCHWEIKERT. Mr. Chairman, fellow Members, and witnesses, first off, in my opening remarks, I hope I didn't cause a little bit of fussing when I complained that the Administration hadn't met its obligation. Being a freshman Member, I have actually really, really been killing myself to read everything I get my hands on, Mr. Chairman. And, with that, I was trying to be fair-minded and read stuff that was coming from all directions. And, apparently, I annoyed the ranking member with my fairness.

Mr. Pollock, I absolutely love this. Having now read binder after binder after binder, yours is one of the best white papers I have read so far. But one of your premises in there is that Fannie Mae and Freddie Mac distort the true price of risk. Am I fair in that assumption or in that interpretation or of what am I reading out of that?

Mr. POLLOCK. That is exactly right. It is what we say, and I think it is quite indubitably the case.

Mr. Chairman, may I request that the white paper that the Congressman refers to be entered in the record, if that is all right?

Chairman GARRETT. Does the vice chair wish to—

Mr. SCHWEIKERT. Mr. Chairman, I would actually be elated. There are some terrific items in there.

Chairman GARRETT. Without objection, it will be entered into the record.

Mr. POLLOCK. Thank you.

So when you push credit at an asset, at a market, the credit flow gets capitalized into the prices in that market. And when you separate the risk of the providers of the funds by telling them they are guaranteed by the government so they don't suffer the results of their putting a large flow of money into a real estate market and driving up the prices, I think the only fair way to describe that is as a distortion of prices. The result will always be unhappy.

Mr. SCHWEIKERT. Mr. Chairman, I know I have very limited time, and I have a handful of questions, so can I bounce on to the next one? This one is for all the witnesses.

In also reading your white paper, the belief that if we were to move to a much more true either private market or some sort of bifurcated, that we would also have to reach out and touch FHA and Ginnie Mae and those, so we didn't create a push from one side of the bubble to the other.

Mr. Chairman, witnesses, is there an agreement that if we are going to approach a GSE government-insured market that we have to do something holistic?

Mr. POLLOCK. I think we all agree on that.

Mr. RANDAZZO. I do.

Mr. CALABRIA. I agree, absolutely, with that. And I think we should keep in mind that a lot of that already is happening. FHA is about half of new homebuyers now. So it is already a considerable push of risk on to FHA as it is. But we need to avoid that further erosion of credit quality on FHA.

Mr. RANDAZZO. It would be very irresponsible to just look at Fannie and Freddie and not address all the components that impact housing in the United States.

Ms. WARTELL. I would agree that we need to—one of the reasons I would argue against a fully private market is because, in fact, it will push and create enormous pressure for us to keep FHA taking on risks that I think otherwise the private sector could be bearing if the government were standing behind with a limited liquidity backstop. So we are taking on more risk than we need to.

Mr. SCHWEIKERT. Mr. Chairman, you actually hit an issue. I am concerned that if we are going to do something, we need to be looking at everything together.

Mr. Chairman, witnesses, do I have a prediction on the total loss in Fannie and Freddie? When we look back a decade from now, how much taxpayer money will have bled?

Mr. POLLOCK. It is very hard to know, even if you are inside and poring over the numbers. But informed estimates range from $180 billion to $300 billion or $400 billion. It is highly uncertain, of course.

Ms. WARTELL. I agree with that; like he said, it is highly uncertain. But the one thing I would say is that our actions now can

very much affect the size of that obligation, both in how quickly we liquidate their portfolios—if we sell at fire sale prices, that actually potentially increases the amount of the losses.

And, similarly, the GSEs have an obligation to repay the taxpayers, in effect, in the form of these dividend payments. And if we, sort of, withdraw them from the market too quickly, their ability to continue to make those payments might be mitigated.

Mr. SCHWEIKERT. Okay. Mr. Chairman—and it is, Ms. Wartell?

Ms. WARTELL. Yes.

Mr. SCHWEIKERT. Forgive me. To that point, if I am holding huge amounts of nonperforming paper and I am waiting for the market to come up to sell it, don't I perpetuate a 5-year real estate depression to last a decade? Because when do you hit bottom? If prices move, and the expectation—and there is always an expectation of this huge overhang. And, Mr. Chairman and Ms. Wartell, maybe it is because I come from the Phoenix area, where there are 50,000 foreclosures in process, and a year ago, there were 50,000 foreclosures in process, and the year before, 50,000, there is no change in expectation.

I almost wish we would take our lumps, process through those. We may come down substantially more, but at least we start to build a base back up.

Give me your comment.

Ms. WARTELL. My comment is, I guess, the question of, who gets the benefit of the upside and having taken the losses on the taxpayers? If we sell them at fire sale prices, then private investors will get the market when it comes up, and we will end up having larger obligations. It seems to me that the taxpayers ought to be able to make a sensible, staggered sale.

And the other thing I would say is, not all those assets they hold are nonperforming. In fact, the majority of them are performing assets.

Mr. SCHWEIKERT. Mr. Chairman, Ms. Wartell, I was only speaking to the nonperforming portion of the portfolio. And being at foreclosure central, I don't know how you get the chicken and the egg. We are going to wait until it gets better to sell, but it never gets better to sell because I always have an anticipation of all these foreclosures that are in process that never go to the actual sale.

Chairman GARRETT. And, with that—

Mr. SCHWEIKERT. Sorry, Mr. Chairman. Does that mean I am beyond my time?

Chairman GARRETT. Just a smidge.

Mr. SCHWEIKERT. Thank you.

Chairman GARRETT. And I thank the gentleman.

The gentleman from Colorado.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

Mr. Pollock, you and I have had a chance to talk about this subject on a couple of occasions. And so my first question to you is, when was Fannie Mae created?

Mr. POLLOCK. Fannie Mae was created in 1938.

Mr. PERLMUTTER. Okay. When was Freddie Mac created?

Mr. POLLOCK. By the Emergency Housing Finance Act of 1970.

Mr. PERLMUTTER. Okay. And just so we understand that we are all talking the same language, we are not talking about Federal

Home Loan Banks? Are any of you? When we talk GSEs, you are not talking about the Federal Home Loan Banks, are you?

Are you, Mr. Pollock?

Mr. POLLOCK. Congressman, I understood the hearing to be about Fannie Mae and Freddie Mac.

Mr. PERLMUTTER. Okay. But it also says "GSEs," and the Federal Home Loan Banks are GSEs, are they not?

Mr. POLLOCK. That is true, Congressman.

Mr. PERLMUTTER. Okay. What about—we are not talking Ginnie Mae here?

Mr. POLLOCK. Ginnie Mae is not a GSE. It is a wholly owned government corporation whose credit is the full faith and credit of the United States.

Mr. PERLMUTTER. Okay. But your premise is that Fannie Mae more or less has been treated as something that is backed by the full faith and credit—rightly or wrongly, it has been promoted as being backed by the full faith and credit of the United States, right?

Mr. POLLOCK. That is correct. I don't think there is any doubt that is the way the markets looked at them.

Mr. PERLMUTTER. Okay. So here is my question. Initially, was Fannie Mae simply government owned and then it became partially privatized?

Mr. POLLOCK. That is correct, Congressman. Fannie Mae originally was a 100-percent government-owned corporation. It was actually owned by the Reconstruction Finance Corporation when it was first set up. It had an extremely limited function; it was to buy FHA loans. That is all it was allowed to do for a portfolio.

Mr. PERLMUTTER. Right.

Mr. POLLOCK. Probably the original sin was the 1968 restructuring, which most people think was done in order to get Fannie Mae off the Federal budget because President Johnson was running outsize deficits at that point and he wanted Fannie's debt off the budget. That unleashed the much wider activity of GSEs, and we are now living with the results.

Mr. PERLMUTTER. Okay. And so, I guess the thing that concerns me is that from—and I am to not going to be their defender, but I want to understand really what is going on here. You all have given us several proposals. We can do an FDIC kind of a proposal and have a guarantee fund if everything fails. We can have a Ginnie Mae, Fannie Mae kind of proposal, which is you just go out and buy these mortgages, and you provide liquidity in that fashion. Or you can do nothing at all. I think there are sort of three—there is a guarantee, there is the buy, there is just let the market handle it.

Given the history, what I see—and, I have my apple, and I have—it really was a crash of the housing market starting in really, oh, the end of 2007, beginning of 2008. It is about as big a picture of a crash as you could have.

Prior to that, was the full faith and credit of the country being called upon in Fannie Mae or Freddie Mac? Had it ever occurred before?

Mr. POLLOCK. Congressman, the answer to that is "yes." In fact, Fannie Mae was in serious trouble in the early 1980s, 1981–1982,

just as the savings and loans of the day were. They were losing tens of millions of dollars. But they were always able to keep borrowing because their debt was viewed by the market as government debt.

Mr. GARY MILLER OF CALIFORNIA. Would the gentleman yield on that question?

Mr. POLLOCK. Sure.

Mr. GARY MILLER OF CALIFORNIA. The first time they lost money was 1985.

Mr. PERLMUTTER. Okay. In 1985 though 1990, the model that was used as a guarantee model, the Federal Savings and Loan Insurance Corporation—which is one of the proposals here, something like that—failed, and the government had to pick it up through the RTC.

So, I harken back to Mr. Oxley and the effort of the Republican Congress in 2005 to put some limits on Fannie Mae and Freddie Mac. And, I have said to you his quote. He was upset because the House passed it, and the Senate wouldn't. He said, "All the hand-wringing and bed-wetting is going on without remembering how the House stepped up on this. What did we get from the White House? We got a one-finger salute."

Okay? The White House, under the Bush Administration, opposed any limitations on Fannie Mae and Freddie Mac because it is my opinion, whether it was because of the government-backed guarantee being promoted or that real estate only goes up in the United States, we were repatriating a lot of money that had gone overseas.

And so, Mr. Calabria, or Doctor, you said that China was one of the owners of this debt. So in a perfect world those creditors should just get hammered. Why did Mr. Paulson not want to take that step?

Mr. CALABRIA. I think, to some extent, Secretaries Paulson and Geithner were both concerned about, if you impose haircuts on foreign holdings of GSE debt, then there would be questions about how that would bleed over to the response by Treasuries, so that you might see an increase in Treasury costs.

Now, I don't think that was ever explicitly made, but that is an important part of it. So I do think it is looked it as the credibility of the American public.

Mr. PERLMUTTER. Thank you.

Chairman GARRETT. I thank the gentleman.

I now turn to the gentleman from Virginia, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

This is for Mr. Pollock. I was wondering, going back to, kind of, the history of Fannie Mae and Freddie Mac, if you look back at the time that it was established and formed, how come, since that time, we haven't seen a private market for these mortgages develop over that time?

And it sounds like from the question that was just asked that, from its founding in 1938 to 1968, that, really, it had a very narrow mission. Why didn't the private sector step in during that period? And how does that inform us as we go forward?

Mr. POLLOCK. Congressman, that is a very good question. And the answer is, of course, the private sector was acting in the market all during that period.

If I could put in a historical footnote, as I think one of the other Congressmen said, there always was a secondary mortgage loan market. Going back to the 1920s, there was a channel of mortgage bankers who placed loans with insurance companies, for example. So that is a classic idea.

But as the GSEs developed in their post-1968 form, which was really the invention of the GSE form, wherever they could operate they dominated the market, because no one could compete with their government advantages and subsidies.

So, as I said a little bit ago, the market where it would be most likely to have a private securitization market in addition to a private portfolio lending market didn't develop. It didn't develop because it was dominated by the subsidies given to Fannie and Freddie. Of course, the subsidies include the government guarantee—real, though not formal.

Mr. HURT. Thank you.

I yield back my time.

Chairman GARRETT. Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman.

Just as a follow-up to the questions that were asked about the private loan market in the 1920s, is it true that market had balloons? And is it true that market had interest-only loans? Is it true that market was very much akin to what we just went through, with what we are calling "exotic products" now?

Is that true, Ms. Wartell?

Ms. WARTELL. Yes, Congressman, that is absolutely true.

Mr. GREEN. So you had a private loan market in the 1920s, but did it make homes available? Let's not talk about affordable, since that has become a negative term now. I marvel at how "affordable" can be negative for middle-class people.

But did it make those homes available to middle-class people? Were middle-class people able to buy homes and fulfill the American dream to the extent that they were before the bubble and before the crash?

Ms. WARTELL. In that period, most people who were able to buy homes had been able to accumulate very significant amounts of savings, sometimes up to 50 percent. And so the availability of homeownership was very limited compared to modern—

Mr. GREEN. Seems like somebody ought to say that, that we had that problem—that it was a circumstance. Let's not call it a problem, but it was a circumstance. And we have metamorphosed. It is no longer a circumstance.

But let's move forward to something else. Ms. Wartell, you indicated that all governments, I believe, have some kind of government involvement in the loans. Is that correct?

Ms. WARTELL. Either explicitly or implicitly. In many of the European countries, which are often cited as a comparison, there are a relatively small number of financial institutions that serve those markets that benefit very significantly from an implied "too-big-to-fail." And, in fact, many of them have been supported by their countries as they have gotten in trouble.

Mr. GREEN. Let me intercede because I have limited time.

My assumption is that the three other persons at the table—all of whom I have great respect for, by the way; I appreciate your commentary—but that all of you are in favor of no government involvement at all. Is that a fair statement, or did I miss something?

Mr. POLLOCK. I will speak for myself, Congressman.

My long-term objective for American housing finance is a market that is principally a private market. I estimate about 85 percent. And about 15 percent—

Mr. GREEN. Mr. Pollock, you know I love you. We have been together before here. And, I have a deep, abiding affinity for you.

But the three of you, in essence, would have no government involvement.

Now, let me ask you, Mr. Pollock, do you speak for the banks when you say this?

Mr. POLLOCK. No, sir. I speak only for myself.

Mr. GREEN. All right. Let's go to your next colleague.

Do you speak for the banks, sir?

Mr. RANDAZZO. No, I do not speak—

Mr. GREEN. Do you speak for the banks, sir?

Mr. CALABRIA. I only speak for myself.

Mr. GREEN. Okay. Is it not true that, generally speaking, we consider what those in the industry have to say about this? Does someone have some plethora of evidence, empirical evidence, if you will, connoting that the banks entirely support this type of circumstance that you have called to my attention?

Mr. CALABRIA. I will react—

Mr. GREEN. Is it yes or no?

Mr. CALABRIA. It is no. I put—

Mr. GREEN. No. Okay, here is why I bring this up. We put a lot of thought on this committee into what those who actually have to do what we say will be done, what they think about it.

It seems to me that, given that you are talking about what is revolutionary—and I think Ms. Wartell said that we should be thoughtful and have a resolution, not an overnight revolution.

Is that your phrase?

Ms. WARTELL. Evolution, not revolution.

Mr. GREEN. Evolution, not revolution.

It seems to me that the banks ought to have some say in this process, as well, since they had a pretty good say in all of the other aspects of things and since they are going to do the lending, they will do the lending.

How is it that we conclude that banks will do all of these things that you say and not what they are saying they will do?

Because the bankers who talk to me, they tell me they would like to see a Federal backstop. That is what the bankers talking to me say. And if you tell me that you speak for them and that is not what they are saying, I will put that into my computer and let that be a part of my processing of this intelligence.

One more thing before we go, and I have to do this. I apologize to you. But you indicated that it would be bad for taxpayers—I believe this was indicated by Mr. Randazzo—bad for taxpayers, but you didn't say what it would be like for the economy to allow the default.

"Bad for taxpayers." Taxpayers have to be a part of the economy. What is it going to be like for the economy if we just allow the collapse? What would it be like if we allow all of this bad paper to just go under?

Ms. Wartell, would you respond, please?

And I thank you, Mr. Chairman. I know that will be my last question.

Chairman GARRETT. Was that Mr. Randazzo's question?

Mr. GREEN. No. It is to Ms. Wartell, please.

Chairman GARRETT. Okay. If you will keep that to 10 seconds, because we are over time.

Ms. WARTELL. Too rapid a withdrawal of support from the housing market could cause us to take the fragile economic growth we are currently seeing back in the wrong direction.

Chairman GARRETT. And I thank you.

The gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

I would like to thank the panelists for coming today.

The thing that I was struck by is that there does seem to be some similarities, commonality, that all of you agree on at least some of the steps that we might want to consider moving forward, or at least there is a consensus among you. And I know that there are clearly some differences.

My first question is for Ms. Wartell. You talked about a yield spread analysis, and you used that to conclude that investors in Europe view covered bonds as having essentially a government guarantee. But I guess the part I am trying to understand is that yield spread was actually smaller than the yield spread between U.S. Treasuries and the Fannie and Freddie debt, which does have a government guarantee.

Isn't it really a statement by those investors that they are admitting that there is less risk in those covered bonds because the banks that originated them have continued to have skin in the game, and they believe when somebody who originates a mortgage has skin in the game, they are not going to let themselves lose money, versus the system we have, where you can originate and sell off 100 percent? Isn't that another way to look at the view?

And, obviously, there is no—it is all speculation, too, because we are just looking at a yield analysis instead of really interviewing investors who have invested in these.

Ms. WARTELL. It is my—let's put aside the analysis of the spreads, because I think obviously different people can interpret it different ways. But I do think that it is safe to say both, as you said, that there is particular collateral behind the covered bonds, and the investors understand they have that, and that they believe that those institutions in most of those countries benefit from an implied government guarantee

Mr. STIVERS. Thank you. Do you think, Ms. Wartell, that the retention of risk leads to less risky behavior by those institutions that have skin in the game?

Ms. WARTELL. I generally have supported that lending institutions should retain risk, have skin in the game, in their loans, as the Dodd-Frank legislation also would require.

Mr. STIVERS. Sure. Thank you.

And the second question I have, also for Ms. Wartell, how do you explain the 30-year, fixed-rate mortgage in Denmark if you think that a covered bond won't lead to a fixed-rate mortgage here in the United States?

Clearly, it seems that it is a market requirement that consumers in Denmark, consumers in the United States, have demanded those products, and, therefore, the market has provided them.

Ms. WARTELL. Actually, I think there are two different arguments that I have made that are being conflated in this case. Denmark has provided, through the covered bond mechanism, long-term, fixed-rate mortgages.

My point is that I think that if you have a purely private market, the appeal of covered bonds for most of our financial institutions under the U.S. regulatory scheme is very different. It won't likely be the primary mechanism of funding. And I also think that here we will end up with short-term debt.

But it is not the covered bond that I argue won't produce 30-year, fixed-rate mortgages. It is the fact that if we have—

Mr. STIVERS. The problem with the FDIC.

Ms. WARTELL. If we don't have the backstop for the investments.

Mr. STIVERS. Okay. Thank you.

Could the other panelists comment on their thoughts, quickly, on retention of risk and what that would mean for the marketplace?

Mr. POLLOCK. Congressman, I have worked on introducing credit risk retention into the mortgage markets for 15 years. I think it is an extremely useful and important idea. It is one of many ideas, but it is a very useful one.

I think the advantage of the covered bond, which you cite, is that there is 100-percent credit risk "skin in the game" for the covered bond issuer. This is also extremely important in understanding how these bonds work.

Mr. RANDAZZO. I would just echo the comments of my colleague.

Mr. STIVERS. Thank you.

Mr. CALABRIA. And I would say, I think retention of risk is an important thing in the marketplace, but I also believe there was considerable retention of risk prior to the crisis. In fact, most of the 400-some subprime lenders that went out of business were because they were forced to buy back the piece that they had. So skin in the game is important, but it isn't a cure-all.

Mr. STIVERS. Sure.

Mr. CALABRIA. I would also argue that one of the things that should be considered going forward, if we are going to keep a Fannie and Freddie model, is to get them out of the guarantee basis, where they simply sell off the MBS, they don't guarantee the credit risk, because three-fourths of their losses have come about because they retained that risk and the investor did not take it.

So we have lots of retention of risk. It hasn't always worked that well. Sometimes it has; sometimes it hasn't. But it is not a cure-all.

Mr. STIVERS. Thank you.

Now for the whole panel, just going across, the focus of a lot of your testimony was on covered bonds. Are there approaches somewhere between what we are doing today and covered bonds? Are there other approaches that people are talking about, reinsurance

or any other approach outside of just the two approaches that we have heard today?

And I know that we don't have much time, so—

Chairman GARRETT. Ten seconds.

Mr. CALABRIA. I will say very quickly that I think that you can have a large amount of money that is portfolio-based not in a covered bond way, even though that is portfolio-based.

Mr. POLLOCK. My answer is yes.

Mr. STIVERS. Thank you.

Thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentlewoman from New York.

Dr. HAYWORTH. Thank you, Mr. Chairman. I will make this brief.

I was thinking about the comments that Ms. Waters made regarding the PIMCO chair reflecting his comments about how increasing the downpayment on houses might be burdensome for homebuyers. But isn't it true that it would also help to, if you will, rationalize home prices? I would appreciate the panel's assessment of that.

Mr. CALABRIA. Yes, it largely would. I do think that we need to get back to a point where housing prices reflect fundamentals rather than availability of credit driving prices, necessarily. There should be credit there.

I do want to note, as well, there was an earlier discussion about very large downpayments in the 1920s. And I will note that the homeownership rate for working males aged 55 to 64 in 1920 was 66 percent. So in no way was the 1920's homeownership limited only to the wealthy. That is false.

Mr. POLLOCK. Congresswoman, I would say I have spent a lot of time around bond markets in my career. The head of PIMCO's comments have been widely cited. I never take too seriously what bond traders say.

When it comes to downpayments, there is no doubt—and this is just an unquestionable regularity of housing finance—that size of downpayments or, inversely, the extent of the loan-to-value ratio, is one of the most reliable indicators of credit performance, either good or bad.

Ms. WARTELL. I think that it is true that downpayment is a relevant factor, but I think we overemphasize it in the conversation. In the late 1990s, there was a great deal of very positive experimentation that was going on, demonstrating positive ways to mitigate the risk of low-downpayment lending. And all of those good practices were wiped out by the abusive practices in the subprime market.

And there are enormous disparities of wealth in our society, and communities with low homeownership rates have other social costs. So if we go to a system where we mandate very high downpayments, there will be consequences that I think we will all be very sorry to see.

So we need to make sure that there are ways to mitigate risk, but downpayment should not be our only measure.

Dr. HAYWORTH. Is it fair to ask, on a very fundamental level, whether or not all that these GSEs have done and all that the Federal intervention in the housing and mortgage markets has done,

is it fair to conclude that those most vulnerable have actually benefited from these interventions? Because, certainly, the state of our economy would suggest otherwise.

Mr. RANDAZZO. I would say, in large part, no. And if you just look at the waves of foreclosures that have basically been besieging the United States over the past several years, any gains that were established turned out to be faulty and have been wiped away. And, in large part, there are a number of individuals who seemingly thought that we were helping that are now worse off than when we started.

Mr. CALABRIA. If I could make a comment, I have worked on housing policy and mortgage finance policy for a very long time. And one of the things that has constantly puzzled me is that proposals that have the aim of running up housing prices are presented as enhancing affordability. That kind of confuses me. Usually, that is a transfer to the seller.

I look at it as, housing is a basic necessity of life. Everybody needs shelter. And when housing becomes more affordable—that is, when prices come down—I think that is a great thing.

Now, currently, the impact of that certainly helps the poor, hurts maybe the middle class and the rich, but that is a policy outcome I can live with.

Ms. WARTELL. I think it is important, as we look backwards, though, not to conflate the role that the GSEs played in the housing market with the consequence of the subprime crisis that we had.

The reality is, if you look at the Financial Crisis Inquiry Commission report and others, the preponderance of the evidence here is that there was an intervening factor. There was this unregulated market, the shadow banking that was accelerated with the Wall Street inventions. The result of that was chasing horrible loans. And it is those lending practices, and not the lending practices of the GSEs. They reacted to those; they joined in the party. They have cost a significant amount of money to the taxpayers.

I have no book to protect their record. But I think we should be very careful here not to conflate the role the GSEs played in the housing market prior to the year 2000 with the consequences of the subprime crisis.

Dr. HAYWORTH. May I have 30 more seconds, Mr. Chairman?

Chairman GARRETT. No, I am sorry, no. Your time has expired.

Dr. HAYWORTH. Thank you.

Chairman GARRETT. Your colleague from New York is up next. If he wants to yield you—

Mr. GRIMM. I will yield my time.

Dr. HAYWORTH. Oh, thank you, Mr. Grimm.

I would simply submit to you that there were, as we all know, dissenting opinions regarding that Financial Crisis Inquiry Commission report. And the clear message that someone like me would take from it is that it is, in fact, the implicit Federal guarantee, indemnification of bad risk, that created the impetus for all of these risky investments.

Thank you.

Mr. GRIMM. On that note, I think, Mr. Pollock, if you would like to comment on the last comments, please, I will give you a minute to do so.

Mr. POLLOCK. Thank you very much, Congressman.

I want only to make two points. One, when it comes to subprime mortgage-backed securities, of course Fannie Mae and Freddie Mac were among the biggest buyers and the richest bids for subprime securities.

But on a more general point, having to do with credit policy and housing finance policy everywhere, the worst thing you can do for somebody is to make them a loan they can't afford.

Ms. WARTELL. No disagreement.

Mr. GRIMM. I think we are getting ready to wrap up, and I will be very brief.

Overall, I think to bring this all together at where we are at, the Federal debt stands at $14 trillion. GSE debt stands at $8 trillion.

I will ask Mr. Pollock, what are the implications of this unsustainable debt load, in a nutshell?

Mr. POLLOCK. Unsustainable debt can't be sustained, and it has to be addressed and adjusted to. It usually involves finding ways to reschedule, restructure, or inflate your way out of it. We are faced with a really tough problem, as you suggest, Congressman.

Mr. GRIMM. My last question: Mr. Calabria, you have proposed that Congress establish a recoupment fee on all mortgages purchased by Fannie Mae and Freddie Mac to reduce the deficit and to recoup as much of the losses as possible. Just very briefly, how would that work?

Mr. CALABRIA. Essentially, it could be a fee that the GSEs charge to any lender that sells them the mortgage, and then that fee is recovered just like the way the guaranteed fee structures work now. Essentially, you would layer it on top of the guarantee fee that the GSEs already require from lenders, and then you put it off to pay down the amount of money we put in.

So I certainly would not suggest that we charge them any more than we have already put in, but just as an attempt to recoup what we have put in.

Mr. GRIMM. Okay.

And, in closing, I would just like to say that we have heard both sides and that, on one hand, we need the government to make sure that we still have mortgages. And, without it, there will be the collapse of our economy and the collapse of home housing. My inclination innately is always that, where there is a need, the market will fill that need and that this country was founded on private-sector principles that have really risen to the occasion time and time again.

And if the government were to, say, step aside and move out of the way of our free market, it would thrive. And a lot of the answers to this insurmountable debt is that free market, the enterprise, the entrepreneurial spirit that has made us great and will continue to make us the greatest nation in the world.

And, with that, I yield back the rest of my time.

Chairman GARRETT. The gentleman yields back, but the gentlelady from New York could have 1 minute left of his time to use for any other questions that she has.

Dr. HAYWORTH. Would the panel agree that, in fact—and I thank you, Mr. Chairman. I am sorry.

Would the panel agree that the mobility issue created by the challenges that mortgage holders face because of the bad risks they undertook with Federal help, if you will, actually affects our unemployment rate materially today?

Mr. POLLOCK. Many economists, Congresswoman, have pointed out the labor mobility problem entailed by having houses that are underwater on their mortgage.

There is something else we should point out. For all the advantages of a 30-year, fixed-rate mortgage, there are also disadvantages to it. For example, if you are underwater and you have what is now a high-rate mortgage, you can't refinance it. I call that the "dark side of the 30-year, fixed-rate mortgage," and we have to take that into account. It relates to this mobility problem.

Mr. CALABRIA. Responding to the Congresswoman's question, there are a number of empirical studies that have looked both across countries and across States and have reached the conclusion that the higher your homeownership rate, the higher structural unemployment you have. And this is something that is very well-founded, in peer-reviewed journals.

My back-of-the-envelope is that at least a percentage point of the unemployment rate we are seeing today is due to the high homeownership rate we had going into the crisis.

Chairman GARRETT. Thank you. And the gentlelady yields back.

The gentleman from California.

Mr. GARY MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

This has been a very interesting hearing. I have heard so many different sides.

I heard one of my good friends from the other side of the aisle say that the Bush Administration did not support reforming GSEs. That is fallacious. I met with the President many times on this issue. We probably sent the bill to the Senate 3, 4, maybe 5 times. And there was a filibuster that occurred, and it wasn't by the Republicans, that stopped the bill from being heard. So that is the fact on there. I corrected one thing on you earlier, but that was just wrong on that.

And I am having trouble with a lot of facts out here. I am not taking sides on the issue. No doubt we have serious, serious problems. But I am hearing a lot of the debate that doesn't make sense when it is applied to reality, in some way.

Mr. Calabria, you made a great statement on mortgage-backed securities because the only mortgage-backed securities worth a darn are GSEs out there. The alternative, when the market got really good in 2004, 2005, and 2006 was the private sector. Countrywide did come in and be major players in the marketplace. Now, if we had defined predatory versus subprime, they would have never been in the marketplace. But they played a huge part in the marketplace, made a tremendous number of loans to people who could never pay them back, sold them off to the private sector. And the way those loans are bundled, they can't be debundled.

Now, GSEs—I will say that if you buy a mortgage-backed security from the GSEs, you will get what you are promised. Because they bundle them in a way where a nonperforming loan is removed

and replaced with a loan that is performing. And many of the loans that the GSEs are eating today is because they are taking those loans out and replacing them.

The problem we have is—let's go back to 2008. When you look at the total losses in the marketplace in 2008, the lending sector lost about $2.7 trillion in losses. Now, understanding at that point in time that Fannie and Freddie represented 70 percent of the marketplace, or 31 million loans, Fannie lost $117 billion, Freddie lost $67 billion—a lot of money, but let's put it in perspective. They had 70 percent of the marketplace. Out of $2.7 trillion lost, they lost less than $200 billion of it. Unacceptable numbers, no argument.

There have been statements made that the problem is that we made loans to people with low downpayments. But VA and FHA do that today. Let's look at the reality. In my district alone, LA County, VA and FHA loan defaults are 2.6 percent; Freddie and Fannie are 3.9; the jumbos, 10.1. Obviously, VA and FHA are doing very well making low-downpayment loans.

In Orange County, the FHA/VA default rate is 1.4 percent; Freddie and Fannie, 2.1 percent; the jumbo private sector is 2.89 percent. San Bernardino County—a high default rate in San Bernardino County overall. VA and FHA is 3.5 percent; Freddie and Fannie, 7.8 percent; jumbo is 18.4 percent.

So if the logic is that a low downpayment means necessarily a high default rate, the numbers don't verify that argument.

To make a loan to somebody that they cannot repay, it doesn't matter what they put in, they are going to default. If they can't make the payments and they put 20 percent down, they are still going to lose the house. If they put zero down and they can't make the payments, they are still going to lose the house.

So if we would have taken at some point in time and said, let's define predatory versus subprime—which I know I put in at least five bills going to the Senate, and my good Democrat friends filibustered it—a matter of record, not fallacious—we would probably not have some of the problems we have today.

And if you look at the chart, a great example of that is delinquencies today. Had we taken and fixed the problem in 2000 when we tried to fix predatory versus subprime, the subprime ARMs had a default rate of about 5 percent. Now, you go from 2000, when we did not fix it, to 2008; they had a default rate of 38.7 percent. Why? Because nobody bothered to define predatory versus subprime.

The default rate also, if you look at the middle-range market, an average in 2000 was about 2 percent. An average in 2009 was 8 percent. The default rate for Freddie and Fannie in basically 2000 were nonexistent. They had no default rate. It rose in 2009 on the Freddie side to 3.1 percent and the Fannie side to 4.2 percent. It is too high. But the average market is 8 percent. Subprime is 26.5. The better subprime, the ARM subprime, is 38.7.

So when you look at the numbers, you say, is there a problem? A serious problem with the entire industry. I remember when I was a young man in my 20s, if I went to borrow money from a lender for a construction loan, if I didn't meet conforming standards, they would not make me the construction loan. Why? Because at the end of the day, there was probably not going to be a lender

to make them the loan to do the takeout on the house I had just built.

So, Freddie and Fannie were basically created to provide liquidity to the marketplace. Had Freddie and Fannie not been there in 2007, you could not have given a house away, period. Wall Street was shut down. Private sector was shut down. Wells Fargo, Bank of America didn't know if they could survive the next day.

So what did we do to the taxpayers in this country who own a home? Sixty-five percent of the families own a home. Many of those homes have double—I ran out of time, didn't I?

I hate this when I am preaching. I love to preach. I should have been a preacher. If I was a Baptist, I would be a preacher today, but I am not.

But, in closing—

Chairman GARRETT. Was there a question in there?

Mr. GARY MILLER OF CALIFORNIA. Yes, there was. I never got to the question.

My question was, I heard a lot of great information today, but I heard it from a lot of different perspectives. And when you put it together in reality, you see there are some basic problems that should have been corrected. Was low downpayment the problem? According to FHA and VA, no. Were underwriting standards a problem? Absolutely. And guidelines were a problem. Predatory versus subprimes were a problem.

And, Mr. Chairman, I hope we have a lot of these because there is so much we need to get on the table, because I know you have a passion on this issue, and so do I and many other Members. But we have to figure out what we are going to do to fix the housing market in this country without destroying it. And if Fannie and Freddie don't make sense, let's get rid of them. If they can make sense with modifications, let's look at that. But let's just don't make assumptions based on an entity that has 70 percent of the marketplace and is performing better than any lender sector out there today other than FHA and VA. So when we move into getting an answer for this, let's move with that understanding and move cautiously.

I yield back the balance of my time.

Chairman GARRETT. I appreciate that.

Mr. GARY MILLER OF CALIFORNIA. Thank you for your generosity.

Chairman GARRETT. And I will seek unanimous consent to allow the witnesses, even though it is over time, just to give a short—

Mr. GARY MILLER OF CALIFORNIA. —answer to my question.

Chairman GARRETT. Yes, answer his global, and then they will be our last—

Mr. CALABRIA. There was an awful lot there, but let me first react to—in 2007, Fannie and Freddie were actually pulling back. And one of the reasons that Secretary Paulson gave for taking the conservatorship was to get them to make more lending. Now, the fact is today that the reason they are making lending is because their losses and their debt are essentially backed by the government. And I would put it this way: You cover all my losses, guarantee all my debt, and I will go out and buy a whole lot of mortgages, too. So we have to remember what is the important part here that is keeping them together.

I 100 percent agree that downpayment alone is certainly not the determinative factor. I think FICO score is far more predictive of default than downpayment. So, certainly, that could be a tradeoff.

I do think we need to keep in mind the vintages of loans that we are looking at. As you are very well aware, in about 2005—

Mr. GARY MILLER OF CALIFORNIA. Can I ask one question?

Mr. CALABRIA. Sure.

Mr. GARY MILLER OF CALIFORNIA. Yes, on Freddie and Fannie's making loans today, but the underwriting standards are tremendously different than they were 3 or 4 years ago.

Mr. CALABRIA. Yes.

Mr. GARY MILLER OF CALIFORNIA. Especially in the high-cost areas, they are very stringent.

Chairman GARRETT. Yes. Let's let the panel complete, because otherwise we will—

Mr. CALABRIA. So, but what I was going to say, in comparing FHA to jumbo or any other part of the market, you do have to look at vintages. As you are well aware, FHA's market share in California in 2005 was about 2 or 3 percent. So there was very little lending, where they have picked up since when the loan limits were raised. So my point would be, you have to make sure you are comparing 2005 to 2005 loans. And that is an important part of it.

I do think you can offset the downpayment if you put other factors in the require good credit quality.

Mr. RANDAZZO. I would be happy to submit comments in writing.

Chairman GARRETT. All right.

Mr. Pollock?

Mr. POLLOCK. Mr. Chairman, I look forward to the discussion of this at another hearing, should you ever want to invite me back.

Chairman GARRETT. Oh, okay.

Ms. WARTELL. Thank you very much, Mr. Chairman, for having us.

Chairman GARRETT. Thank you.

And I thank all the witnesses and the members here today.

I seek unanimous consent to enter into the record the statements of the National Association of Realtors, the American Bankers Association, the National Multi Housing Council, and the National Association of Federal Credit Unions.

And, with that, the Chair also notes that some members may have additional questions for this panel, which apparently they do, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit questions to these witnesses and to place their responses in the record.

This hearing is thereby adjourned.

[Whereupon, at 4:50 p.m., the hearing was adjourned.]

A P P E N D I X

February 9, 2011

Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
Subcommittee on Capital Markets & Government Sponsored Enterprises
House Committee on Financial Services
On "GSE Reform: Immediate Steps to Protect Taxpayers and End the Bailout"
February 9, 2011

Mark A. Calabria, Ph.D. is Director of Financial Regulation Studies at the Cato Institute. Before joining Cato in 2009, he spent seven years as a member of the senior professional staff of the U.S. Senate Committee on Banking, Housing and Urban Affairs. In that position, he handled issues related to housing, mortgage finance, economics, banking and insurance. Prior to his service on Capitol Hill, Calabria served as Deputy Assistant Secretary for Regulatory Affairs at the U.S. Department of Housing and Urban Development, and also held a variety of positions at Harvard University's Joint Center for Housing Studies, the National Association of Home Builders and the National Association of Realtors. He has also been a Research Associate with the U.S. Census Bureau's Center for Economic Studies. He holds a doctorate in economics from George Mason University. http://www.cato.org/people/mark-calabria

Testimony of Mark A. Calabria, Ph.D.
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Chairman Garrett, Ranking Member Waters, and distinguished members of the Subcommittee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington, DC. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen, homeowner and taxpayer, I have no direct financial interest in the subject matter before the Committee today, nor do I represent any entities that do.

Need for Reform

Given the central role of Fannie Mae and Freddie Mac in the financial crisis, the need for reform should be beyond dispute. What will be debated is the substance of such reform. While I believe a major overhaul of our federal mortgage policies should happen sooner, rather than later; reform should be done in a deliberate and thoughtful manner. The need for a deliberate and thoughtful process, however, does not preclude the necessity of taking immediate steps to protect the taxpayer and reduce the perverse incentives that permeate our financial system. My testimony will focus upon those steps which Congress and the Administration should take immediately.

Receivership, not Conservator

The most immediate and powerful step that can be taken to protect the taxpayer is to change the role of the Federal Housing Finance Agency (FHFA) from that of conservator to receiver. Section 1145 of the Housing and Economic Recovery Act (HERA) of 2008 establishes a resolution and/or reorganization process for the GSEs. Unlike the conservator powers in Section 1145, the receiver provisions allow losses to be imposed upon the GSEs' debtholders, rather than the taxpayer.

It should also be noted that there is little, if anything, that a conservator can do that a receiver cannot. There is, however, a considerable amount that a receiver can do, which a conservator cannot. As mentioned, the most important difference is that a receiver can impose losses on creditors and other parties. This would also subject the remaining shareholders, subordinated debtholders and other creditors to potential losses.

Some might object to a receivership on the basis that it would "end" the GSEs. Such a position would be mistaken. Section 1145 specifically prohibits the receiver from revoking, annulling or terminating the charter of an enterprise. Quite simply, the charters of Fannie Mae and Freddie Mac would remain in place under a receivership. As a former staffer who worked on Section 1145, I very much recall that the purpose of this section is to "clean" a GSE and ready a new charter, not end the GSE model.

Another potential objection to receivership would be that it forces a solution before Congress has had sufficient time to deliberate. Such an objection would also be false. Again under Section 1145 of HERA, a limited-life regulated entity, essentially a bridge bank for GSEs, has an initial life of 2 years, which can be extended by FHFA for 3 additional 1-year periods. This would give Congress, the Administration, and FHFA five years to arrive at a suitable replacement for Fannie Mae and Freddie Mac. Again, as HERA prohibits FHFA, in its role as receiver, from "ending" the GSEs, a receivership still allows Congress the option of keeping the GSEs in their current form.

Another important feature of receivership is that it would help to lessen the perception that certain entities, including our largest bank holding companies, are "too big to fail". The Dodd-Frank Act establishes a resolution process for both non-banks and bank holding companies. This resolution process mirrors in many ways the receivership provisions of HERA. Market participants have rightly questioned whether the resolution powers of Dodd-Frank would ever be used to impose losses on creditors. If we are unwilling to take Fannie Mae into a receivership, then most market participants will conclude that we would also be unwilling to take Citibank or Goldman Sachs into a receivership. Moving Fannie Mae and Freddie Mac into receivership will likely reduce the favorable funding advantage which "too big to fail" institutions currently enjoy (at the expense of the taxpayer).

Lastly, some might object to a receivership in that it would impose losses on creditors. The concern being that as most of these creditors are other financial institutions, about 80 percent of Fannie and Freddie funding is provided by the remainder of the financial services industry, the imposition of losses could cause other financial institutions to fail or at minimum experience financial stress. I believe such a concern is overstated, particularly since we are past any "panic" in the financial markets. If Fannie and Freddie were to experience losses of another $100 billion, then it is likely that MBS holders would experience little loss and holders of unsecured debt would receive about 94 cents on the dollar. Subordinated debt would likely be wiped out. As insured depositories hold mainly MBS, additional resulting bank and thrift failures would be few. Money Market Mutual Funds would likely incur significant losses, with several funds "breaking the buck". Foreign holders, particularly central banks, would experience losses, although these losses would be likely less than that already experienced due to exchange rate movements.

To summarize, I believe that shifting losses from the taxpayer to GSE creditors would have minimal disruptions on our financial markets in the current environment. More

importantly, the taxpayer should no longer be on the hook for protecting the financial services industry from the consequences of its own mistakes.

Lower Loan Limits

In transitioning from a government-dominated to market-driven mortgage system, we face the choice of either a gradual transition or a sudden "big bang". While I am comfortable with believing that the remainder of the financial services industry could quickly assume the functions of Fannie Mae and Freddie Mac, I recognize this is a minority viewpoint. Practical politics and concern as to the state of the housing market point toward a gradual transition. The question is then, what form should this transition take? One element of this transition should be a gradual, step-wise reduction in the maximum loan limits for the GSEs (and FHA).

If one assumes that higher income households are better able to bear increases in their mortgage costs, and that income and mortgage levels are positively correlated, then reducing the size of the GSEs' footprint via loan limit reductions would allow those households best able to bear this increase to do so. As tax burden and income are also positively correlated, the reduction in potential tax liability from a reduction in loan limit should accrue to the very households impacted by such a reduction.

Moving beyond issues of "fairness" – in terms of who should be most impacted by a transition away from the GSEs – is the issue of capacity. According to the most recent HMDA data (2009), the size of the current jumbo (above $729k) is approximately $90 billion. Reducing the loan limit to $500,000 would increase the size of the jumbo market to around $180 billion. Since insured depositories have excess reserves of over $1 trillion, and an aggregate equity to asset ratio of over 11 percent, it would seem that insured depositories would have no trouble absorbing a major increase in the jumbo market.

Given that the Mortgage Banker Association projects total residential mortgage originations in 2011 to be just under $1 trillion, it would appear that insured depositories could support all new mortgages expected to be made in 2011 with just their current excess cash holdings. While such an expansion of lending would require capital of around $40 billion, if one is to believe the FDIC, then insured depositories already hold sufficient excess capital to meet all new mortgage lending in 2011.

Moving more of the mortgage sector to banks and thrifts would also insure that there is at least *some* capital behind our mortgage market. With Fannie, Freddie and FHA bearing most of the credit risk in our mortgage market, there is almost no capital standing between these entities and the taxpayer.

The bottom line is that reducing the conforming loan limit to no more than $500,000, if not going immediately back to $417,000, would represent a fair, equitable and feasible method for transitioning to a more private-sector driven mortgage system. Going

forward, the loan limit should be set to fall by $50,000 each year. As this change could be easily reversed, it also represents a relatively safe choice.

GSE employees are Government Employees

The hallmark of a private corporation is that its owners (shareholders) bear the benefits and costs of its activities. This situation no longer holds for Fannie Mae and Freddie Mac. These entities will never be able to grow their way out of their current obligations to the American taxpayer. Any revenues going forward will help to reduce the size of the hole, while expenses dig it deeper. Given that the taxpayer is now the residual claimant to these entities, it should be clear that the employees of Fannie Mae and Freddie Mac are working not on behalf of the shareholders, but on behalf of the taxpayer. They should be paid like other government employees. I recommend that all GSE employees be transitioned to the GS pay scale as soon as possible. This would include the executive officers. Ever penny of the close to $7 million in total annual compensation paid to Fannie Mae's President and CEO comes at the expense of the taxpayer. This is simply offensive. If FHA can adequately manage the mortgage risk in its business while paying its employees on the GS scale, then so can Fannie Mae and Freddie Mac.

Bank Buybacks

Credit losses suffered by Fannie Mae and Freddie Mac have in some instances been caused by the violation of representations and warranties by the originating lender. While the GSEs have made some efforts to recover losses from the originating lenders, there is simply not enough public information to gauge the aggressiveness of these efforts. Congress should examine in detail the agreements reached between the GSEs and the banks in regard to loan repurchases and recovery for losses on purchased private-label securities. I believe a GAO audit of these agreements, along with detailed information by lender, would help aid in the stemming of losses. Funds recovered should be used exclusively for off-setting previously provided taxpayer assistance to the GSEs.

"Pay it back"

Section 134 of the Emergency Economic Stabilization Act of 2008, better known as the TARP, directed the President to submit a plan to Congress for recoupment for any shortfalls experienced under the TARP. Unfortunately HERA lacked a similar requirement. Now is the time to rectify that oversight. Rather than waiting for a Presidential recommendation, Congress should establish a recoupment fee on all mortgages purchased by Fannie Mae and Freddie Mac. Such a fee would be used directly to reduce the deficit and be structured to recoup as much of the losses as possible. I would recommend that the recoupment period be no longer than 15 years and should begin immediately. A reasonable starting point would be 1 percentage point per unpaid principal balance of loans purchased. Such as sum should raise at least $5 billion annually and should be considered as only a floor for the recoupment fee. A recoupment fee would have the additional advantage of reducing the competitive position of Fannie Mae and Freddie Mac.

Bank Capital Standards

The structural flaws in our mortgage finance system were not limited to Fannie and Freddie, but also included the treatment of GSE debt within the bank capital standards. One of the rationales for the rescue of Fannie and Freddie was a concern as to the impact their failure would have on the rest of the financial system. According to the FDIC, holdings of GSE securities, bonds and mortgage-backed securities as well as preferred stock, constitute more than 150% of Tier 1 capital for insured depositories. This high level of concentration of GSE debt in our banking system was a direct result of the favorable treatment of GSE debt by bank capital standards. Whereas whole mortgage loans require a 50% risk-weighting under Basel II, GSE debt only requires a 20%. The result is that the overall system holds only about 40% of the equity behind the mortgage market as it would otherwise. Congress should direct bank regulators to remove the preferential treatment of Fannie and Freddie. This change would require the banking system to increase capital by approximately $24 billion; accordingly it can be implemented over a reasonable period of time.

Mortgage Credit Quality

The bulk of losses suffered by Fannie Mae and Freddie Mac were the direct result of declines in credit quality. In order to limit future losses, Fannie Mae and Freddie Mac should be restricted as to the quality of loans they can purchase. Under current law, Fannie Mae and Freddie Mac essentially set their own credit quality standards. This has allowed the GSEs to aggressive purchase poor quality mortgages. Going forward, the GSEs should be limited to purchasing only those mortgages that meet the definition of a "qualified residential mortgage" as will be determined by regulations promulgated under the authority of the Dodd-Frank Act.

As regulators are still crafting definitions for "qualified residential mortgage"; the following restrictions should be immediately placed by the GSEs: prohibit the purchase of mortgages for investment properties and second homes; require a minimum cash investment by the borrower of 10 percent of the purchase price or existing home value; and prohibit the purchase of mortgages which have a credit quality indicating a projected delinquency rates of 5% or higher. While there remains considerable debate as to the role of the GSE housing goals in driving their credit losses, I believe it is beyond debate that such were a contributor. Accordingly, the housing goals should be permanently suspended; their future should await the outcome of the broader reform process.

Reduction of Retained Portfolios

Although credit losses have so far constituted the majority, the retained portfolios of Fannie Mae and Freddie Mac continue to pose significant credit and interest risk to both the enterprises and the taxpayer. While the retained portfolios are projected for a gradual decline, that decline could and should be accelerated. The composition of their retained

portfolios should also be restricted to mortgage-related investments only, wish some minor provision for cash and Treasuries.

Conclusions

Reform of our federal mortgage finance policies should be among Congress' top priorities. While the complexity of reform demands a deliberate and thoughtful process, there are immediate steps that can be taken to protect both the taxpayer and our broader economy. Among these steps are: moving Fannie Mae and Freddie Mac into receivership; lower the current conforming loan limits; aligning GSE compensation standards with that of the Federal government; improving the credit quality of GSE loan purchases; and instituting a mechanism to recoup taxpayer assistance to the GSEs.

Testimony of

Alex J. Pollock
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American Enterprise Institute

To the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing on GSE Reform: Immediate Steps

February 9, 2011

A Dozen Ideas for What to Do About Fannie and Freddie

Mr. Chairman, Ranking Member Waters, and members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004, and I am a Past-President of the International Union for Housing Finance. I have both professionally experienced and studied key transitions in mortgage finance, including of course, the one we are trying to shape in the wake of the 21st century Bubble.

Marvin Bower, the great Managing Partner of McKinsey & Company in the 1950s, offered this advice: Direct every action toward building a stronger position for the long term, but take the action now. I think we can apply this advice to addressing the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac, and the huge distortions and losses they have caused.

We should aim in the long term for a housing finance sector which is principally a robust private market, and one in which you can be either a private company, or you can be a government agency, but you can't be both. In other words, in the long run, there should be no GSEs.

As we all know, the GSE charters meant that Fannie and Freddie were private corporations with an implicit, but absolutely real, taxpayer guaranty; they were granted many special privileges and very large economic subsidies, which privatized profits and socialized risk, and as a result, have passed giant losses to the taxpayers. The GSEs were highly politicized, exercised duopoly market power, and transferred a portion of their subsidies to politically-directed housing programs, thereby escaping the democratic discipline of appropriations. They were described as "Masters of Beltway Capitalism."

Fannie, in particular was genuinely feared as a hard-ball political operator. They had especially high leverage and low capital ratios, because their real capital was known by the bond market to be the credit card of the U.S. Treasury.

A private company is subject to market discipline; a government agency is subject to government discipline: GSEs escape both. Virtually everyone now agrees that they must be fundamentally reformed. Of course, prescriptions differ, but no mortgage sector reform which fails to address Fannie and Freddie can be meaningful.

My view is that in the long run, Fannie and Freddie need to be divided into a "bad bank," a "good bank," and a government agency. The bad bank should be put into a liquidating trust, the good bank should be privatized, and the governmental activities of delivering subsidies and non-market loans should be merged into the structure of the Department of Housing and Urban Development.

Such a restructuring would certainly be complex, and while we are still mired in the aftermath of the Bubble which Fannie and Freddie did so much to help inflate, probably can't be done yet. But there are a number of focused, specific actions we could take now, consistent with our long term aim. I suggest a dozen of them.

1. Enable Covered Bonds as an Alternate Long-Term Mortgage Funding Option

A principal challenge of mortgage finance is developing long term funding for mortgages, and for fixed rate mortgages, in particular. To help develop a more robust and competitive housing finance sector, alternatives to Fannie and Freddie securitization should be encouraged.

This should include creating a statutory basis for a U.S. covered bond market, as has been done in many other countries, in some cases of very long historical standing. Legislation is required, I believe, to protect the covered bond holders' rights to the relevant collateral; regulatory policies are insufficient, subject to change, and suffer from a conflict with the self-interest of the managers of the deposit insurer.

A lesson everyone has learned from the Bubble is the importance of whether mortgage lenders retain "skin in the game" for the mortgage credit they originate. With covered bonds, the issuing bank has 100% "skin in the game" credit responsibility—a major advantage over the GSE "originate and sell" model.

2. Set a Sunset Date for Fannie and Freddie's Charters

Granting perpetual charters to GSEs was a major historical mistake—all GSEs should have limited life charters, so the Congress must periodically re-examine their structure, privileges, risks and usefulness. I suggest a five-year sunset be put on Fannie and Freddie's charters, thus having them expire in 2016. Before then, we will be ready for

their long term restructuring and being divided into a truly private business, a fully governmental agency, and a liquidating trust.

3. Bring GSE Capital Requirements Up to Those of National Banks

Although Fannie and Freddie's own capital (excluding taxpayer contributions) is hugely negative, we should formally end their history of being allowed to run with much less capital and much more leverage than was prudent, as events have conclusively demonstrated. Very low capital requirements also gave them a major competitive advantage versus private actors, thus causing risk to become concentrated in the GSEs.

Congress should instruct the GSE regulator to set Fannie and Freddie's capital requirements at no less than those applied to national banks for the same assets and risks. This is basic financial prudence, and would also help prepare for the ultimate privatization of their "good banks."

4. Mandate the Run-Off of the GSEs' Investment Portfolios

The GSEs' investment portfolios in loans and securities serve little purpose except to arbitrage the government's credit. This is particularly true of their investing in their own MBS (with "Kafkaesque circularity," to use of phrase of former full Committee Chairman Jim Leach), by issuing unsecured, taxpayer guaranteed debt. This debt was sold all over the world as "Treasury credit with a higher yield," which indeed it was, just as the bond salesmen said. Now ordinary Americans are being taxed so that the foreign bondholders can be paid at par.

The GSE regulator should be instructed to put Fannie and Freddie's investment portfolios of both loans and securities into run-off mode. (The only exceptions should be a liquidity portfolio composed solely of Treasury bills, and the inventory involved in pooling MBS.) As these assets run off, GSE debt will be correspondingly reduced, as will the derivatives activity needed to hedge these assets.

5. Set a Regular, Predictable Reduction in GSE Conforming Loan Limits

No private entity can compete with the government-granted advantages of the GSEs, which are even greater now that they have no capital of their own left to worry about. But the future American mortgage finance sector should have a robust private market for its largest segment: prime, middle class, conforming loans. In this segment, private investors should put private capital at risk, and prosper of lose as the case may be. Risks here are fully manageable; no taxpayer subsidies or risk exposures are needed or desirable.

A private secondary market for prime, middle class mortgages would have been a natural market development, but cannot develop while the GSEs wield market power derived from their government-granted advantages.

Thus market space must be cleared for the growth of the private market. For now, the logical thing to do is to start at the top, by a regular, predictable reduction in the level of Fannie and Freddie's conforming loan limits. One probably would wish to start incrementally, say with a reduction of 3% to 5% per quarter, now that the financial panic is over. I would suggest a formal, scheduled review of the results in two years, at which time the reductions could be made larger.

6. Mandate Clear Federal Budget Accounting for Fannie and Freddie

At present, as we all know, Fannie and Freddie are wards of the state, owned overwhelmingly and totally controlled by the government. Their debt is debt of the government; their obligations are obligations of the government. This ought to be accordingly accounted for on the government's books.

As proposed in the "Accurate Accounting of Fannie Mae and Freddie Mac" bill introduced in 2010, the GSEs should be accounted for on-budget and be subject to the Gramm-Rudman-Hollings At of 1985 and the Credit Reform Act of 1990.

Obviously, this would no longer apply to the "good banks" after they are privatized.

7. Prohibit Lobbying by Fannie and Freddie Until Privatization

The prohibition of GSE lobbying should be made statutory until they are privatized. The biggest mistake we could make would be to re-create the "masters of beltway capitalism" with their former political clout.

8. Eliminate All GSE Affordable Housing Goals. Transfer Such Goals to HUD.

Public subsidies for affordable housing and non-market, higher risk lending should be explicitly governmental activities, carried out by the Department of Housing and Urban Development, and subject to the governmental disciplines of oversight and appropriations. They should be not financed by taxpayer subsidies or, as it is now, taxpayer capital, moving thorough the GSEs. This is one aspect of the essential principle that you can be a private company, or a government agency, but not both.

All affordable housing goals, assets, and related funding should be ended for the GSEs. Such goals should, as appropriate, become the responsibility the housing finance operations of HUD.

9. Prohibit Double Leveraging of GSEs by the Banking System

One of the big mistakes made by bank regulation was to use the banking system to increase the systemic risk of the GSEs. Banks and thrifts were encouraged to hold disproportionate amounts of GSE credit and debt, without exposure limits, and moreover to invest in the equity of Fannie and Freddie in the form of GSE preferred stock. The banks could leverage this equity investment 60 to 1 for risk-based capital (that is, it had a 20% risk weighting), which is equivalent to buying stock on 98% margin. The result was that insured deposits were used to leverage GSE equity. The GSEs then again leveraged the preferred stock 60 to 1. The actual leverage of the combined preferred stock structure was thus 60-squared to 1.

This was double-dipping on the government guaranty, and more importantly, was double leverage of the GSEs. In other words, if you combine the capital of the system of GSEs plus banks to understand the systemic risk, most of the GSE equity held by the banks disappears as a consolidating elimination. Thus, the GSE system was even more leveraged than it appeared to be because of how it used the banks. As we all know, the subsequent losses on their leveraged equity investments in GSEs was very painful for many banks, and fatal for some.

The correct principle is for equity investments made by banks to be capitalized dollar for dollar with equity, not to be leveraged with insured deposits. This would eliminate the double leverage.

10. Require a One-Page Mortgage Information Form for All Loans Guaranteed by GSEs

Everyone agrees about one improvement sorely needed by American mortgage finance: the provision of clear, simply stated, straightforward key information to the prospective borrowers about the debt commitments they are considering entering into.

This can and should be accomplished in one page, with the addition of some avuncular explanations of the vocabulary of mortgages. The form should help the borrower answer this fundamental question: "Can I afford the payment commitments I would be making?"

It has been hard to get this obviously good idea implemented, but the GSEs offer us a direct way to do so: Mandate that no loan can be guaranteed by Fannie or Freddie which has not provided the borrower with the appropriate one-page information form.

11. Consider Requiring GSE Approval for the Addition of Second Liens

Second mortgages have made coping with the collapse of the housing Bubble very much more difficult, in addition to having contributed to its hyper-leveraged expansion. This is nothing new. As *The Magazine of Wall Street* wrote in 1932, "The second mortgage is

the curse of the own-your-own-home program." (Yes, the government had an "Own Your Own Home" program starting in the early 1920s.)

Normal commercial debt contracts have covenants limiting how much additional leverage can be undertaken. Residential mortgages might usefully adapt this idea. We should consider requiring that mortgage loans may be guaranteed by Fannie or Freddie only if they include a second lien covenant. Such a covenant would provide that second liens could additionally encumber the property only subject to certain defined conditions.

12. Remove the Taxpayer Guaranty of GSE Subordinated Debt

An outrageous part of the GSE bailout was the full protection, at the expense of the taxpayers, of the holders of Fannie and Freddie's subordinated debt. This subordinated debt was sold with the explicit purpose of introducing market discipline into the debt behavior of the GSEs. The theory obviously did not work, but the risk of the subordinated status was fully articulated to the buyers of this debt. They need to experience the market discipline intended, but so far lacking.

Even if we cannot provide this discipline at the moment, we should clearly articulate that in the ultimate long term restructuring of Fannie and Freddie, the subordinated status of this debt will be appropriately reflected.

In sum, I believe there is a lot we could do now to move in the right direction, even though the required long term restructuring of GSEs may be a few years away.

It would be a pleasure to expand on any of the recommendations. Thank you again for the opportunity to share these views.

Note

For more detailed discussions, please see the following, all available at www.aei.org:

"Revoke All Perpetual GSE Charters," Alex J. Pollock, Financial Services Outlook, November, 2005

"Seven Steps toward Sound Mortgage Finance," Alex J. Pollock, Testimony to the Financial Services Committee, April 14, 2010

"Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market," Peter J. Wallison, Alex J. Pollock and Edward Pinto, White Paper, January, 2011

"To Overhaul the GSEs, Divide Them into Three Parts," Alex J. Pollock, *American Banker*, August 26, 2010

Testimony of Anthony Randazzo
Director of Economic Research

Reason Foundation

Before the Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

U.S. House of Representatives

February 9, 2011

Chairman Garrett, Ranking Member Waters, and distinguished members of the subcommittee, thank you for the opportunity to join you in discussing the important matter of reforming the nation's mortgage finance system. My name is Anthony Randazzo, I am director of economic research at Reason Foundation, a non-profit think tank that researches the consequences of government policy, works to advance liberty, and develops ways the free market can be leveraged to improve the quality of life for all Americans.

It is important, at the outset of this debate, to frame the issue properly: mortgage finance policy and affordable housing policy are two different things. Whether we should or how to subsidize low-income Americans putting a roof over their heads must not cloud the analysis and debate about the consequences of government policy distorting mortgage prices for nearly the entire housing market. Separating mortgage finance from affordable housing is important to shed light on what policy options can best be pursued to prevent another artificially-induced boom and catastrophic bust.

That being said, *now* is the time for major reform of the government's role in the mortgage finance market. The housing boom and bust of the last decade is the main source of our recent economic crisis, lethargic recovery, persistent unemployment, and the massive wave of foreclosures. Yet, the past two Congresses have failed to reform America's housing finance system. It seems the time is never right to make serious, much needed changes. When the market was going strong, no one wanted to derail the train. And with the market weak, it's been argued that the government is needed to get housing back on track. This Congress must resist the urge to maintain the status quo.

Significant reform is not only desirable, but also necessary. There can be no sustainable recovery as long as public policy manipulates mortgage prices and directs investment resources toward the housing sector and away from more economically productive areas. And while it may appear that the government is necessary to provide most of the financing needed for mortgages today, the government-sponsored enterprises (GSEs) and Federal Housing Administration (FHA) are crowding out any possible return of private capital in the name of preserving a fragile market.

Ideally, a fully reformed system would have no explicit or implicit government guarantee for mortgage finance—such financial support only subjects taxpayers to high risks and eventual losses. Taxpayers should not be forced to guarantee payments to investors in any asset class, including mortgage-backed securities. If we learned anything from recent housing bust it is this: Federal guarantees lead to credit misallocation, mispricing of risk, unstable price swings, and weakened underwriting standards, all of which contributed to the destabilization of the housing market (see Appendix A).

Allowing market forces to price credit and interest rate risks and no longer shielding institutions from the consequences of poor investment decisions, would avoid these

traps and lead to stable and sustainable growth in the housing sector. There must be no explicit guarantee and Congress should ensure that any reform does not simply transfer the implicit guarantee of Fannie Mae and Freddie Mac onto the banking sector.

The subcommittee should focus on a robust proposal to overhaul the housing finance sector. An effective way to start would be to place Fannie and Freddie into receivership, and spend three to five years winding down their mortgage business and portfolios. With the phase out of the GSEs, private capital—without government backing—could begin to move into the mortgage secondary market where it has been crowded out.

Realistically, this will take time to accomplish. And in the near term there is still a need to protect taxpayers from additional, future losses while ending the ongoing bailout of the GSEs. The government's role in housing must be reduced and private capital must be allowed to return. The following are ten ideas that will help achieve these goals.

1. Lower all conforming loan limits for Fannie Mae and Freddie Mac by 20 percent by the end of September 2011.
2. Increase the down payment requirement for mortgages backed by government agencies to 20 percent over the next three years.
3. Instruct FHFA to begin slowly increasing the guarantee fee charged by Fannie Mae and Freddie Mac.
4. End all affordable housing goals.
5. Raise the capital requirement for Fannie Mae and Freddie Mac.
6. Create a legal framework for covered bonds.
7. Cap expansion of Fannie Mae and Freddie Mac's portfolios at a certain date and have the Treasury Department buy their existing combined portfolio to let them run off over time.
8. Put the staffs of Fannie Mae and Freddie Mac on the federal pay scale.
9. Require the Treasury Department to formally approve new debt issuance by Fannie Mae and Freddie Mac.
10. Wipeout the remaining stock of Fannie Mae and Freddie Mac.

These should not be considered ways to fix the GSEs so that we can continue government support of housing finance, but rather interim steps that can help taxpayers and the housing sector while Congress debates how to fully reform the mortgage market. I will now walk through each of the ten ideas with more detail and am happy to follow up with additional supporting data upon request.

Ten Ideas for Short-Term Mortgage Finance Reform

1. Lower all conforming loan limits for Fannie Mae and Freddie Mac by 20 percent by the end of September 2011.

The government should not subsidize mortgages, particularly mortgages for the affluent. Congress could start the process of reducing maximum loan amounts eligible for purchase by the housing agencies, but limit it to a one-time decline. Even though the so-called high-cost area limit is set to decline to $625,500 from $729,750 at the end of September, I would propose a uniform, across-the-board reduction of 20 percent in the loan limits for Fannie Mae and Freddie Mac (and FHA-backed mortgages, though their jurisdiction lies outside this subcommittee).

This is needed in order to reduce the government's role in housing finance and to create room for private lenders to enter the mortgage market as Congress debates how to reform the system as a whole.

The current traditional maximum loan the GSEs are allowed to buy and securitize is $417,000, but this is well above median and average housing values. According to the National Association of Realtors, the median price for existing homes in the U.S. is $168,800 and the average price is $217,900, both not seasonally adjusted. At the same time the median price of new homes is $221,900 and the average price is $271,600. Lowering the traditional conforming loan limit 20 percent would cap GSE loans at $333,600, still above even the average prices.

For those concerned about removing government supports too quickly, this would still leave plenty of room for the GSEs to operate for the time being. In fact the conforming loan limit was $359,650 at the height of the housing bubble in 2005, and the GSEs were still able to support (and manipulate) the mortgage market.[1]

At the same time, this would be a small step towards creating more room for the private sector to engage the mortgage market, and it could be a test case to see how far the jumbo market is able to expand in this economic climate.

The same reduction should apply to the so-called high cost area maximum. Currently, the high cost conforming loan limit is set to decline to $625,500 from its temporarily ceiling of $729,750 at the end of September 2011. Making the same 20 percent cut to the current level would just reduce the high cost maximum to $583,800. And still this is a very high number, especially if the objective of GSE loan purchases is to assist lower income households.

The high cost areas of the country are located almost exclusively on the coasts, as can be seen in Figure 1. The map on the next page was produced from Federal Housing Finance Agency data detailing the Fannie and Freddie loan limit maximums for fiscal year 2011, broken down by county (see Appendix B for a larger version).[2]

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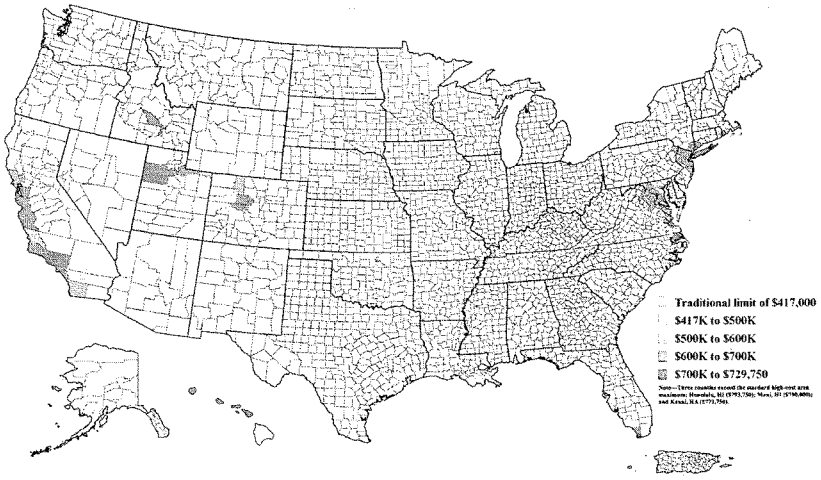
[1] http://www.mortgagebible.org/conformingnon.html

[2] These loan limits are established by FHFA per the requirements of the Economic Stimulus Act of 2008 and Housing and Economic Recovery Act of 2008. They are valid through the end of fiscal year

Figure 1: Fannie Mae and Freddie Mac Maximum Loan Limits by County,
For One-Unit Loans Originated Between Oct. 1, 2010 and Sept. 30, 2011



Source: Reason Foundation, Federal Housing Finance Agency

Given that federal guarantees supporting the purchase of loans represents a subsidy, the map shows that, essentially, high cost area mortgage purchases and guarantees are wealth transfers from Middle America to the coasts. While it is true that the relative cost of housing is higher in Los Angeles County and Nantucket County, that does not mean individuals buying homes in those areas need or should receive a subsidy to buy a house (see Appendix C for a list of counties that qualify for the high cost area subsidy). It may even be preferable to eliminate these high cost exemptions completely, but in the near term, a 20 percent reduction would allow more private capital to phase into the mortgage secondary market while avoiding the potential negative effects of shutting down Fannie and Freddie immediately.

A robust overhaul of the mortgage finance system could build on this proposal and phase out the GSEs by reducing the conforming loan limit by 20 percent each year for five years.[3] But while broader housing reform is being discussed, this would be a good way to get private capital flowing again while at the same time reducing the government's footprint in the mortgage market.

2011 (September 30, 2011). This map outline was originally used by a Mortgage Bankers Association map to communicate the same information as presented here.

[3]A suggested means of winding down the GSEs over five years would be to reduce the conforming loan limit by 20% per year from the previous year's cap. For the traditional conforming limit of $417K that would wind up with a max of $137K after 5 years; for the high-cost limit of $729K it would drop the limit to $239K over 5 years. That would mean at the end of five years all of the GSE business would be in FHA jurisdiction and could simply be taken over by the HUD agency without any market disruption. Ideally, FHA's limits would be lowered to the same rates, or roughly 80% of the median housing value measured on a local level.

2. Increase the down payment requirement for mortgages backed by government agencies to 20 percent over the next three years.

It is universally accepted that weak underwriting standards contributed to and exacerbated the financial crisis. One of the most pervasive problems plaguing homeowners today is the lack of equity in their homes. Contributing to this is the fact that mortgages with very low down payments of just 10 percent or less became commonplace in the bubble period. These underwriting standards were lowered by banks that were ignorant of or defiant of the risks and by the GSEs because of their affordable housing mandate and to compete with the private sector.

While private businesses should still be allowed to lend to whom they want and bear the responsibility of poorly underwritten loans going bad, there is no reason the government should promote risky lending or borrowing. Low down payments amplify cyclical fluctuations in housing markets, both locally and nationally.[4] Plus they set borrowers up to fail and put lenders at risk. And, in this case, the ultimate lending financer is the taxpayer.

I would propose gradually increasing the down payment requirement for mortgages that are bought, securitized by, or guaranteed by Fannie Mae and Freddie Mac to 20 percent by 2014 (or three years from the date of enactment). If private mortgage insurance is also taken out on the loan, then the goal should be that borrowers being supported by the government are putting in at least 10 percent of their own cash.

This would decrease government exposure to risky mortgages and prevent the government from supporting mortgages for those without the resources to become a homeowner. Both those who want to prevent future bailouts and those who are looking to protect consumers from loans that would hurt them in the future should support this idea.

Corollary idea: Prevent Fannie Mae and Freddie Mac from buying or guaranteeing any loan originated outside the yet-to-be-established Qualified Residential Mortgage guidelines.

3. Instruct FHFA to begin slowly increasing the guarantee fee charged by Fannie Mae and Freddie Mac.

One way to decrease the government's exposure to housing market risk would be to begin increasing the guarantee fee (g-fee) charged by Fannie and Freddie for ensuring payment on mortgage-backed securities to investors. This could be done slowly so as to not cause the GSEs to exit the mortgage market overnight. Over time this would increase the cost of doing business with the GSEs and create room for

[4] Low down payments mean more individuals capable of buying homes. This means increased demand, which can drive up prices. When the price bubble being amplified on the front-end eventually collapses, the homeowners with very little equity in their homes will quickly find themselves underwater. A resulting wave of defaults and foreclosures would put further downward pressure on housing prices. This is, in part, also the story of the most recent housing boom-and-bust.

private capital to be more competitive with the government agencies. In the meantime, the GSEs would be collecting more revenue to put back towards the cost of bailing them out and taxpayers would be protected from the risks of bailing out Fannie and Freddie again in the future.

4. End all affordable housing goals.

Again, mortgage finance policy should not be considered the same as affordable housing policy. Over the past several decades these two issues have become confused, as policymakers used GSEs to expand access to mortgage credit and advance the goal of increasing homeownership. But conflating the two policy issues has resulted in failure on both fronts: the mortgage credit market is more than 90 percent dominated by Fannie Mae, Freddie Mac, and the FHA; meanwhile the homeownership rate is lower today than before the housing bubble—68 percent at the end of the 2001 recession, but just 66.6 percent in the fourth quarter of 2010 (see Appendix D).

Here is the good news: eliminating affordable housing goals and removing government supports for mortgage finance does not mean Congress has to end subsides for the poor. While I would argue that we should have no subsidies for mortgages at all, it is possible that aid for low-income families can be pursued in more effective ways that do not distort the entire mortgage market.

It has now become widely accepted that it is not a good idea to push people into homes they cannot afford. If Congress chooses to encourage homeownership for low-income families they should ensure it is sustainable for the homebuyer. Any subsidies provided by the government should be 1) direct to the borrower, 2) on-budget and subject to appropriation, 3) narrowly targeted so as not to compete with the private sector, 4) built on sustainable underwriting standards, and 5) governed by responsible accounting standards.

Using these guidelines we can have a housing market, funded solely by private capital, that has much milder cyclical fluctuations than the past, and at the same time provide narrow, direct subsidies limited to low-income Americans if Congress wants to appropriate the funds as necessary. There need not be any arbitrarily established affordable housing goals.

5. Raise the capital requirement for Fannie Mae and Freddie Mac.

It has been well documented that financial institutions were able to take advantage of a capital arbitrage opportunity created by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. Single-family mortgages with 4 percent risk-based capital requirements were shifted from banks and thrifts to the GSEs and, with federal backing, only required 1.6 percent risk-based capital. However, Fannie and Freddie themselves were only required to hold 0.45 percent against the

mortgages they held or were guaranteeing. This left a gap in the capital being reserved that has still not been corrected. I would propose that the GSE's capital requirement be raised to 2.4 percent to eliminate the current capital arbitrage opportunity and to protect taxpayers. This would also raise the costs of doing business with Fannie and Freddie and create incentives for more private capital to compete with the GSEs.

6. Create a legal framework for covered bonds.

The mortgage market has changed permanently and the future will require new ways of financing housing. One proposal is to create a legal framework for covered bonds, which are debt securities backed by cash flows from dedicated pool of mortgages. While covered bonds are not a holy grail that will give the housing market eternal life, they may help bring a substantive amount of private capital back to mortgage finance and help the recovery process. Whether or not they will be widely used, investors should be given the option to develop this method of mortgage financing if it is profitable. Chairman Garrett's bill, introduced in the 111th Congress, would do this and could be used as the basis for pursuing legislation in this Congress.

7. Cap expansion of Fannie Mae and Freddie Mac's portfolios at a certain date and have the Treasury Department buy their existing combined portfolio to let them run off over time.

As Fannie Mae and Freddie Mac will soon need to begin reducing their portfolios per the terms of conservatorship, I would suggest targeting an end date—in the next 24 months—for the GSEs to be allowed to add new mortgages to their portfolios (except for specified, short periods as necessary to support securitization) and have all business activities limited to mortgage securitization. All new single-family mortgages purchased must be securitized and sold. Multi-family mortgages, which are harder to securitize, could be subsidized elsewhere in the government, in a more direct manner, if Congress chooses.

I would also suggest having the Treasury Department buy the combined portfolios—about $1.6 trillion as of third quarter 2010 statements—purchased at par and place them in a separate liquidating pool.

Having the GSE portfolios run down on the government's balance sheet would allow Treasury to take advantage of Uncle Sam's debt funding advantage. Treasury could fund the shrinking portfolio with roughly a 25 basis point lower borrowing rates than the GSEs. The exact savings would depend on how much GSE debt is replaced with Treasury debt. For example, Fannie Mae reported in its third quarter 2010 SEC

filing that 39 percent of their short- and long-term debt will mature in the next year, requiring reissuance.[5]

Overall, this would help protect taxpayers from further losses and would not undermine the ultimate reform of the housing finance system. Also, because Treasury would be adding the assets in the portfolios to its balance sheet as well, this action should not require Congress to raise the debt ceiling. If it were determined this action would add to the national debt, another means of running off the portfolio should be pursued.

8. Put the staffs of Fannie Mae and Freddie Mac on the federal pay scale.

One way to reduce bailout costs and save taxpayers money would be to put the GSE staff on the General Schedule (GS) pay scale like all other government employees. Some have argued the staff and executives at Fannie and Freddie need to earn more to be competitive with the private sector. But for years, the staffs of Ginnie Mae and FHA have been able to operate on the GS pay scale, and employees of Fannie and Freddie—now being paid from taxpayer funds—should be able to do so as well.

Fannie Mae and Freddie Mac are, for all practical purposes, government agencies. They are being used by FHFA and the Treasury Department to support fiscal policy, social policy, and to protect banks. In these capacities their employees should be treated the same as all other federal staff. And, given that Ginnie Mae staff and executives are able to operate on federal pay, there is no reason Fannie and Freddie should not be able to operate at their existing capacity, even if the change to federal pay reduced their compensation from current salaries. The change in compensation policy would not necessarily have to occur immediately. The adoption of the GS pay scale could be phased in over two years. But at the very least, new employees should be subject to government pay levels while the rest are phased in.

9. Require the Treasury Department to formally approve new debt issuance by Fannie Mae and Freddie Mac.

In the charters of Fannie and Freddie, Treasury Department is required to review and approve any new debt issued by the GSEs. This process was scaled back by the Clinton administration and by the middle of the last decade debt issuance approval became a mere formality with the GSEs simply notifying Treasury of their intentions.

I would suggest Congress reestablish this practice of having the Treasury Department formally approve debt issued by the GSEs. Fannie and Freddie should have to sufficiently justify their need for debt issuance and the Secretary of the Treasury should have to personally approve each debt issuance. This would help protect taxpayers by providing more accountability and transparency to the GSEs while their fate is being further considered.

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[5] Federal National Mortgage Association quarterly filing, page 74

10. Wipe out the remaining stock of Fannie Mae and Freddie Mac.

Had Fannie Mae and Freddie Mac been put in receivership in the first place, their common stock would have been wiped out. Instead, the conservatorship arrangement with the GSEs has preserved hope for some of their common stockholders that the companies may one day be resurrected with a return of value. However, the baseline for any substantive reform of the housing finance system should start with the premise that Fannie Mae and Freddie Mac have already failed and must be shut down. This could most effectively be done through receivership and with a structured wind down of the mortgage business and portfolios of the GSEs as part of at transfer to a fully private system.

As Congress debates how to reform the mortgage finance market, though, there should be no doubt that Fannie and Freddie will one day cease to exist. I would suggest a simple statute wiping out the common and junior preferred stock in both GSEs, bringing the end of bailouts one step closer to reality. Stockholders will object. But this is now taxpayer money. It should be clear that had Fannie Mae and Freddie Mac been treated like private companies going bankrupt, the equity stakes would have lost all of their value long ago.

The Importance of FHA Reform

It is critical that mortgage finance reform be paralleled by FHA reform. Housing finance is more than just Fannie and Freddie. FHA has also crowded out private lending, increased the exposure of taxpayers to significant risks, and encouraged the sort of speculative housing purchases that destabilize housing markets and lead to foreclosures. As previously stated, if Congress chooses to maintain government assistance to low-income individuals, those subsidies should be on the budget with credible accounting measures, should encourage sustainable underwriting standards, and should not take the form of open-ended guarantees.

While FHA is not within the jurisdiction of this subcommittee, I would encourage any proposed legislation to be coordinated with reforms considered by the Subcommittee on Insurance, Housing, and Community Opportunity.

Conclusion

These 10 ideas should not be considered an adequate fix of Fannie Mae and Freddie Mac or as sufficient to reform the housing market. They are merely a starting point, a first step towards a robust overhaul, and should open the door to further mortgage finance reform discussion, as well as affordable housing discussion.

One the benefits of these 10 proposals is that, while they are focused on addressing short-term needs to protect taxpayers, reduce federal bailouts, limit government's

role in the housing sector, and for private capital to return to mortgage finance, they also can be the basis for long-term reform.

The GSEs could be completely wound down by reducing the conforming loan limits annually (suggestion 1). Underwriting standards for all mortgages could be made safer (suggestion 2). G-fees could be increased incrementally over a three-to-five year time frame until they are so high as to be cost prohibitive for the private sector to do business with the GSEs (suggestion 3). The remaining seven suggestions, which include a portfolio wind down proposal, form the basis for the rest of what would be needed to reform the housing finance sector. Other financing innovations, like covered bonds, that are presented to Congress should also have legal frameworks considered to help the flow of private capital to the mortgage secondary market.

Ultimately the goal of housing finance reform should be to allow private investors to replace the government—i.e. taxpayers—as financers in the housing market while ensuring that any subsidies remaining in the system are explicit, direct, narrow, and on-budget. Congress should then continue in earnest to implement such reforms, ensuring that in the future, America's housing market is far closer to a free market.

Thank you for the opportunity to discuss this important issue with you, and I look forward to answering any questions that you may have.

Appendix A: Ten Arguments Against Government Guarantees
(Adapted from Rethinking Homeownership Issue Brief #1, published by Reason Foundation. See www.reason.org/news/show/housing-finance-reform)

There are many possible ways to reform the U.S. housing finance system, but any explicit government guarantee for housing, whether by the sale of insurance on mortgage-backed securities or a new public utility model, would be a tragic mistake. It would repeat the errors of history by putting taxpayers and the housing industry itself at risk. Here are ten reasons why:

1. Government guarantees always underprice risk. All federal guarantees underprice risk in order to provide a subsidy for lending. That is their purpose. And taxpayers will be exposed to losses in the future, as those risks materialize.

2. Guarantees eventually create instability. Guarantees failed to prevent the savings-and-loan crisis and subprime crisis. In fact, they contributed to the cause of both by distorting the market.

3. Guarantees inflate housing prices by distorting the allocation of capital investments. The artificially increased capital flow will make mortgages cheaper, boosting demand for housing and pushing up prices, ultimately creating another bubble.

4. Guarantees degrade underwriting standards over time. Historically, a primary justification for guarantees has been to increase the availability of finance to politically important groups with higher credit risks. It is inevitable that this will continue to happen, requiring the government to lower underwriting standards, and resulting in more risky mortgages.

5. Guarantees are not necessary to ensure capitalization of the housing market. As has begun already, the jumbo market will evolve and practically any credit-worthy potential homebuyer will be able to get a mortgage in a fully private system.

6. Guarantees are not necessary for homeownership growth. Other nations have substantially higher homeownership rates in spite of having far less government interference in their housing markets.

7. Guarantees drive mortgage investment in unsafe markets. As long as there is a government guarantee covering financial institutions, investors and lenders will look to the government's credit, not the credit of institutions and loan applicants themselves.

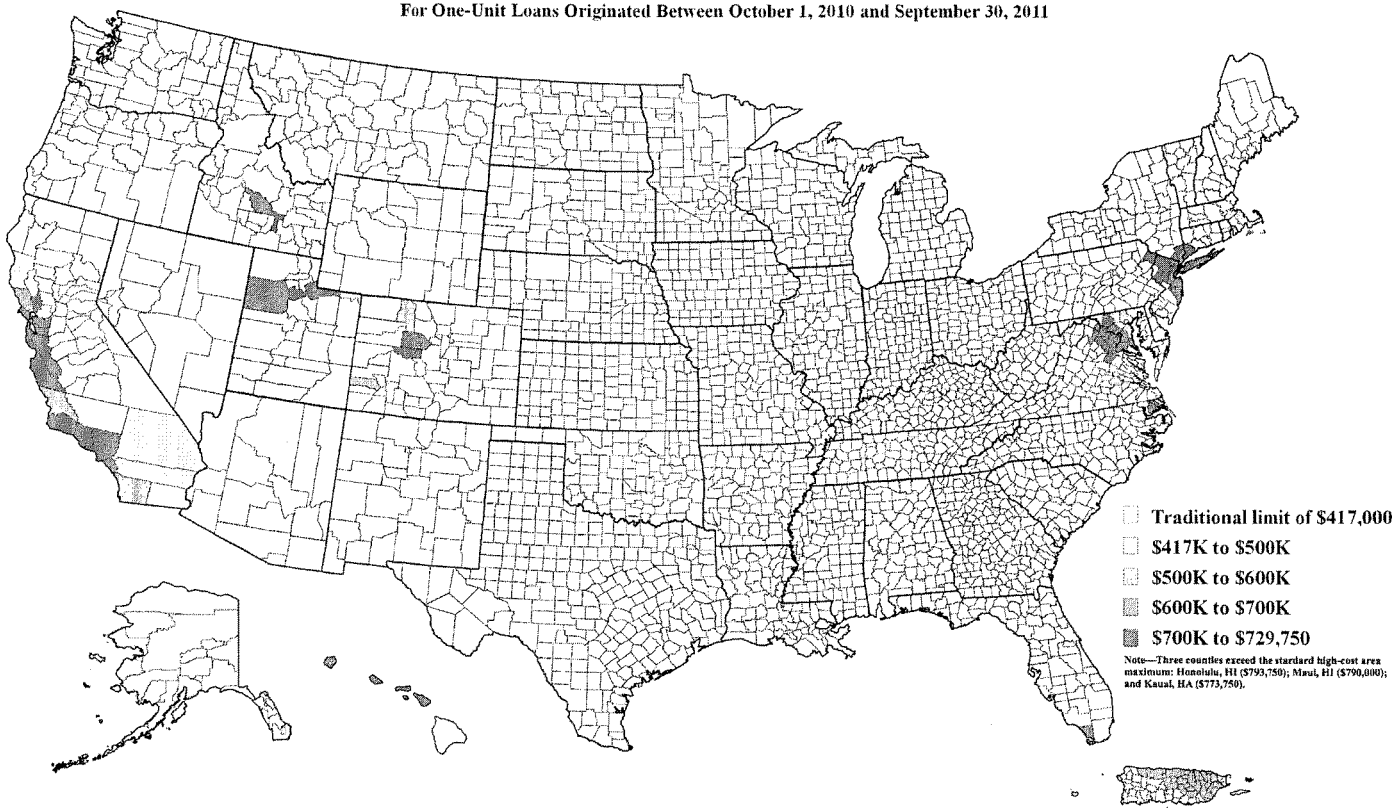
8. Guarantees are not necessary to preserve the "To Be Announced" market for selling mortgage-backed securities. If needed, a TBA market could easily develop with originators hedging against any short-term interest-rate risks in the private sector.

9. Guarantees are not needed to prevent "vicious circles" that drive down prices. Mild price movements in the housing market are necessary to keep balance in the market. Keeping prices artificially high reduces housing demand and prolongs recovery. The most common threat of default as prices decline is from borrowers who have little equity in their homes—because they borrowed at high loan-to-value ratios—seeing the value of their homes drop below what they owe. Guarantees support these high-credit-risk borrowers.

10. Even a limited guarantee on just mortgage-backed securities targeted at protecting against the tail risk will slowly distort credit allocation and investment standards, ultimately destabilizing the market and forcing the need to rely on the guarantee.

Appendix B: Fannie Mae and Freddie Mac Maximum Loan Limits By County

For One-Unit Loans Originated Between October 1, 2010 and September 30, 2011



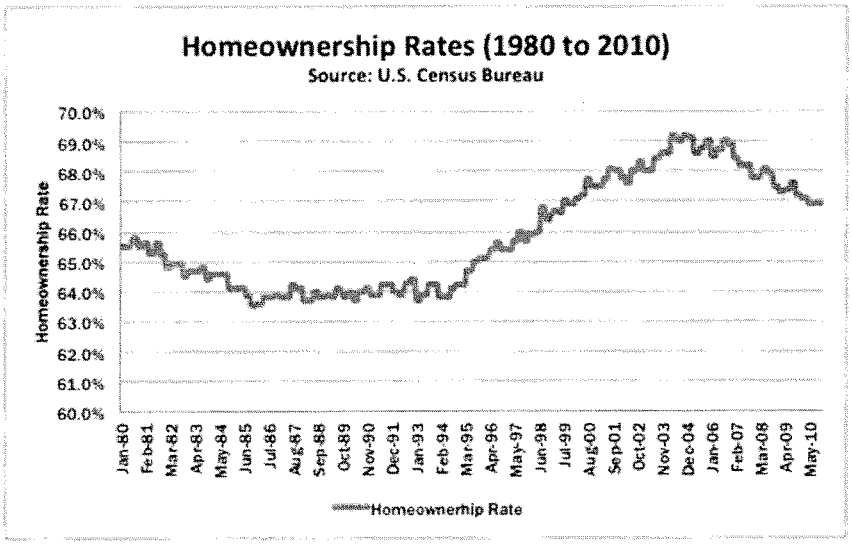
Appendix C: List of Counties With the Top Fannie Mae and Freddie Mac Maximum Loan Limits (One-Unit Properties, Mortgages Originated in FY2011)
Source: Federal Housing Finance Agency

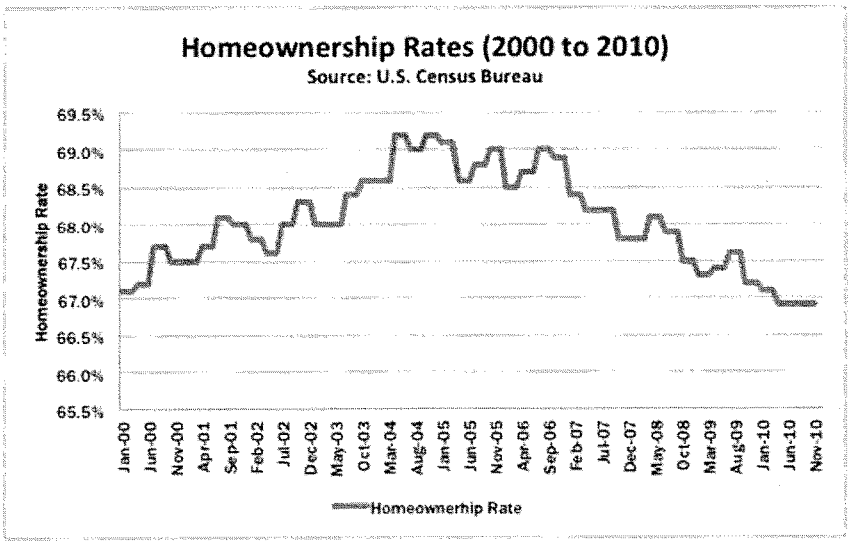
County Name	State	One-Unit Limit
HONOLULU	HI	$793,750
MAUI	HI	$790,000
KAUAI	HI	$773,750
ALAMEDA	CA	$729,750
CONTRA COSTA	CA	$729,750
LOS ANGELES	CA	$729,750
MARIN	CA	$729,750
MONTEREY	CA	$729,750
NAPA	CA	$729,750
ORANGE	CA	$729,750
SAN BENITO	CA	$729,750
SAN FRANCISCO	CA	$729,750
SAN MATEO	CA	$729,750
SANTA BARBARA	CA	$729,750
SANTA CLARA	CA	$729,750
SANTA CRUZ	CA	$729,750
VENTURA	CA	$729,750
EAGLE	CO	$729,750
LAKE	CO	$729,750
PITKIN	CO	$729,750
SUMMIT	CO	$729,750
DISTRICT OF COLUMBIA	DC	$729,750
MONROE	FL	$729,750
BLAINE	ID	$729,750
CALVERT	MD	$729,750
CHARLES	MD	$729,750
FREDERICK	MD	$729,750
MONTGOMERY	MD.	$729,750
PRINCE GEORGE'S	MD	$729,750
DUKES	MA	$729,750
NANTUCKET	MA	$729,750
BERGEN	NJ	$729,750
ESSEX	NJ	$729,750
HUDSON	NJ	$729,750
HUNTERDON	NJ	$729,750
MIDDLESEX	NJ	$729,750
MONMOUTH	NJ	$729,750
MORRIS	NJ	$729,750
OCEAN	NJ	$729,750
PASSAIC	NJ	$729,750
SOMERSET	NJ	$729,750
SUSSEX	NJ	$729,750
UNION	NJ	$729,750
BRONX	NY	$729,750

KINGS	NY	$729,750
NASSAU	NY	$729,750
NEW YORK	NY	$729,750
PUTNAM	NY	$729,750
QUEENS	NY	$729,750
RICHMOND	NY	$729,750
ROCKLAND	NY	$729,750
SUFFOLK	NY	$729,750
WESTCHESTER	NY	$729,750
CAMDEN	NC	$729,750
PASQUOTANK	NC	$729,750
PERQUIMANS	NC	$729,750
PIKE	PA	$729,750
SALT LAKE	UT	$729,750
SUMMIT	UT	$729,750
TOOELE	UT	$729,750
ARLINGTON	VA	$729,750
CLARKE	VA	$729,750
FAIRFAX	VA	$729,750
FAUQUIER	VA	$729,750
LOUDOUN	VA	$729,750
PRINCE WILLIAM	VA	$729,750
SPOTSYLVANIA	VA	$729,750
STAFFORD	VA	$729,750
WARREN	VA	$729,750
ALEXANDRIA	VA	$729,750
FAIRFAX IND	VA	$729,750
FALLS CHURCH	VA	$729,750
FREDERICKSBURG	VA	$729,750
MANASSAS	VA	$729,750
MANASSAS PARK	VA	$729,750
JEFFERSON	WV	$729,750
KALAWAO	HI	$716,250
FAIRFIELD	CT	$708,750
SAN DIEGO	CA	$697,500
TETON	ID	$693,750
TETON	WY	$693,750
SAN LUIS OBISPO	CA	$687,500
ROUTT	CO	$675,000
SONOMA	CA	$662,500
GREENE	GA	$662,500
SAN MIGUEL	CO	$651,250
GUAM	GU	$651,250

Note—All counties within a defined metropolitan area have the same loan limit. For example, all of the counties in Virginia and Maryland that surround Washington, D.C. are counted as having the same loan limit.

Appendix D: Homeownership Rates from 1980 to 2010





Center for American Progress Action Fund

Statement of Sarah Rosen Wartell
Executive Vice President
Center for American Progress Action Fund

before

The Committee on Financial Services
Subcommittee on Capital Markets and Government-Sponsored Enterprises
United States House of Representatives

hearing on

"GSE Reform: Immediate Steps to Protect Taxpayers and End the Bailout"

February 9, 2011

Introduction

Mr. Chairman and members of the committee, I am honored to have the opportunity to share some thoughts on GSE reform.

This testimony benefits from over two years of conversations with the Mortgage Finance Working Group, sponsored by the Center for American Progress. The members of this working group began gathering in 2008 in response to the U.S. housing and financial crises in an effort to collectively strengthen their understanding of the causes of the crises and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. I am grateful for all I have learned from these colleagues, but of course I speak only for myself in the views expressed here. I also offer my thanks to CAP's David Min and Lauren Bazel for their assistance in preparing this testimony.

The invitation to appear today spoke of the committee's goals of building a stable housing finance system based on private capital and minimizing taxpayer losses. I share these objectives. What is more, I agree that the current situation is unsustainable. We find ourselves—in the aftermath of badly designed mortgages, mispriced risk, excessive leverage, and lack of supervision that triggered the financial crisis—with government bearing the credit risk on the vast majority of residential mortgage lending. Private capital must be encouraged to bear as much of the load as possible in our housing finance system going forward. We can begin that process by carefully restoring the private sector's appropriate role in our home mortgage market place.

Our nation's goals, however, should also include some other things that are important to the American people, including:

- Decent, safe, and affordable rental and homeownership options alongside an adequate supply of rental and residential housing so that American families have *appropriate* housing *choices* to meet their circumstances and needs
- Access to the American Dream of homeownership for those creditworthy borrowers who are ready to sustain the responsibilities that accompany a mortgage
- Fair, equitable, and nondiscriminatory access to credit so that the color of one's skin or the composition of the neighborhood of one's home does not determine availability of credit
- The opportunity to rebuild (based on sound and sustainable lending principles) those communities where every fourth house is now in foreclosure, where homeowners' equity is long-gone, and where vandalism, crime, and community deterioration are today the result of the mortgage crisis
- And a diverse housing finance system that is not dependent on a handful or large and ultimately too-big-to-fail financial institutions but rather also includes community banks and other local financial institutions that can compete and offer products to meet the needs of the communities they know best

I will argue that some of the policy prescriptions offered by others testifying before this panel today would not only fail to accomplish these additional goals but also put at risk the Committee's stated goals of broad economic and housing market stability and taxpayer protection. We have learned all too painfully just how closely our economy's fate is tied to housing market stability. If American families see home values continue to fall over the next two years, then still shaky consumer confidence will collapse, bank balance sheets will suffer, credit availability will tighten further, and the vicious circle of falling home values will resume. With housing markets struggling with an enormous overhang of inventory and weak employment, we can ill afford to take any further missteps in housing policy.

In this testimony, I first lay out some principals that should underlie housing finance reform. Then I discuss how to achieve the Committee's stated goals of attracting private capital and reducing taxpayer losses. There are some important preconditions for successfully reducing our reliance on the GSEs in conservatorship and the return of a private securitization market, including completion of the implementing regulations regarding the mortgage market under the Dodd-Frank Act and the development by industry and regulators of industry standards for servicing. I argue that we must ensure that the private market is ready to resume serving portions of the market before we begin to withdraw the GSEs or we could have significantly distorting effects on home values and economic growth.

Then, I will argue that we must have a long-term plan in mind for what replaces the GSEs so that we can build a smooth transition. Taking some of the steps recommended by other panelists would serve the goals of our system badly. So finally this testimony describes some possible consequences of the radical privatization proposals that have been offered to the committee. These proposals would take us to uncharted territory. The reason: Despite assertions to the contrary, no developed country has a private housing finance market without government support in one form or the other. After the sorry consequences of our dangerous experiment with private-market innovation over the precious decade, I will caution against going down that path—leaving American families who have already suffered the worst economy in our lifetimes to once again pay the price.

Principles of reform

A new housing finance system should be based on five key principles: liquidity, stability, transparency, affordability, and consumer protection. I describe these goals below and then explain what these mean in lay terms for American families.

First, there must be broad and constant liquidity

The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. Because long-term, fixed-rate loans impose both interest-rate risk and liquidity risk on lenders, they have become increasingly unwilling to hold these loans on their balance sheets. The capital markets therefore have become increasingly important to the intermediation necessary for mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times.

It is also important to consider the distribution of mortgage originations. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JP Morgan Chase Co., Bank of America Corp, Citigroup Inc., and Wells Fargo & Co.—all of which benefit from federal deposit insurance and the perception that they are too big to fail. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than these larger institutions. These many small but important financial institutions need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

What does consistent liquidity mean for American families?

It means that developers will find capital to finance new apartments and other homes so that families will not see their rents spike as growing demand and inadequate supply put decent rental options out of reach. It means that regardless of what community they live in lenders will offer them credit at a fair price. It means that families will be able to afford a long-term mortgage that offers a fixed housing cost that they can budget for the costs without fear that interest rates will drive up their costs and force them to relocate. It means they can put their hard earned savings into a home with confidence that, whether the economy is up or down, when they need to sell to move to be near an ailing family member or to get a new job, potential buyers will have reasonable access to credit from an array of competing lenders and the family will be able to sell their home at a fair market price.

Second, any new system must foster financial stability

Stability is best achieved by reining in excessive risk taking and promoting reasonable products and sufficient capital to protect our economy from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause the misallocation of capital and result in significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

Mortgage lending is inherently procyclical. Mitigating that tendency requires strong, consistently enforced underwriting standards and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy.

To stabilize the mortgage markets and the economy, sources of countercyclical liquidity are required. Lenders are naturally inclined to minimize risk-taking during uncertain economic times, but the resulting absence of credit can severely exacerbate economic distress in a "vicious circle" of falling asset prices, increasing credit defaults, and reduced availability of loans. This problem is especially acute in economically distressed regions and communities. The system has to be able to make sources of mortgage liquidity available during housing and economic downturns.

What does housing market stability mean for the American family?

It means that they will not experience wild fluctuations in home values. Markets will go up and down, so families cannot be protected against all changes in value, but market stability means that speculation will not create a bubble that inflates family housing costs and then lead to a bust that will destroy their savings.

Third, transparency and standardization will support these other principles

Underwriting and documentation standards must be clear and consistent across the board so consumers, investors and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. Similarly, when standardized mortgage-backed securities trade in transparent markets, investors and regulators can understand the actual risk of both instruments and institutions and markets can price securities accurately.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products, from nonstandard mortgages that could not be understood by consumers at the bottom of the chain to securities that could not be traded due to their complexity at the top. This lack of transparency and standardization resulted in opacity and adverse selection because the issuers knew more than the investors. The yields investors demanded to take on risk decreased while the risk of the underlying assets increased. It is unlikely that a private mortgage-backed securities market will reemerge unless investors are convinced these problems have been resolved.

Moreover, because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the market place. Mortgage-backed securities pooled together by any institution will not be priced properly if alternative investments that are in fact more risky are priced as if they had the same risk characteristics as those in other pools. Standardized data fields with verification

of data are necessary for all mortgage-backed securities. Finally, no securitizer should be allowed to issue products that cannot be analyzed using standard financial models.

What does standardization and transparency mean to the American family?

First of all, it means that they can make good choices in their family's best interest. The mortgage products they can choose from are not so complex that their consequences are hidden. But families also benefit from a market where their mortgages packaged into securities are traded in a transparent market where investors are confident they can assess risk from well understood and standard products. In the aftermath of the housing and financial crises, investors will charge a significant risk premium (if they will invest at all) if they cannot become confident that they understand the mortgage assets underlying the securities that they purchase. Secondary market transparency and standardization lower costs and increase availability.

Fourth, the system must ensure access to reasonably priced financing for both homeownership and rental housing

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit. Liquidity and stability are essential to affordability, but they will not do the job without specific attention to whether private mortgage credit is affordable to support appropriate and sustainable homeownership and quality rental options for Americans.

For most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class. An important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century—is the principle that housing costs should ideally comprise no more than 30 percent of income. This should remain a central principle of the system that is created for the 21st century as well.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment, while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility.

Multifamily rental housing also gains stability from long-term, fixed-rate financing. Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet. In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the

nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

Affordable housing finance must also be available for areas that are not well served by mainstream financial channels, including multifamily rental housing and nontraditional credit risks such as prospective first-time homebuyers with incomes sufficient to support a mortgage but who are unable to raise a large down payment. We have ample evidence that many households who may not fit the 20 percent down, established credit, 30 percent debt-to-income" model can become successful long-term homeowners, when given access to well underwritten, affordable, fixed-rate financing.

What does affordability mean for the American family?

It does not mean that people should stretch to purchase more house than they can afford. It does mean that homeownership's benefits of forced savings and wealth appreciation are available to those with sustainable incomes and strong credit history without regard to race or geography. It also means that there is enough supply of quality rental housing appropriate for individuals and families so that rents charged are affordable—meaning housing costs are no more than 30 percent of incomes.

Finally, the system must support the long-term best interest of all borrowers and consumers and protects against predatory practices

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also delivers devastating consequences to communities, the financial markets and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans.

What does consumer protection in housing markets mean to American families?

It means that there is a counterweight to the persistent problem of information asymmetry that typically tilts the mortgage finance system to disadvantage consumers. It means that they need not fear rip-offs and predatory practices, pitched by those who would profit

from selling them unsuitable profits and stripping them of the savings and home equity that their hard work had produced.

How to responsibly attract private capital to return to the housing market

Understanding the current government backstop

Today, the federal government backstops some 90 percent of all home mortgage loans. Nearly half of the home purchase loans are guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture's Rural Housing Services programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are now in government conservatorship. The private secondary market in home mortgages disappeared in 2008 and remains moribund. Fannie Mae and Freddie Mac also now purchase more than 80 percent of all multifamily mortgages, loans to owners, and developers of rental residential properties.

Let us be clear how these loans work. In the case of FHA, VA, and RHS loans, the federal government is effectively guaranteeing the lenders (or investors if these loans are securitized into Ginnie Mae securities) that they will be repaid their principal and interest if the borrower defaults, minus some transaction costs. In other words, the credit risk on a loan-by-loan basis is on the taxpayer. Today, FHA collects premiums to help pay for this insurance and, under most imaginable scenarios, those premiums will be sufficient to cover any losses FHA incurs on this insurance. If so, FHA's record since 1934 of operating at no cost to the taxpayer will be preserved. But the risk of these loans is on the government. **And so we should seek to reduce that risk, and have the private sector serve more of the need, when that can be achieved without destabilizing the market.**

In the case of the GSEs, the investor in Fannie Mae or Freddie Mac mortgage-backed securities are effectively getting a guarantee from the GSE that they will repay loan to the investors if the borrower defaults, from the GSEs' own capital and the proceeds of recoveries. But of course the GSEs capital became so thin that they had to be placed in conservatorship and they now may draw down from funds made available by the Treasury to fulfill these obligations. So, again, taxpayer resources are effectively supporting the market. **The upshot: Restoring private at-risk capital ahead of the taxpayer must be a goal of reform.**

Preconditions to restoring a private securitization market

So what must happen to draw private capital into the system? First, private-label securities backed by well-regulated, high-quality mortgages above the conforming loan limit could return. But so far, there has been one only private securitization deal since the 2008 financial crisis, a $238 million deal underwritten by Redwood Trust, which

consisted entirely of 5-year jumbo adjustable rate mortgages with a 43 percent average down payment, of which 73.74 percent were interest-only ARMs for the first 10 years.

Evidence suggests that other jumbo loans currently available, including a small market for fixed-rate jumbo loans, are provided by portfolio lenders to their high-end customers with exceptional credit profiles. But there is little reason to believe these banks have sufficient capital to originate and leave on their balance sheet comparable products serving the mainstream conventional market.

The investors in the Redwood deal all conducted extensive due diligence. While the relative success of this deal has prompted several other firms to plan their own jumbo securitizations, given the parameters of the Redwood Trust deal it is hard to imagine private-label securitization coming to scale to take any significant part of the conventional market in the near future.

But why not? I see a variety of important barriers to private securitization. . The first is the necessity of clarifying the rules implementing the Dodd-Frank Act. Regulators are hard at work drafting definitions of the "qualified mortgage" and "qualified residential mortgage." Loans meeting this new QM definition benefit from a safe harbor against certain liability. Similarly, under section 941 of the Dodd Frank Act, securitizers are to retain at least 5 percent of the risk on asset-backed securities issues, but issuances composed entirely of loans meeting the QRM definition are exempt from that requirement. The sooner that these rulemaking processes are complete, the sooner the ground rules for securitization will be clear and the sooner investors are likely to return. Those who would delay these efforts undermine the certainty they claim the markets desperately need.

A second barrier today is the lack of investor confidence in private-label securities themselves. Restoring confidence will require regaining trust that mortgage service companies are acting in the best interest of investors. It turns out that, products developed during what seemed like perpetual house price appreciation, did not spell out clearly standard practices for the defaults and declining market circumstances we faced in this crisis. We are hearing that most investors who do not have the capacity to do their own due diligence on all the underlying collateral want to see new industry-standard servicing practices that provide the servicers the right incentives to service loans to maximize investor return, including to modify loans or use other loss mitigation techniques where doing so would provide a better outcome for investors.

The mortgage servicing industry and regulators has just begun a comprehensive look at servicing standards. Standardizing and clarifying servicing practices is a necessary precondition for investor confidence in securitizations that do not carry a government guarantee of return on investment. When this new system is in place, private label securities will attract institutional investor interest once again.

Of course a third barrier is the comparative pricing advantage of GSE-backed lending given the government's lower cost of capital. It will be difficult for issuers of private-

label securities to directly compete with the GSEs in the current context. When these other barriers to private-label securities are removed, however, and the housing market appears to have stabilized, it will make sense to gradually reduce the GSE conforming loan limit from its current high level to invite the private market back in and give it a larger swath of the market in which to develop new capacities.

Yet I fear the consequences of lowering the conforming loan limit too sharply before some of these other steps are also taken. If the loan limit were to fall and the private securitization market was unable to provide capital for homes above a newly reduced conforming loan limit, then homes valued in that band will find credit constrained and it will have an effect on the ability to find buyers, the ability to sell homes, and the value of homes whether or not on the market. In such a fragile economy, policy-induced home price declines seem unwise.

Loan limit declines must come so that the government backstop is increasingly focused on the lower part of the market where middle class families live, as the Center for American Progress and its Mortgage Finance Working Group recommend. But they must not come before we have certain essential pieces of a new system in place so that the private market is in a position to take their place and we do not experience unnecessary shocks to the broader economy.

Putting private capital ahead of the taxpayer

The path described above of attracting private securitization so that it can gradually assume a larger share of the market now served by the GSEs is not alone sufficient to accomplish the housing finance goals I described above. Even if accomplished gradually as the private securitization market's capacity and readiness is established, stepping aside from the entire market will leave us vulnerable to bubble-bust cycles, with market segments and communities without a liquid supply of mortgage credit on fair and sustainable terms, as further described below.

But the status quo and radical privatization are not the only two options. A third option exists in which fully at risk private capital stands ahead of a limited government guarantee of mortgage-backed securities sufficient to attract a highly liquid market for middle class housing finance needs. What is more, private investors should be asked to pay a premium into a Catastrophic Risk Insurance Fund that would work much like the FDIC to protect taxpayers against risk of loss, with the ability to recoup reserves after periods of economic stress. This long-term option, to serve the middle market, would achieve the Committee's goals of attracting private capital and limiting taxpayer risk while also achieving the other goals described in the first section above.

It is beyond the scope of this testimony to describe how such a proposal might work. Many such options have been produced, including one from the MFWG published by CAP. For purposes of today, however, it is sufficient to emphasize that the Committee's goals of reducing risk of loss and attracting private capital can be achieved in ways that

do not abandon the other objectives of liquidity, stability, and affordability so important to American families and our larger economy

Strategies for reducing taxpayer losses

Another goal of this hearing that I share is to reduce taxpayer losses. Some of the proposals described here today might have the opposite effect. Specifically, premature shutting down of the existing GSEs without a system to replace them would be counterproductive, and could prevent the taxpayers from recouping some of the capital that they have invested in the GSEs to keep the housing market afloat.

On October 10, 2010, the Federal Housing Finance Agency published projections of likely future draws against the Treasury through 2013 as well as dividend payments. While it is important to note that any such projections depend on house prices and other factors that are hard to predict, the FHFA predicts that payments of the dividends to taxpayers for their capital investment in the GSEs to prevent their insolvency will soon likely exceed any continued draw upon taxpayer resources. Draws on the Treasury are likely to end as the credit quality of the GSEs' assets continue to improve and credit losses decline, while dividend payments may continue. Shutting down the GSEs' ability to continue to operate during a transition will thus limit their ability to pay the taxpayers in the form of 10 percent dividends, leaving a larger ultimate bailout cost than would otherwise be the case.

Another proposal to rapidly liquidate the GSEs' portfolios could also have the unintended effect of reducing recoveries for taxpayers. The basic laws of supply and demand tell us that when entities the size of the GSEs put a large number of assets on the market at once, particularly in a soft market, prices will fall. Holding these assets for the markets to recover and selling them gradually into the markets over time is far more likely to maximize recoveries. Patience is likely to be rewarded in this case. In addition, the gradual process is less likely to depress asset values for other institutions that hold significant loan and property assets on their book, including financial institutions that we need to be healthy to continue to provide credit to support the nation's recovery.

As the Chairman himself noted in remarks in Orlando earlier this week, there are most certainly many private investors who would be eager to purchase the many good assets in the GSE portfolios. But selling these assets rapidly at firesale prices will simply allow private investors to profit from market recovery rather than the taxpayers. A more gradual liquidation strategy that maximizes returns could be used to support GSE repayment of taxpayer infusions, whether in their current form or under some transition plan to a new housing finance system.

This is NOT to argue for the current GSEs' continuation in perpetuity. I simply am arguing that we must ensure that the private market and regulators have the time needed to build the new infrastructure for private-label securitization (through reform of the mortgage-servicing industry and by providing clarity about the regulatory provisions of

QRM) and build an alternative mechanism for liquidity and affordability before ratcheting down the GSE market and liquidating their portfolios.

Unfortunately, some would argue we can take these steps without putting in place an alternative system because a fully private market, with no government backstop, is the overall desired outcome. n the final section of my testimony below, let me describe some of the potential consequences of simple privatization without ensuring we have ways to achieve the goals for American families and the economy that I set out at top.

Consequences for families and the economy of radical privatization

Some argue that we should be on a path toward no governmental role in the housing market. Rather than design a better, more targeted, government backstop that stands behind private capital—in which the government is paid for the benefit it brings to ensure liquidity and balance—these proposals argue we should instead simply take the government out of housing finance. These radical privatization proposals would present as extreme a change in the housing finance system as we have witnessed since the 1930s. And, I fear, it would leave the U.S. economy vulnerable to the kind of boom-bust cycle that we saw back then and again in the last decade thanks to unfettered private market forces.

What would American housing markets look like under a system where the government plays no role in the conventional mortgage markets?

The honest answer to this question is that nobody knows for certain because there is not a single example of a purely private mortgage system in any advanced economy. In fact, it is hard to believe we could get there ourselves. In the event that purely private intermediaries were able to finance the more than $10 trillion in mortgage debt outstanding, it is difficult to understand how their obligations would not be considered systemically important. This is particularly true given the high degree of concentration in U.S. mortgage activity (origination, servicing) and financial risk. So instead, we might create a new set of implicit, unmonitored, and unpriced government guarantees.

Advocates of a "purely private" mortgage system cite taxpayer protection and moral hazard as the primary reasons for adopting their proposal, but this analysis falls short. A "purely private" system would greatly increase the risk of taxpayer losses and would drastically increase the significant problem of socialized losses and privatized gains that had been cited as a shortcoming of the Fannie Mae/Freddie Mac model.

The problem of unpriced implicit federal government guarantees would be exacerbated if we moved to the European covered bond model that has been suggested by many advocates of the "purely private" approach. As described in more detail below, European covered bonds encourage, and to a large extent are inextricably based on, "too big to fail" institutions and implicit government guarantees. So while we might not achieve a purely

privatized system, protection for taxpayers, and avoidance of direct moral hazard, we would have some very stark consequences for American households:

- Availability of mortgage finance would be sharply reduced, with many more middle-income households shut out of homeownership.
- To the extent that mortgage finance remained available for working households, it would be directed into loans with features that were advantageous to lenders and highly disadvantageous for consumers: mortgages with shorter durations, higher costs, and very high down payments. Products that help families to fix their housing costs over time, like the 30-year fixed-rate mortgage, would not be available at prices affordable to most families.
- These problems with mortgage finance would also strongly impact the availability and cost of rental housing—even as they created a much greater demand for rental units. Rental demand is already expected to be high due to strong demographic and economic trends (in particular, the transition into adulthood for the "Echo Boom" generation, the transition into retirement for the "Baby Boom" generation, and the continuing fallout from the 2000s foreclosure crisis.
- A key strategy by which working families saved a portion of their income ("forced savings") in their homes would be less available. This option, a hallmark of the New Deal-era reforms and a pillar of the socioeconomic mobility that has characterized the American economy until recently, would be lost—and with it a part of the American Dream.

Some advocates of the "purely private" model of housing finance point to pricing in the jumbo mortgage markets, or the availability of 30-year fixed-rate mortgages in the jumbo markets, as evidence that private capital can capably serve the broader needs of American mortgage finance. This argument is inappropriate. No one disputes the idea that the "purely private" portion of mortgage system can capably serve the needs of the wealthiest Americans, just as it has always done. But the evidence—including during the 2000s, when the "purely private" part of the market briefly expanded to 38 percent of all outstanding mortgages, with disastrous results—strongly indicates that this portion of the market cannot be relied upon to serve the broader market, and certainly not if we value the origination of sustainable mortgages or the stability of the financial system.

Let us explore some of the premises underlying this prediction.

Other advanced capital economies all provide significant levels of support to their mortgage markets

The closest comparison to the United States is Canada, which provides explicit government guarantees for as much as 70 percent of its outstanding mortgages through a mixture of explicitly guaranteed mortgage insurance and explicitly guaranteed mortgage securitization.[1] Looking outside of North America, it is clear that every advanced economy in the world features significant levels of government support for its mortgage finance.

While some claim that many developed European countries don't explicitly support their mortgage markets[2], this analysis ignores the extent to which these countries provide significant implicit support to their markets. The close relationship between financial institutions and the state, which means many European financial institutions are thought to be "too big to fail," has led to a broad assumption among investors that European financial intermediaries enjoy an implicit government guarantee. As one European Central Bank official reportedly said, "We don't let banks fail. We don't even let dry cleaners fail."[3]

The idea that European mortgage finance enjoys implicit government guarantees is reinforced by the recent bailouts that have occurred since the 2008 financial crisis. In fact, Germany, Italy and Denmark provided blanket guarantees for their banking systems, and Germany, the United Kingdom, Ireland and Belgium nationalized failing banks.

This implicit guarantee is typically factored into the credit ratings of European financial institutions and their securities.[4] Finally, as discussed in greater detail below, investors appear to view the implicit guarantee, at least for covered bonds—the largest and most important source of mortgage finance for the advanced European economies—as being roughly similar to the implied guarantee provided by the United States government to Fannie and Freddie, prior to the conservatorship of these entities.

The pre-New Deal era provides us with an idea of what a "purely private" mortgage market would look like

Why does every advanced economy support its mortgage market, given all the problems created by government support? The answer to this question appears to be found in our historical experience with purely private mortgage markets.

Prior to the New Deal-era housing and banking reforms, "purely private" financial institutions dominated the markets because there were no government guarantees. By modern standards, this system was unacceptable. Mortgage finance was largely unavailable, except to the very wealthy, and the home loans that existed had terms that would be considered predatory today—high interest rates, short durations of 3-to-5 years, interest-only, a floating interest rate, and featuring "bullet" payments of principal at term (unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance). Mortgages during this period also required very high down payments, typically 50 percent or more of the property value.[5]

In other words, and perhaps unsurprisingly, when private mortgage intermediaries dominated the market, they sought to originate loans that had a high rate of return, shorter time commitments of capital, and terms that protected their principal in the event of a default. In short, when private lenders had the power to dictate the market, they sought as much as possible to lay off risk and maximize returns. Despite a much smaller scale of finance, this system was also excessively volatile, leading to financial bubble-bust cycles every few years that were highly detrimental to economic growth.

The high cost, limited availability, and high volatility of pre-New Deal mortgage finance meant that homeownership was effectively limited to the wealthy. This problem was exacerbated by similarly high cost, high volatility, and limited availability rental housing finance.

The brief dominance of "private-label securitization" also provides us with an idea of what a "purely private" market might look like

The problems we experienced during the pre-New Deal era, when purely private intermediaries dominated the mortgage market, were briefly revisited in this last decade, when purely private intermediaries again, if briefly, dominated the mortgage market, growing tremendously from roughly 10 percent of all mortgage originations in 2003 to nearly 40 percent in 2006. As during the pre-New Deal era, this brief surge in the market share of purely private intermediaries was characterized by high cost products that were originated on highly lender-friendly terms.

The commercial real estate market provides additional evidence of what a "purely private" market might look like

The commercial real estate market, which is very close to the purely private market many are calling for today, resembles in many important ways the residential real estate markets of the pre-New Deal era, with relatively low loan-to-value ratios, high interest rates, interest-only (or similarly low amortization of principal), and short durations being the norm.

Commercial real estate also is extremely volatile, having gone through multiple boom-bust cycles, including one that mirrors the residential real estate boom-bust of the previous decade. Some analysts warn that the commercial real estate market, despite being only 1/3 the size of the residential market, could suffer losses from this most recent cycle that are ultimately larger than those in residential real estate..

Liquidity is likely to be lacking, particularly for consumer-friendly products such as the 30-year fixed rate mortgage

Based on these experiences, it is likely that mortgage liquidity will be severely curtailed in a purely private system. Moreover, with continued problems in private securitization and the unwillingness of insured depository institutions to take on large amounts of interest rate risk by holding too many 30-year mortgages in their own portfolios, it is difficult to imagine how the liquidity needs currently filled by the GSEs would be filled by the purely private segment of the market.

Covered bonds, while potentially a small piece of a reformed system, have severe limitations as a replacement

Some suggest that covered bonds may be the answer to this vexing liquidity problem. Covered bonds are a key source of mortgage financing in Europe. As the European Central Bank has described, "The covered bond market is the most important privately issued bond segment in Europe's capital markets."[6] In Denmark, the only other country where the 30-year fixed-rate mortgage is broadly available, mortgages are primarily financed through covered bonds.

While covered bonds might be an interesting financing option in a future mortgage finance system, they carry their own problems if issued in the United States. First, covered bonds remain on lenders' balance sheets, which means that unlike mortgage-backed securities, the mortgage loans used as collateral must still have capital held against them. For European banks, which may have difficulty securing alternative sources of funding, covered bonds are nonetheless attractive. But for U.S. banks, which already enjoy access to liquid funds through FDIC-insured deposits, covered bonds are less attractive. This is one reason why there has been such a dearth of covered bond issuances in the United States.

Second, covered bonds require a first lien on the assets that secure them, senior to all other rights, in order to achieve high credit ratings. This lien must be superior even to the FDIC's deposit insurance fund. As such, covered bonds create additional risk to taxpayers because they may prevent the FDIC from recovering a bank's best assets in the event of insolvency. Should covered bonds ever achieve a large scale (such as funding any significant portion of the $10 trillion U.S. mortgage market), they would dramatically increase the risk of loss to the FDIC, and thus the taxpayer.

Finally, the success of European covered bonds appears integrally connected to implied guarantees and "too big to fail." Because covered bonds are a hybrid between mortgage-backed securities and corporate debt, the issuer's credit rating is an important factor in attaining the investment grade rating that makes covered bonds attractive to investors. As such, they are not an appropriate funding mechanism for smaller financial institutions, and tend to work best for very large banks that are considered "too big to fail." Should the United States manage to implement a legal and regulatory framework that allowed covered bonds achieve any scale in the United States, it would encourage more consolidation in the financial sector and create more "too-big-to-fail" entities.

Based on the spreads between covered bonds and their European issuer country's sovereign debt, investors view covered bonds as enjoying a similar government guarantee as Fannie and Freddie did. For example, a 2005 survey by the Mortgage Insurance Trade Association and Mercer Oliver Wyman found that in advanced European economies, the spreads between covered bonds and risk free government debt ranged between 10-to-15 basis points.[7] This is less than the spread between mortgage-backed securities issued by Fannie and Freddie and U.S. Treasuries.[8] In other words, investors appeared to view

European covered bonds as enjoying a similar government guarantee as they did for Fannie and Freddie.

In short, the proposal to "fully privatize" the U.S. mortgage markets would essentially recreate the private-label securities market we just experienced, but on a larger scale, and the covered-bond alternative is unworkable. This learns the wrong lessons from the GSEs. The history of the GSEs teaches us that we must avoid implicit, ill-defined and unpaid guarantees not recreate them in spades.

Conclusion

These are complicated issues. We all, myself included, tend to express our views in abstract terms about what markets will do. But at the end of the day what is at stake is how American families live and save for the future. Do those not ready for homeownership have decent, safe and affordable places to live and raise their families? Do those that are ready for it have a chance to be homeowners and invest in creating a place that suits their family? Do they have a stake in their community? Do all American families regardless of where they live have a chance to save and build wealth and use it to create new opportunities for their future, as our wealthiest Americans have always been able to do?

We all know that we are living through one of the most trying and uncertain times for American families. They are far more exposed to economic volatility than they have been in 80 years. Their jobs come and go, wages rise and fall, benefits mostly fall, and retirement savings dwindle. Few believe that their children face a brighter future. Whether owned or rented, for humankind home is a refuge, a base providing the core security upon which risks can be taken and opportunities made. But now, more than in many decades, home too often is a source of insecurity, volatility, and risk.

As we move forward, we must bring private capital back into the mortgage market place and we must minimize the taxpayers' exposure to risk. But we also must try to put people and families and home back into the conversation about housing finance reform.

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Ms. Wartell served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council in the Clinton administration, where she advised the President, led interagency policy development, and negotiated with Congress on banking, housing and community development, consumer protection, pensions, bankruptcy, e-commerce, legal reform, and a host of other issues. She also oversaw the development of President Clinton's New Markets and Consumer Protection and Financial Privacy initiatives.

From 1993-1998, she held various titles including Deputy Assistant Secretary at the Federal Housing Administration in the Department of Housing and Urban Development, where she focused on FHA reform, single-family finance, risk-sharing, credit reform, consumer protection under RESPA and manufactured housing standards, and other housing finance policy issues.

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She is a graduate of the Yale Law School and Princeton University.

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[3] David Wessel, *In Fed We Trust: Ben Bernanke's War on the Great Panic*, p. 22 (New York: Crown Publishing Group, 2009).

[4] See for example, "Moody's Downgrades Danske Bank to Aa3/C and Sampo Bank A1/C," Moody's Investors Service Global Credit Research Rating Action, February 13, 2009, available at http://www.danskebank.com/da-dk/ir/Documents/Ratings/20090213_Moodys_Danske%20Bank.pdf (in a downgrade of Danske Bank's rating, Moody's explicitly factors in the "very high probability of systemic support" for the bank's obligations); "Revised Assumptions for Classifying Swedish Covered Bonds," Standard & Poor's, June 11, 2010, p. 3 ("We consider that the systemic importance of covered bonds in a market determines how likely the program is to be able to access funding through its funding options, and in particular how governments and regulators are likely to respond to support financial stability").

[5] See, for example, Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," August 31, 2007, available at http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm; Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," *Journal of Economic Perspectives* 19 (4) (2005): 93–114, available at http://papers.ssrn.com/sol3/papers.cfm?abstractid=908976.

[6] John Beirne and others, "The Impact of the Eurosystem's Covered Bond Purchase Programme on the Primary and Secondary Markets," European Central Bank Occasional Paper Series, No. 122 (January 2011), p. 9, available at http://www.ecb.int/pub/pdf/scpops/ecbocp122.pdf.

[7] Mortgage Insurance Trade Association and Mercer Oliver Wyman, "Risk and Funding in European Residential Mortgages," April 2005, pp. 46-47.

[8] See, for example, Goodwin Capital Advisors, "Multi-Sector Fixed Income," 3Q 2010, available at http://www.google.com/url?sa=t&source=web&cd=1&ved=0CBYQFjAA&url=http%3A%2F%2Fwww.goodwincap.com%2Fui%2Fpdfs%2FGoodwin_Core_Core_Plus_Multi-Sector_Fixed_Inocme_Commentary.pdf&ei=aldQTZTWHoycsQPli5GYBw&usg=AFQjCNHpZvE-25btUsXZeIoKLyT068dVag&sig2=l-2WDYMtQzVeiCJcwJo_Sg (as of 3Q 2010, the historical spread between agency MBS and Treasuries was 49bp).

Building Success. Together.

Frank Keating
President and CEO
202-663-5111
fkeating@aba.com

February 9, 2011

The Honorable Timothy Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development
451 7th Street S.W
Washington, DC 20410

Dear Secretary Geithner and Secretary Donovan:

With the Administration expected to release policy recommendations for dealing with the conservatorship of Fannie Mae and Freddie Mac in the near future, I wanted to share with you the American Bankers Association's latest recommendations and attached principles regarding the future of the Government Sponsored Enterprises (GSE).

These recommendations have been developed by ABA's GSE Policy Committee and endorsed by ABA's Government Relations Council and Board of Directors. They reflect views across the spectrum of ABA's membership, and include hands-on input from community and regional banks as well as some of the largest banks in the country. Over the course of the last six months in particular, ABA has been pleased to engage in discussions with some of your staff to share and refine our views. Now, as the Administration and Congress begin the next phase in shaping the future of the mortgage markets and the government's role in them, I hope that you will find these summary recommendations useful.

ABA has focused on three broad policy questions: What is the desired end point? How do we get there? What are the costs and how might these costs be mitigated? The following paragraphs will discuss each of these questions in turn.

What is the desired end point?

ABA believes that the role of the government in housing finance should be dramatically reduced from its current level. A private market for the vast majority of housing finance should be fostered and encouraged with an ultimate goal of a much smaller governmental role. That role should be limited to ensuring stability and accessibility of the capital markets in the event of market failure. We expect that direct government involvement may be necessary and desirable for the creation of affordable rental housing and to assist first-time borrowers or others who may not readily qualify for conventional financing. A well regulated private market should be the desired financing source for the bulk of borrowers whose income and credit rating qualify them

for conventional financing. We do strongly urge the continued federal guarantee of *existing* GSE debt and securities to ensure stability as the process moves forward.

Because of the trauma suffered by the financial markets and the borrowers they served during the recent financial crisis, it will be necessary to move toward a substantially private market in a cautious and well-considered fashion. A transition period taking a number of years will be necessary.

ABA has not endorsed a specific structure for the GSEs going forward, but instead has considered the mechanisms to be employed to reduce governmental involvement and to foster private sector financing – and to ensure that such financing can involve private sector banks of all sizes. (These specific mechanisms are discussed in the next section under "How do we get there?"). Possible structures for a transition vehicle (and potential end point) include a well-regulated and controlled cooperative structure owned by the financing entities or a similarly controlled secondary market public utility that is publically owned. Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns and potential taxpayer liability. Activities under the structure will need to be confined to a controlled mission intended, among other things, to foster and accommodate development and expansion of private sector mortgage financing alternatives.

It is also our view that rather than developing a single "silver bullet" solution to housing finance, it may be desirable to develop several sources which aid in the reestablishment of a private market. Thus, in addition to the creation of a successor entity or entities to the GSEs, policy makers may want to consider the creation of a well-regulated covered bond market, as well as enhancements to the Federal Home Loan Banks which better help them continue to meet and capitalize their mission of providing advances to private market portfolio lenders with minimal taxpayer exposure. It is also important to ensure that any actions taken with regard to Fannie Mae and Freddie Mac do not harm or destabilize the Federal Home Loan Banks, which provide a key source of liquidity to our nation's banks, especially community banks. Multiple of sources of liquidity for private market (and especially portfolio) lenders will lead to a more diverse and ultimately safer housing financing system.

How do we get there?

ABA recommends that the primary mechanism for reducing government involvement (and for compensating the government for its ongoing support) is through adjustments to the guarantee fees (G fees) paid to the GSEs (or their successors). The current G fees are too low – the compensation being paid for what amounts to full government backing is simply not priced correctly. Raising the G fee can do much to encourage development of the private market and to begin to repay the government for its current support. By "dialing up" the G fees in an orderly and well-detailed manner, eventually the private market will find itself in a position where it is better able to compete with the GSEs for business. With a high enough G fee, the private market will be able to price for risk in a fashion that allows for safe and sound investment and lending at a rate that is comparable (and eventually better) than the rate charged by the GSEs. In the meantime, the increased rates for G fees will help to offset losses and assist in the repayment of the government's investment in Fannie Mae and Freddie Mac. This approach also allows for flexibility in the setting of guarantee fees, thereby ensuring a safety valve for housing finance in the event of private market disruptions.

The other key mechanism for transition to a private market will be setting more reasonable loan limits for GSE purchases. The current maximum loan limit of $729,750 in high cost areas and $417,000 in all other regions is dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide. While some high-cost areas persist (and a recovery of the housing market will entail a hoped for stabilization and recovery in home values), the conforming loan limits for most of the nation can be reduced. This will assist the development of a private market for loans outside of the conforming loan limits as a step to a more fully private market for all loans.

Underwriting will also be an important mechanism, but given the significant new underwriting requirements required by the banking regulators and by the Dodd/Frank Act, it would seem that the most important role played by the GSEs in this area for the foreseeable future is to ensure that uniform underwriting requirements are followed by all market participants selling to the GSEs or their successors. Under the Dodd/Frank Act the current GSE regulator, the Federal Housing Finance Authority, will be among the regulators establishing underwriting standards and "safe harbors," so they will remain heavily involved with setting underwriting standards.

What are the costs, and how can they be mitigated?

This may be the most critical question, at least in terms of the ability to move forward from the current situation and establish a phased movement to successor entities for the secondary market GSEs. Any successor entity must contribute necessary market stability and liquidity, and have adequate capital. It is reasonable to expect that the users of that entity will contribute to capital or at least pay the full value and cost of any government guarantee, explicit or implicit. Similarly, any assumption of the hard resources of the existing GSEs by a private entity must occur in a manner in which the government recovers fair value for the assets acquired. In other words, the taxpayer should not subsidize formation of privately owned successors.

It is not realistic, however, to imagine that there is capacity within the financial services industry to fully capitalize a new entity in the near term, or to take on the debt of the existing GSEs. It is our recommendation that income from increased G fees be used to begin building capital, to repay the Treasury and to better protect taxpayers. This could be facilitated by cordoning off the troubled assets of Fannie Mae and Freddie Mac into a segment of the enterprises which would remain in need of federal support while being wound down. Ultimately, the troubled assets of the GSEs may have to be separated into a "bad bank" structure and losses realized. However, as the economy recovers some troubled assets may yet be salvaged and loses recovered. The new book of G-fee business, which would consist of guarantees for securitized pools of high quality mortgages – with higher G fees going forward – should provide healthy returns that support government payments and absorb some of the potential bad asset losses.

The resulting healthy guarantee businesses should be managed and regulated in a manner intended to dramatically shrink their market share, and also to establish incentives for growth of purely private mortgage finance alternatives to fill that market share. This most likely will require that the successors initially be managed under a public utility model as previously discussed and while under government control. Subsequently, the government can exit its controlling interest by spinning the successors to private ownership as cooperatives or through public offerings, further recouping its investment. If these private successors retain some form of government guarantee, which we believe likely, a continuation of the public utility regulatory

model will be necessary to ensure capital requirements and G-fee pricing necessary to compensate the government, protect taxpayers and prevent leveraging of the government guarantee in a manner that discourages growth of private sector, non-guaranteed mortgage markets.

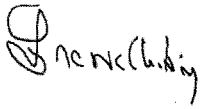
The end goal we envision is a housing finance market in which more than half of mortgage finance occurs without federal secondary market guarantees of any type. Perhaps the mix eventually might be 10 percent in direct government guarantees like FHA and VA, 30 percent in well-regulated and mission-directed businesses that are privately owned and operated with a government backstop, and 60 percent that is without government guarantees. That vision may take years to attain, and goals can be better calibrated as we proceed. However, it is essential that we start taking incremental steps toward these goals, and trust in our ability to make mid-course corrections as we progress.

Further, we would note that to fully protect taxpayers from additional losses, it will be necessary to impose similar reforms on the Farm Credit System, which continues to follow the discredited model of privatized gains and public losses which failed so badly in the housing sector. Without similar reforms to the Farm Credit System, it is only a matter of time until taxpayers again are put at risk.

Conclusion

The task ahead will not be easy. Fannie Mae, Freddie Mac and the Federal Housing Administration currently constitute the vast bulk of available financing for the American mortgage market. It is therefore imperative that reform must be cautious so as not to inflict further harm on an already fragile housing economy, but reform must be deliberate, as the current situation of full federal support is not viable for the long term. I hope that these recommendations and the 11 Principles for Reform which are attached to this letter are helpful to you in this process. The American Bankers Association stands ready to assist in any way possible.

Sincerely,



Frank Keating

Cc: The Honorable Spencer Bachus, Chairman, House Financial Services Committee
The Honorable Barney Frank, Ranking Member, House Financial Services Committee
The Honorable Tim Johnson, Chairman, Senate Banking Committee
The Honorable Richard C. Shelby, Ranking Member, Senate Banking Committee

Attachment

National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
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B. Dan Berger
Executive Vice President
Government Affairs

February 8, 2011

The Honorable Scott Garrett
Chairman
Financial Services Subcommittee on
Capital Markets
and Government Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Financial Services Subcommittee on
Capital Markets
and Government Sponsored Enterprises
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Garrett and Ranking Member Waters:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents the interests of our nation's federal credit unions, I write today in conjunction with tomorrow's hearing, "GSE Reform: Immediate Steps to Protect Taxpayers and End the Bailout."

As you know, the credit union industry has a vested interest in retaining a housing finance system that provides credit unions with the liquidity necessary to serve the mortgage needs of their 92 million members. As the Capital Markets and Government Sponsored Enterprises subcommittee continues to discuss this critical issue, NAFCU would like to share with the committee a core set of principles that must be considered to ensure that credit unions are treated fairly during any reform process:

- A healthy and viable secondary mortgage market must be maintained. A secondary mortgage market, where mortgage loans are pooled and sold to investors, is essential in providing the liquidity necessary for credit unions to create new mortgages for their members.

- There should be at least two Government Sponsored Enterprises (GSEs). To effectuate competition in the secondary market and to ensure equitable access for credit unions, NAFCU supports the creation or existence of multiple GSEs that would perform the essential functions currently performed by Fannie Mae and Freddie Mac. These entities should have the ability to purchase loans and

convert them into mortgage backed securities (MBSs). Each of these functions serves to facilitate mortgage lending.

- The U.S. government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the market, especially for investors who will be needed to be enticed to invest in the MBSs and facilitate the flow of liquidity.

- Fannie Mae and Freddie Mac have been crucial partners for credit unions and have served an important function in the mortgage lending industry. Both have been valuable entities to the nation, particularly to the nation's economy. It is important that during any transition to a new system (whether or not current GSEs are to be part of it) credit unions have uninterrupted access to the GSEs, and in turn, the secondary market.

- We could support a model for the GSEs that is consistent with a cooperative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards. The GSEs should also meet other appropriate regulatory standards to limit their ability to take on risk while ensuring safety and soundness. Rigorous oversight for safety and soundness is also paramount.

- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.

- A central role for the U.S. government in the secondary mortgage market is pivotal, including an explicit government guarantee on the principle and interests of all securities issued by the GSEs. The GSEs should be self-funded, without any dedicated government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans. Credit union loans provide the quality necessary to improve the salability of agency securities.

- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay substantially all their current government debts. Legislation to reform the GSEs should ensure that taxpayer losses are not locked in, but should allow for time for the GSEs to make taxpayers whole.

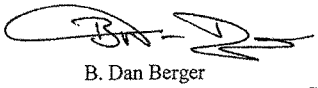
- NAFCU does not support full privatization of the GSEs at this time because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.

- The Federal Home Loan Banks (FHLBs) serve an important function in the U.S. mortgage market. Most importantly, they provide their credit union members with a reliable source of funding and liquidity. Throughout the financial crisis, despite experiencing financial stress, the FHLBs continue to be a strong partner for credit unions. Reform of the nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs. Importantly, access to FHLBs for small lenders should not be impeded in any way.

In summary, NAFCU strongly believes that any reforms must not disrupt the fragile housing finance system that is slowly beginning to recover. As you know, any such disruption could trigger a "double-dip" recession and such an occurrence will have a devastating impact on our country's economy as well as the global finance system. Moreover, NAFCU maintains that the performing key-business functions of Fannie Mae and Freddie Mac should continue so the taxpayers are paid back in full.

We thank you for this opportunity to provide our input on this crucial issue and NAFCU would welcome the opportunity to provide additional views on housing finance reform as the legislative process moves forward. If my colleagues or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Vice President of Legislative Affairs, Brad Thaler, at (703) 842-2204.

Sincerely,



B. Dan Berger
Executive Vice President, Government Affairs

cc: Members of the Subcommittee

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Jamie Gregory, Deputy Chief Lobbyist

STATEMENT OF THE

NATIONAL ASSOCIATION OF REALTORS®

SUBMITTED FOR THE RECORD TO THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

HEARING REGARDING

GSE REFORM: IMMEDIATE STEPS TO PROTECT TAXPAYERS AND END THE BAILOUT

FEBRUARY 9, 2011

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

INTRODUCTION

On behalf of the 1.1 million members of the National Association of REALTORS® (NAR), who are involved in residential and commercial real estate as brokers, sales people, property managers, appraisers, counselors, and others engaged in all aspects of the real estate industry, thank you for holding this very important hearing on reforming the Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac.

REALTORS® are fervent in their belief of "free markets", and that private capital is required to reduce Federal government financial support of the housing sector if the housing finance system is to right-track itself. However, REALTORS® are also practical and understand that in extreme economic conditions, private capital will retreat from the market, requiring the assistance of the Federal government to ensure there is a continual flow of capital into our nation's housing finance system – as it has during this, and so many past, economic downturns.

REALTORS® also believe that job creation and good fiscal policy must be fostered in order to pull the nation's economy out of the quagmire that it currently resides. However, the pursuit of these goals should not come at the detriment of our nation's economy or our still fragile housing recovery. Therefore, the mantra that we believe Congress and the Administration should follow as they work with housing industry participants to prevent another financial system collapse is to first, "do no harm".

REALTORS® agree that taxpayers should be protected, open-ended bailouts should end, private capital must return to the housing finance market, and that the size of the government participation in the housing sector should decrease if the market is to function properly. Where there is disagreement is around the "how" these aspirations should be accomplished. Proposed plans that call for full privatization of entities that will replace the function of Fannie Mae and Freddie Mac need only examine the miniscule activity in the jumbo and manufactured housing markets in order to understand the implications of just having private capital form the foundation of the housing market. In both instances, mortgage capital became nearly non-existent, which prohibited qualified borrowers from access to the funds required to purchase a home. NAR's economists estimate that a retreat of capital from the housing marketplace will negatively impact the 2.5 million jobs generated by home sales, and reduce the $60,000 pumped into the economy by each home purchase for furniture, home improvements, and other related activities.

REALTORS® recognize that the existing system failed and changes are needed. Therefore, NAR recommends that all parties involved in the reform of our housing finance system take a breath, slow down, and consider the practical points from our members' GSE Reform plan as this process moves forward.

KEY GSE REFORM POINTS BASED ON NAR's PRINCIPLES

- An efficient and adequately regulated secondary market is essential to providing affordable mortgages to consumers. The secondary market, where mortgages are securitized and/or combined into bonds, is an important and reliable source of capital for lenders and therefore for consumers.

Without a secondary market, mortgage interest rates would be unnecessarily higher and unaffordable for many Americans. In addition, an inadequate secondary market would impede both recovery in housing and the overall economic recovery.

- We cannot have a restoration of the old GSEs with private profits and taxpayer loss system. The current GSEs should be replaced with government chartered, non-shareholder owned entities that are subject to sufficient regulations on product, revenue generation and usage, and retained portfolio practices in a way that ensures they can accomplish their mission and protect the taxpayer.

- Government-chartered entities have a separate legal identity from the federal government but serve a public purpose (e.g. the Export-Import Bank). Unlike a federal agency, the entities will have considerable political independence and be self-sustaining given the appropriate structure.

- The mission would be to ensure a strong, efficient financing environment for homeownership and rental housing, including access to mortgage financing for segments of the population that have the demonstrated ability to sustain homeownership. Middle class consumers need a steady flow of mortgage funding that only government backing can provide.

- The government must clearly, and explicitly, guarantee the issuances of the entities. Taxpayer risk would be mitigated through the use of mortgage insurance on loan products with a loan to value ratio of 80 percent or higher and guarantee or other fees paid to the government. This is essential to ensure borrowers have access to affordable mortgage credit. Without government backing, consumers will pay much higher mortgage rates and mortgages may at times not be readily available at all (as happened in jumbo and commercial real estate loans)

- The entities should guarantee or insure a wide range of safe, reliable mortgages products such as 30 & 15 year fixed rate loans, traditional ARMs, and other products that have stood the test of time and for which American homeowners have demonstrated a strong "ability to repay."

- For additional safety, sound and sensible underwriting standards must be established for loans purchased and securitized in MBSs, loans purchased for portfolio, and MBS purchases.

- The entities should price loan products or guarantees based on risk. The organization must set standards for the MBS they guarantee that establish transparency and verifiability for loans within the MBSs.

- Political independence of the entities is mandatory for successful operation (e.g. the CEOs will have fixed terms so they cannot be fired without cause, they should not be allowed to lobby, and the authorities should be self-funded – no ongoing appropriations).

- In order to increase the use of covered bonds, particularly in the commercial real estate arena, the entities should pilot their use in multifamily housing lending and explore their use as an additional way to provide more mortgage capital for residential housing. The entities should be allowed to pave the way for innovative or alternative finance mechanisms that meet safety criteria.

- There must be strong oversight of the entities (for example, by the Federal Housing Finance Agency – FHFA or a successor agency), that includes the providing of timely reports to allow for continual evaluation of the entities' performance.

Why not Full Privatization?

As mentioned in testimony before the House Financial Services Committee during the 111th Congress, NAR considered a number of different models for the operation of the GSEs moving forward. The first models that our members considered were the obvious, either fully private or fully federal. Our members thought that neither would effectively protect taxpayers nor ensure a continual flow of mortgage capital into all markets during economic downturns.

REALTORS® believe that full privatization is not an effective option for the secondary market because a private firms' business strategy will focus on optimizing its revenue / profit generation. This model would foster mortgage products that are more aligned with the business' goals (e.g. based upon significant financial risk-taking) than in the best interest of the nation's housing policy or the consumer. This situation, we believe, would lead to the rescinding of long-term, fixed rate mortgage products (e.g. 30-year fixed-rate mortgage products), and an increase in the costs of these products to consumers, or both.

According to research provided to NAR by economist, Susan Woodward, there is no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without government urging. Ms. Woodward points out that a few developed countries have encouraged the use of amortizing long-term loans, but in all instances (save for Denmark), the loans have adjustable rates and recast every 5 years. She goes on to indicate that the United States is unique in supporting a residential mortgage that is long-term, amortizing, fixed-rate and pre-payable, and that Americans have come to view this product as one of their civil rights. Ms. Woodward highlights that in early 2000, when Former Federal Reserve Chairman, Alan Greenspan, hinted at its abandonment, the public outcry was such that he eagerly abandoned that position.

Second, the issue of the size of the US residential mortgage market arises. Currently, the US residential mortgage market stands at $10.6 trillion, with the GSEs owning or guaranteeing $5 to $6 trillion of mortgage debt outstanding and providing capital that supports roughly 70% of new mortgage originations. REALTORS® believe that it is extremely unlikely that enough pure private capital – without government backing - could be attracted to replace existing mortgage funding, or assume the GSEs market share, and make mortgage lending available in all types of markets.

Finally, our members fear that in times of economic upheaval, a fully private secondary mortgage market will cease to exist as has occurred in the jumbo mortgage, the commercial mortgage, and the manufactured housing mortgage markets. When the economy turns down, private capital rightfully flees the marketplace, and should that occur in the residential market it would come to an abrupt and complete halt. Should that happen in the residential mortgage market space, the results for the entire economy – because of the plethora of peripheral industries that support and benefit from the residential housing market – would be catastrophic.

CONCLUSION

The National Association of REALTORS® supports a secondary mortgage market model that includes some level of government participation, but that protects the taxpayer while ensuring that all creditworthy consumers have reasonable access to mortgage capital so that they too may

attain the American Dream – homeownership. Our members recognize that this is just one of many conversations regarding how we mend and improve the housing finance system that has served us well for many years. We believe that the key points that we mentioned will help Congress and our industry partners design a secondary mortgage model that will be in all of our nation's best interest today, and in the future.

I thank you for this opportunity to present our thoughts on reforming our housing finance system, and as always, the National Association of REALTORS® is at the call of Congress, and our industry partners, to help continue the housing and national economic recovery.

STATEMENT FOR THE RECORD

ON BEHALF OF THE

NATIONAL MULTI HOUSING COUNCIL

AND THE

NATIONAL APARTMENT ASSOCIATION

BEFORE THE

HOUSE COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

ON

GSE REFORM: IMMEDIATE STEPS TO PROTECT TAXPAYERS AND END THE BAILOUT

FEBRUARY 9, 2011

1850 M Street, NW, Suite 540 ▪ Washington, DC 20036 ▪ 202.974.2300 ▪ FAX 202.775.0112 ▪ www.nmhc.org ▪ info@nmhc.org

Chairman Garrett, Ranking Member Waters and distinguished Members of the Subcommittee, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) support housing finance reform to ensure appropriate government oversight to meet the mortgage finance needs of the multifamily rental housing industry. We commend Congressional efforts to address the future of the housing finance system and respectfully submit this statement regarding the reform of the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac.

NMHC and NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is a federation of 170 state and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes.

The bursting of the housing bubble exposed serious flaws in our nation's housing finance system. As policymakers craft solutions to fix the single-family housing problems, they should be mindful not to do so at the expense of the much smaller and less understood, but vital, multifamily sector.

Apartments are a critical component of the nation's housing market, but history has made it clear repeatedly that the private market simply cannot meet a majority of the industry's capital needs. A federally backed secondary market is absolutely critical to the sector's health and our ability to continue to meet the nation's growing demand for rental housing.

Fortunately, to date meeting that need has posed little to no risk to the taxpayer. In stark contrast to the single-family sector, the apartment industry did not overbuild during the housing boom. Even more importantly for the issue at hand, the GSEs' multifamily programs did not contribute to the housing meltdown.

Overall loan performance in the $2 trillion multifamily sector remains relatively healthy, and the strongest performance has been recorded by the debt provided by the GSEs. Their multifamily delinquency and default rates remain below one percent—a tenth of the size of the delinquency/default rates plaguing single-family.

Through careful underwriting, the GSEs' multifamily models have met the test. They have attracted enormous amounts of private capital; helped finance millions of units of market-rate workforce housing without federal appropriations; sustained liquidity in all economic climates; and ensured safety and soundness in their multifamily business. As a result of the liquidity provided by the GSEs, the United States has the best and most stable rental housing sector in the world.

As you consider policy to alter the government's role in mortgage financing for our housing system we ask that you consider the following factors affecting the financing needs for multifamily housing:

Private Capital is Necessary, But Not Sufficient

We are encouraged by the thawing in the private capital markets and support a return to a marketplace dominated by private capital. But lawmakers need to understand that even in healthy economic times, history has made it clear that the private market simply cannot meet a majority of the rental housing industry's capital needs.

Banks are limited by capital requirements and have never been a source of long-term financing. Life insurance companies have typically been less than 10 percent of the market, lend primarily only to newer, luxury high-end properties and enter and leave the multifamily market based on their investment needs and economic conditions. The private-label CMBS market is unlikely to return to the volume and market share it reached a few years ago, and the FHA has exceeded its capacity to meet the sector's capital demands. While covered bonds might provide some additional liquidity to apartment borrowers, they are unlikely to provide the capacity, flexibility and pricing superiority necessary to adequately replace traditional sources of multifamily mortgage credit, including the GSEs.

Growing Importance of Rental Housing, Experts Forecast Supply Shortage
The United States is on the cusp of a fundamental change in our housing dynamics. Changing demographics are causing a surge in rental demand that will continue long after the economic recovery. This includes 78 million echo boomers entering the housing market, baby boomers downsizing and a dramatic decrease in the number of married couples with children to less than 22% of households.

Between 2008 and 2015, nearly two-thirds of new households formed will be renters. That's six million new renter households. University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 will have to be rental units. Yet, private capital for new apartment construction all but disappeared during the crisis, virtually halting new development activity for nearly two years.

New multifamily construction set an all-time post-1963 low in 2010 at 97,000 new starts. We need to be building an estimated 300,000 units a year to meet expected demand. Yet most forecasts suggest we'll start fewer than half that many in 2011. That's not even enough to replace the units lost every year to demolition, obsolescence and other losses.

Without government credit support of multifamily mortgages or mortgage-backed securities to ensure a steady and sufficient source of capital going forward, the apartment industry will not be able to meet the nation's housing needs and Americans will pay more for workforce housing. A federally backed secondary market is critical not only for the long-term health of the industry but also to help refinance the estimated $300-$400 billion in multifamily mortgages that will mature by 2015.

Workforce Housing Without Federal Subsidies
Policymakers should understand that nearly ALL of the multifamily funding provided by the existing GSEs helped create workforce housing (not just the capital they provided to properties designated "affordable"). Fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to families at or below the median income for their community. This includes an overwhelming number of market-rate apartments with no federal appropriations, produced with virtually no risk to the taxpayer.

Key Principles for GSE Reform
The apartment industry urges you to consider the following key points for inclusion in any reform measure:

1. **Do No Harm: Preserve Multifamily Lending Programs**
   The multifamily sector produces the vast majority of this nation's affordable, workforce housing. Therefore there is an appropriate public mission for the government to provide an effective financing system to ensure the nation's housing needs are met. In addition, the multi-

family sector, and more specifically the GSEs' multifamily programs, did not contribute to the housing meltdown. Therefore, as policymakers "fix" the problems in the single-family sector, they should not do so at the detriment of the multifamily industry.

2. **Protect the Taxpayer: Look to Proven Multifamily Models**
The taxpayer is footing the bill for the breakdown of the single-family housing sector and that should never happen again. The GSEs' multifamily programs can serve as a model for a reformed housing finance system. They have performed extraordinarily well and have less than a one-percent delinquency rate. Historically, they have been well capitalized, have covered all their losses through the loss reserves they collected and have earned a profit. Even during conservatorship, the GSEs' multifamily programs have earned net revenues of $2 billion.[1] Their success is the result of strong business models that use retained risk and stringent underwriting criteria.

To protect the taxpayer going forward, these models should be carefully studied for a broader application within the larger housing finance system. Specifically, the government must ensure strong regulatory oversight. It should consider implementing some level of retained risk by mortgage originators and servicers and adequate capital standards to fund loan-loss reserves. These steps would preserve the strong mortgage loan performance and track record seen in the multifamily sector and protect the taxpayer.

3. **Federal Government Involvement Necessary and Should be Appropriately Priced**
Even after we transition to a new housing finance system, there will be an ongoing need for an explicit federal government guarantee on multifamily mortgage securities and portfolio-held loans. Over the past 40 years, there have been numerous occasions when the private sector has been unable or unwilling to finance multifamily loans. There is a legitimate concern that the private sector cannot be counted on, from both reliability and capacity standpoints, to consistently finance the majority of multifamily borrowers' needs. Hence it is hard to envision a reformed housing finance system without some form of federal credit enhancement. However, that credit should be priced at an appropriate level that reflects the mortgage risk and the value of the government's credit enhancement and in such a way that it complements, but does not unfairly compete with, private debt capital.

4. **Liquidity Support Should be Broad and Available at All Times, Not Just "Stop-Gap" or Emergency**
Any federal credit facility should be available to the entire apartment sector and not be restricted to specific housing types or specific renter populations. Narrowing any future credit source would remove a tremendously important source of capital to a large portion of our industry, namely market-rate developers who actually provide a large volume of unsubsidized workforce housing. Such a facility should also be available at all times to ensure constancy in the U.S. housing market throughout all business cycles. It would be impossible to turn on and off a government-backed facility without seriously jeopardizing capital flows.

5. **Mission Should Focus on Liquidity, Not Mandates**
The public mission of a federally supported secondary market should be clearly defined and focused primarily on using a government guarantee to provide liquidity and not specific affordable housing mandates. Such mandates create conflicts within the secondary market and are partially responsible for the housing crisis because of the distortions the mandates introduced into the GSEs' business practices. Instead of mandates, the new housing finance system should provide incentives to support the production and preservation of af-

[1] Source: GSE SEC filings. This does not include writedowns of Low-Income Housing Tax Credit holdings that the firms have been prohibited from selling and liquidating.

fordable multifamily housing. Absent incentives, the government should redirect the affordability mission to HUD/FHA and the Low-Income Housing Tax Credit program.

6. **Retain Portfolio Lending While Expanding Securitization**
   Securitization must be used to attract private capital for multifamily mortgage capital. However, unlike single-family loans, multifamily loans are not easily "commoditized." Without the ability to hold some loans in portfolio, multifamily lending activities will be significantly curtailed. In addition, securitizing multifamily loans is not always the best way to manage credit risk. Portfolio capacity is also required to aggregate mortgages for a structured securities sale.

7. **Create Certainty and Retain Existing Resources/Capacity During the Transition**
   To avoid market disruption, it is important that policymakers clearly define the role of the government in a reformed system and the timeline for transition. Without that certainty, private capital providers (e.g., warehouse lenders and institutional investors) are likely to limit their exposure to the market, which could cause a serious capital shortfall to rental housing. In addition, during the transition years, we believe it is critical to retain many of the resources and capacity of the existing GSEs. The two firms have extensive personnel and technology expertise as well as established third-party relationships with lenders, mortgage servicers, appraisers, engineers and other service providers that are critical to a well-functioning secondary market.

We appreciate the opportunity to present the views of the apartment industry and look forward to working with you to build a world-class housing finance system that meets the nation's changing housing needs while also protecting the taxpayers.

Taking the Government Out of Housing Finance: *Principles for Reforming the Housing Finance Market*

An American Enterprise Institute
Policy White Paper

Peter J. Wallison Alex J. Pollock Edward J. Pinto

Preliminary draft dated January 20, 2011

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Executive Summary

Many commentators have pointed out that the Dodd-Frank Act ignored the fundamental causes of the financial crisis it was supposed to address. While imposing new, costly and growth inhibiting regulations on the entire financial system, the act failed to reform the US government's housing policies—policies that fostered the creation of 27 million subprime and Alt-A loans and the inflation of a massive housing bubble between 1997and 2007. When the bubble began to deflate, these weak and high-risk loans started to default in unprecedented numbers, driving down housing values and weakening financial institutions in the United States and around the world.

Implicit in most of the proposals for reforming the housing finance system is the idea that institutional investors will not buy mortgage backed securities (MBS) backed by US mortgages unless they are issued by a government sponsored enterprise (GSE), a US government agency, or are otherwise guaranteed by the US government. We believe, however, that there is a robust alternative to government support of the housing finance system—a system which in the past has led to large scale taxpayer bailouts and losses. Our alternative approach is to ensure that only prime quality mortgages, which comprise the vast majority of US mortgages, are allowed into the securitization system. The very low delinquency and default rates on prime mortgages will be attractive investments for institutional investors and enable the housing finance system to function effectively with no government support. This will eliminate the potential for additional taxpayer losses in the future, and allow the eventual elimination of Fannie Mae and Freddie Mac.

In order to implement our approach, in this white paper we outline four basic principles on which US housing policy should be based in the future. If these principles had been in place for the last twenty years, we would not have had a financial crisis in 2008. But that is water over the dam. The current interest in replacing Fannie Mae and Freddie Mac provides another opportunity to adopt reforms that will prevent a recurrence of another financial crisis in the future.

The four central principles of our plan are the following:

I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any direct government financial support.

Under this principle, we note that the huge losses associated with the Savings and Loan debacle of the late 1980s and Fannie and Freddie—as well as the repetitive volatility of the housing business—did not come about *in spite of* government support for housing finance but *because of* government backing. Government involvement not only creates moral hazard but also sets in motion political pressures for further and more destructive actions to bring benefits such as "affordable housing" to constituent groups.

Although many new ideas for government involvement in housing finance are being circulated in Washington, they are not fundamentally different from the policies that have caused the failures of the past, including the substantial losses in the S&Ls and the losses still to come from Fannie and Freddie. The fundamental flaw in all these ideas is that the government can successfully establish an accurate risk-based price or other compensatory fee for its guarantees or other support. Many examples show that this is beyond the capacity of government and is in any case politically infeasible. The problem is not solved by limiting the government's risks to mortgage-backed securities (MBS); the government's guarantee eliminates an essential element of market discipline—the risk aversion of investors—so the outcome will be the same: the underwriting standards will deteriorate, regulation of issuers will fail, and taxpayers will take losses once again.

II. To the extent that regulation is necessary, it should be focused on ensuring mortgage credit quality.

This principle is based on the fact that high quality mortgages are good investments and have a history of minimal losses. Instead of relying on a government guarantee to assure investors of the quality of mortgages or MBS, we should simply make sure that the mortgages made in the United States are predominantly prime mortgages. We know what is necessary to produce a prime mortgage; these characteristics are outlined in this white paper. Before affordable housing requirements were imposed on Fannie and Freddie in 1992, these were the standards that kept credit losses in the mortgage markets from affecting the entire economy.

Experience has shown that some regulation of credit quality is necessary to prevent the deterioration in underwriting standards. The natural human tendency to believe that good times will continue—and "this time is different"—will always spawn bubbles in housing, as in other assets. Bubbles in turn spawn subprime and other risky lending, as most participants in the housing market come to believe that housing prices will continue to rise, making good loans out of weak ones. Bubbles and the losses suffered when they deflate can be minimized by interrupting this process—by inhibiting the creation of weak and risky mortgages through appropriate regulation.

III. All programs for assisting low-income families to become home-owners should be on-budget and should limit risks to both homeowners and taxpayers.

The third principle recognizes that there is an important place for social policies that assist low-income families to become homeowners, but these policies must balance the interest in low-income lending against the risks to borrowers and the interests of the taxpayers. In the past, affordable-housing and similar policies have sought to produce certain outcomes—for example, an increase in home ownership—which turned out to escalate the risks for both the borrowers and the taxpayers. The quality of the mortgages made under social policies can be lower than prime quality—the taxpayers may take risks for the purpose of attaining some social goods—but there must be quality and budgetary limits placed on riskier lending in order to keep taxpayer losses within reasonable bounds.

IV. Fannie Mae and Freddie Mac should be eliminated as government-sponsored enterprises (GSEs) over time.

Finally, Fannie and Freddie should be eliminated as GSEs and privatized—but gradually, so the private sector can take on more of the secondary market as the GSEs depart. The gradual withdrawal of the GSEs from the housing finance market should be accomplished by reducing the conforming loan limit by 20 percent each year, according to a published schedule so the private sector knows what to expect. These reductions would apply to the conforming loans limits for both regular and high-cost areas. Banks, S&Ls, insurance companies, pension funds, and other portfolio lenders would be supplemented by private securitization, but Congress should make sure that it does not foreclose opportunities for other systems, such as covered bonds.

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I. The housing finance market—like other US industries and housing finance systems in most other developed countries—can and should principally function without any government financial support.

Given the spectacular failures of US housing finance and the enormous cost to taxpayers of two massive bailouts in twenty years, the housing industry should be required to show why it needs government support again.[1] No other developed country provides anything that approaches the support for housing provided by the US government, and—as shown below—many of these other systems produce higher homeownership rates,[2] lower mortgage interest rates (see table 1) and fewer losses when defaults occur (see table 2).

In the last twenty years, US taxpayers have had to pay for bailouts of two major elements of the housing finance system: the S&Ls in the late 1980s and early 1990s and the GSEs Fannie Mae and Freddie Mac beginning in 2008. As two commentators described it, the S&L crisis of the 1980s and early 1990s "produced the greatest collapse of US financial institutions since the Great Depression. Over the 1986–1995 period, 1,043 thrifts with total assets of over $500 billion failed. The large number of failures overwhelmed the resources of the Federal Savings and Loan Insurance Corporation (FSLIC), so US taxpayers were required to back up the commitment extended to insured depositors of the failed institutions. As of December 31, 1999, the thrift crisis had cost taxpayers approximately $124 billion and the thrift industry another $29 billion, for an estimated total loss of approximately $153 billion."[3]

Today, taxpayers face even larger losses arising from the insolvency of Fannie Mae and Freddie Mac, both of which are now operating in conservatorships controlled by the government. Thus far, the Treasury has contributed approximately $150 billion to keep the two GSEs solvent; but the Federal Housing Finance Agency (FHFA), the GSEs' regulator, has estimated that their losses will fall between $221 billion and $363 billion. If housing prices continue to fall, many observers believe the total losses of the GSEs will eventually exceed $400 billion.

The taxpayer losses in both the S&L and GSE debacles are related; as we will show, they are the inevitable result of extending government guarantees or subsidies to the housing finance industry. Before Congress considers any action on the future of housing finance it should ask those who are pressing for government backing to explain why the taxpayers should be put at risk again.

Recent research by Dwight Jaffee, set out in table 1, documents that, notwithstanding the absence of government guarantees in most cases, many housing finance markets have achieved better outcomes than the US market along a number of critical dimensions.[4] For example, as

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[1] In principle 3, we discuss how the government should proceed with respect to providing financial support for social policy purposes.

[2] *Testimony of Alex J. Pollock, Subcommittee on Security and International Trade and Finance, U.S. Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (September 29, 2010).

[3] Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review, December 2000*, http://fcx.fdic.gov/bank/analytical/banking/2000dec/brv13n2_2.pdf (accessed January 14, 2011)

[4] Dwight M. Jaffee, "Reforming the U.S. Mortgage Market through Private Market Incentives" (presentation, Federal Reserve Bank of St. Louis, November 17, 2010) http://research.stlouisfed.org/conferences/gse/Jaffee.pdf (accessed January 14, 2011).

table 1 shows, the United States has one of the highest mortgage debt levels (column 1) and among the highest mortgage interest rates (column 5) and spreads (column 6), yet is only average in owner occupancy rates (column 2). This is not an enviable record, and certainly not what American taxpayers deserve for all the losses they have covered to support the housing industry.

Table 1: The Performance of European Mortgage Markets in Comparison with the US Markets *
(Statistical measures computed with annual data by country for 1998 -2008)

	(1)	(2)	(3)	(4)	(5)	(6)
	Mortgage to GDP Ratio	Rate of Owner Occupancy	Coefficient of Covariation Housing Starts	Standard Deviation of House Price Inflation	Mortgage Interest Rate Average Level	Mortgage Interest Rate Average Spread **
	2008	2008				
Western Europe						
Austria	25.3%	57.0%	8.3%	2.6%	5.12%	0.66%
Belgium	39.8%	78.0%	16.3%	4.0%	5.87%	1.37%
Denmark	95.3%	54.0%	40.8%	6.1%	5.96%	1.41%
Finland	47.5%	59.0%	11.0%	3.4%	4.5%	0.05%
France	35.9%	57.4%	16.4%	5.5%	4.93%	0.53%
Germany	46.1%	43.2%	30.1%	0.8%	5.27%	0.97%
Iceland	129.0%	82.5%	56.3%	9.8%	5.01%	0.64%
Ireland	80.0%	74.5%	35.8%	11.5%	4.69%	0.22%
Italy	19.8%	80.0%	47.0%	3.1%	5.25%	0.64%
Luxembourg	43.5%	75.0%	19.2%	4.3%	4.33%	-0.16%
Netherlands	99.1%	57.0%	10.2%	5.5%	5.17%	0.77%
Norway	55.7%	77.0%	21.1%	5.0%	6.54%	1.61%
Portugal	63.3%	76.0%	31.5%	5.4%	5.15%	0.61%
Spain	62.0%	84.5%	32.5%	2.5%	4.38%	-0.09%
Sweden	60.6%	52.0%	53.9%	5.1%	4.05%	-0.49%
UK	80.5%	59.0%	10.5%	5.0%	5.32%	0.42%
Euro Average	**61.5%**	**66.6%**	**27.6%**	**5.0%**	**5.10%**	**0.57%**
US Average	**83.6%**	**67.8%**	**24.9%**	**5.5%**	**6.57%**	**1.82%**
US Rank	**4th of 17**	**9th of 17**	**9th of 17**	**4th of 17**	**1st of 17**	**1st of 17**

Notes:
* Unless noted otherwise, the data are all from European Mortgage Federation (2008), an annual fact book that contains comprehensive mortgage and housing market data for 1998 to 2008 for the sixteen Western European countries and the United States.
** The mortgage interest rate spread equals the mortgage interest rate (column 5) relative to the government bond rate of each country derived from the International Financial Statistics of the International Monetary Fund.

Moreover, Jaffee's research also shows that when recent bubbles deflated in these other countries, the number of delinquencies and foreclosures was much lower than in the United States. All the countries in table 2 below had housing bubbles during the 2000s, some of them even larger than the one in the United States, but the outcomes in these countries were far better.

Table 2: Troubled Mortgages: Western Europe and the United States

	≥ 3 Month Arrears %	Impaired or Doubtful %	Foreclosures	Year
Belgium	0.46%			2009
Denmark	0.53%			2009
France		0.93%		2008
Ireland	3.32%			2009
Italy		3.00%		2008
Portugal	1.17%			2009
Spain		3.04%	0.24%	2009
Sweden		1.00%		2009
UK	2.44%		0.19%	2009
U.S. All Loans	9.47%		4.58%	2009
U.S. Prime	6.73%		3.31%	2009
U.S. Subprime	25.26%		15.58%	2009

Source: European Mortgage Federation (2010) and Mortgage Bankers Association for U.S. Data.

With this background, it is time to examine why the US housing finance system fails so consistently, even though since the 1930s it has been supported or backed by a growing phalanx of government agencies and enterprises (Federal Housing Administration, Fannie, Freddie, FSLIC, Federal Home Loan Banks, and Ginnie Mae).

The reason, we believe, is that the US system fails *because* of its connection to the government. Government guarantees create moral hazard on two levels. First, by assuring the housing industry of a steady supply of underpriced funds, government support encourages overbuilding and speculation. In other industries, variations in the availability of funding suppress risk taking. In addition, by relieving investors of risk through a guarantee, government support makes it possible for mortgage originators to offer liberal lending terms such as zero or low down payment loans, loans without documentation, and loans to credit-impaired borrowers.[5]

The result is not the stability the industry is seeking but a repetitive volatility—the growth and deflation of housing bubbles leading to credit crises such as the one that occurred in 2008. It is because of excessive government intervention in the housing market that we now have both historically high borrower leverage and a clearly inadequate amount of capital backing a debt market consisting of $10.6 trillion in first and second mortgages.[6]

[5] Additional commonly-used provisions include: negatively amortizing loans (option ARMs), ARMs as an affordability aid, liberal terms for cashing out equity, minimal right to recourse or enforcement of same, second mortgages (sometimes hidden), and loans to investors/speculators masquerading as prospective homeowners.
[6] Fannie and Freddie, now, with no capital of their own, guarantee about 45 percent of all outstanding mortgages. The FHA, with about $5 billion in regulatory capital (likely much less or none on a GAAP basis), guarantees another 10 percent, and commercial and savings banks own another 25 percent, which on a mark to market basis are substantially underwater. Most of the remainder is in the form of private MBS, also substantially underwater.

Accordingly, for the reasons outlined below, our first principle is that the housing finance system should be free of any government assistance in the future, other than for social policy reasons through FHA and other explicitly government programs.

1. *The government cannot successfully price for risk.* Many of the plans currently making the rounds in Washington depend on government backing at some level—usually as a guarantor of MBS issued by a financial intermediary. Rumors about the nature of the forthcoming administration plan are to the same effect. These plans are based on a fundamental error: that the government can act like an insurance company and set a correct price for the risk it is taking. There are three reasons why this cannot be done:

(i) Unlike an insurance company, the government has no profit incentive to price for risk, and because risk-pricing can seem arbitrary and unrelated to current conditions, the government has many incentives to avoid the controversy that risk pricing entails;

(ii) If the government actually attempted to set a price for mortgage risk, it would be discriminating among its citizens, since some present greater risks than others; this would inevitably bring the risk pricing project to a halt; and

(iii) Successful insurance systems require the build-up of reserves during good times to pay claims during the inevitable bad times, but the government lacks the discipline and incentives to follow through. During the good times, the government comes under political pressure not to increase a reserve fund by continuing to collect fees or premiums. The argument is made that the times are different, the fund is large enough, or even that the industry is strapped for investment capital. These pressures cause the government to let it ride, to refrain from collecting the necessary fees or premiums. This has occurred with the National Flood Insurance Program,[7] the Pension Benefit Guaranty Corporation,[8] the FHA,[9] and the Federal Deposit Insurance Corporation (FDIC).

Recent FDIC experience is symptomatic of government's tendency to avoid collecting the necessary premiums. When the deposit insurance system was reformed in 1991 in response to the failure of the FSLIC, Congress placed a limit on the size of the deposit insurance fund that the FDIC could accumulate to meet the demands of a future crisis. Since 1996, the FDIC has been prohibited by law from charging premiums to well-capitalized and stable institutions. As a result, between 1996 and 2006, institutions representing 98 percent of deposits paid no deposit

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[7] "FEMA Administrator Craig Fugate says the debt results partly from Congress restraining insurance rates to encourage the purchase of coverage, which is required for property owners with a federally backed mortgage.... 'It is not run as a business,' Fugate said. Congress' Government Accountability Office said in April that the program is 'by design, not actuarially sound' because it has no cash reserves to pay for catastrophes such as Katrina and sets rates that 'do not reflect actual flood risk.' Raising insurance rates or limiting coverage is hard. 'The board of directors of this program is Congress,' Fugate said. 'They are very responsive to individuals who are being adversely affected.'" (Thomas Fink, "Huge Losses Put Federal Flood Insurance Plan in the Red," *USA Today*, August 26, 2010.

[8] As of the end of FY2010, the Pension Benefit Guaranty Corporation (PBGC) reported a deficit of $23 billion. "In part, it is a result of the fact that the premiums PBGC charges are insufficient to pay for all the benefits that PBGC insures, and other factors." Pension Benefit Guaranty Corporation, "2010 PBGC Annual Report," www.pbgc.gov/about/ar2010.html (accessed January 14, 2011)

[9] Barclays Capital estimates that the FHA has drastically underpriced the risk of its guarantees and could face losses of up to $128 billion. Barclays, "US Housing Finance: No Silver Bullet," December 13, 2010

insurance premiums. In 2009, FDIC chair Sheila Bair observed: "An important lesson going forward is we need to be building up these funds in good times so you can draw down upon them in bad times."[10] Instead, once the bad times hit, the FDIC was forced to raise its premiums at the worst possible moment, thereby reinforcing the impact of the down cycle. Principle II will discuss in greater detail the need for countercyclical reserving policies.

2. ***A government guarantee of MBS alone will have the same effect in creating taxpayer losses as any other guarantee.*** Several of the ideas recently advanced for government backing of the housing market have suggested that the government's guarantee would extend only to MBS and not to the issuers of these securities. These plans would obligate the government to pick up losses only after the capital of an MBS issuer has been exhausted and would require the issuer to pay a fee to the government to cover the government's risks. This idea is presented as though it will prevent losses similar to those that have resulted from the operations of Fannie and Freddie—that the government's risks will be reduced and the likelihood of taxpayer losses will be minimized.

But it's an illusion. As noted above, the fee to cover the government's risks cannot be effectively set by the government. Even if government had the incentives and capabilities to assess a proper fee, the assessment would be seen and attacked as an unfair tax on those who are using the government's services. For example, when the Office of Management and Budget suggested near the end of the Clinton administration that Fannie and Freddie pay a fee for the government's risk on its implicit backing of their obligations, the idea was immediately derided as a tax on homeownership, the administration was inundated with protests from the housing industry, and the proposal was promptly abandoned. Apart from whether a fee can be credibly established, it is fanciful to believe that any government will have the political fortitude to impose a fee that burdens homeowners because of the risks they pose to taxpayers.

Nor is the problem solved—as many of the supporters of these guarantee plans suggest—if the government is liable for losses on guaranteed MBS only after the issuer of the MBS has absorbed the first losses and exhausted its capital. It is true that in this case issuers will have an incentive to be cautious about risk taking, but the government guarantee eliminates an important element of market discipline—the risk aversion of investors. These securities will undoubtedly be sold worldwide as US government credit. The existence of a government guarantee will mean that no MBS buyer needs to be concerned about the quality of the underlying loans or the financial stability of the issuer. This is exactly analogous to the effect of deposit insurance on risk taking by banks. As is well known, deposit insurance permits bank depositors to ignore the risks a bank is taking—the principal reason that so many banks fail. As in the case of deposit insurance, government backing of MBS will eliminate investor concerns about both the financial stability of the issuer and the quality of the mortgages underlying the MBS. This will introduce destructive moral hazard into the housing finance system, allowing the expansion of risks through the securitization of very low-quality mortgages.

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[10] Center on Federal Financial Institutions, "Federal Deposit Insurance Corporation," August 10, 2005, www.coffi.org/pubs/Summaries/FDIC%20Summary.pdf (accessed January 14, 2011). See also Congressional Budget Office, "Modifying Federal Deposit Insurance," May 9, 2005, "Currently, 93 percent of FDIC-insured institutions, which hold 98 percent of insured deposits, pay nothing for deposit insurance."

The protection of the government and the taxpayers in these cases will then supposedly come through —regulation—another prescription of the advocates of government backing for MBS. They argue that regulation of the issuer will ensure that it has sufficient capital to cover the risks it is taking and thus to protect the government and the taxpayers from loss. But experience with bank regulation has shown that it does not prevent excessive risk-taking and does not ensure sufficient capital to cover risks. Moreover, regulators are frequently unable to determine the financial condition of a regulated entity until it is too late. In these cases, the taxpayers will once again end up holding the bag.

3. ***Government backing distorts prices, resource allocation, and competition.*** The fact that the government cannot price for risk should be an important clue about the distorting effect its guarantee will have on competition. For the reasons outlined above, the government's charge for supporting one sector of the housing market will be lower than what the actual risk would demand, so its backing will operate as a subsidy for the sector of the housing market it is actually covering. For an equivalent risk, the government-guaranteed mortgage will always be cheaper than the privately backed mortgage. This simply means that the taxpayers are providing a benefit to the borrower and the lender. The real costs to society appear later.

As a result, private competitors will be driven out of any sector of the market where the government guarantee is offered. Moreover, political pressures will make it attractive to extend the benefits of the lower-cost government-backed mortgage to more constituents, expanding the size of the sector that will be covered by the guarantee, and thus gradually extending the government's obligations to cover a larger sector of the market.

We have seen this before. With Fannie and Freddie able to borrow at much lower rates than others because of their implicit government backing, they drove all potential private competition out of the market for fixed-rate prime loans at or below the conforming loan limit, and most mortgage originators preferred to direct their production to Fannie and Freddie, which could offer them the best pricing. Political pressure—to allow more members of the public to get the benefits of the taxpayer subsidy—also extended the subsidized market into an area that had previously been reserved for private activity. Thus, when Congress enacted the Housing and Economic Recovery Act of 2008,[11] it raised the conforming loan limit for Fannie and Freddie so buyers of million-dollar homes would have access to the benefits of the taxpayer subsidy provided free to Fannie and Freddie. Accordingly, if a government guarantee is again introduced into the housing sector, it will gradually grow to squeeze out private nongovernmental financing of mortgages. In other words, it will be unlikely that Congress, once it allows any portion of the housing market to be covered by a government guarantee, will be able to place any effective limits on the extent of the taxpayers' risks.

4. ***It is a myth that only a government guarantee can make a thirty-year fixed-rate mortgage available.*** Those who argue for a government role in housing finance frequently contend that the thirty-year fixed-rate mortgage will not be available without government backing. On its face, this is not true, since anyone can go to the Internet and find lenders offering jumbo fixed-rate thirty-year loans—which, by definition, have no government backing. It is true that a thirty-year fixed-rate mortgage is somewhat more expensive than a government-backed thirty-year fixed-rate mortgage, since the lender is taking a longer-term risk on interest rates, but

[11] *Housing and Economic Recovery Act of 2008*, Pub. L. No. 110-289 (July 30, 2008).

the lower cost of the government mortgage simply means that the taxpayers—as well as all other mortgage borrowers who are not taking thirty-year fixed-rate mortgages—are providing a subsidy to the person who wants a government-backed mortgage with these terms.

History has shown—and simple economics would anticipate—that a government subsidy for a thirty-year fixed-rate mortgage is not good policy. The subsidy causes most borrowers to choose the thirty-year fixed-rate loan, since in general it offers the lowest monthly payment for a loan of a given size. However, the loan amortizes slowly; this keeps the homeowner's equity low and corresponding debt level high over the life of the loan. None of the proponents of government backing ever explains why the taxpayers and other mortgage borrowers should be subsidizing this particular type of mortgage. For homeowners who want a thirty-year fixed-rate loan, as noted above, it is available for a slightly higher cost without a taxpayer subsidy.

We believe that in a market without government guarantees, borrowers would have a variety of solidly underwritten loan choices. What the interest rates would actually be depends, of course, on monetary and fiscal policy in the United States. As an example of what the loan menu might look like, we take a historically typical spread of about 2 percent over the ten-year Treasury rate for a thirty-year fixed-rate jumbo loan and assume a 4 percent yield on the ten-year Treasury note. (The average spread on a thirty-year fixed-rate jumbo loan was a little under 2 percent, and the average ten-year Treasury yield was about 4 percent, for 2002–2008.) This gives a base price of 6 percent for a jumbo, thirty-year fixed-rate, freely prepayable mortgage. A loan with the same structure, but guaranteed by Fannie or Freddie, would be slightly less costly because of the government subsidy. A 2005 study estimates the differential at about thirty basis points;[12] a Federal Reserve study in 2005, on the other hand, estimates the differential at seven basis points.[13] Whichever is correct, the benefit associated with the government subsidy is far outweighed by the detriments a government role carries with it.

In the list below, we use the 6 percent jumbo fixed-rate mortgage as a benchmark to estimate the range of probable rates for a series of mortgages with different characteristics that would be available in a nongovernment market. In this market, we would expect some borrowers to select a thirty-year fixed-rate freely prepayable loan at an interest rate of 6 percent with others selecting a different option based on their needs and cost. These options offer a lower rate for a shorter maturity and/or a lower rate if borrowers choose a loan with a prepayment fee:

6.00%	thirty-year fixed-rate term with no prepayment fee
5.625%	thirty-year fixed-rate term with a 3-2-1 prepayment fee[14]
5.375%	thirty-year amortization with fifteen-year fixed-rate term and a 3-2-1 prepayment fee

[12] Anthony B. Sanders, "Measuring the Benefits of Fannie Mae and Freddie Mac to Consumers: Between De Minimis and Small?" July 2005, http://fic.wharton.upenn.edu/fic/papers/05/0536.pdf (accessed January 14, 2011).
[13] Wayne Passmore, Shane M. Sherlund and Gillian Burgess, "The Effect of the Housing Government Sponsored Enterprises on Mortgage Rates,"**Federal Reserve Board Finance and Economics Discussion Series**, January 2005, http://www.federalreserve.gov/pubs/feds/2005/200506/200506abs.html
[14] A prepayment fee of 3 percent in year one, 2 percent in year two, 1 percent in year three and zero percent thereafter.

5.375%	fifteen-year fixed-rate term with no prepayment fee
5.125%	fifteen-year fixed-rate term with a 3-2-1 prepayment fee
5.00%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with no prepayment fee
4.75%	seven-year ARM with thirty-year amortization underwritten at fully indexed seven-year rate with a 3-2-1 prepayment fee

5. *Should the government guarantee a steady flow of credit for housing?* One of the key arguments for a government support in housing finance is that only with such support can a steady flow of credit to the housing market be assured. Originally, this argument was based on past experience which is no longer relevant. Government regulation of interest rates, specifically the old Regulation Q deposit rate ceilings, caused frequent periods when banks and savings and loans could not offer competitive rates for savings. The result was that mortgage lending, housing construction and house sales were severely impaired. However, after Regulation Q was eliminated, this ceased to be a problem.

Now the argument has changed; in the event of a financial crisis, it is said, the government should make sure housing gets credit and funding in preference to manufacturing, commerce, consumer credit, or anything else. This proposed preference is hard to defend on economic grounds. Indeed, most of the time, the involvement of the government in housing finance creates a danger in the opposite direction: that of excess supply of credit to housing relative to all other sectors. Government involvement helps encourage homebuilders to overbuild, lenders to overlend, and borrowers to overborrow. In other words, it is a source of moral hazard.

If participants in the housing market are insulated from the changes in the market, they will take more risks and be less prudent in their investment decisions. This is what helped create housing bubbles in the past. The possibility that financing for housing could be subject to disruption or financing restrictions is, of course, one of the risks the housing industry fears, but that fear will reduce the overbuilding and excessive leverage that have caused volatility and repeated housing bubbles in the past. Other industries, of course, manage perfectly well to survive fluctuations in the availability or cost of funding.

A related and frequently cited reason for a government role in housing finance is what is known as TBA—or "To Be Announced"—MBS. TBA permits homebuyers to "lock in" an interest rate with a bank or other financing source when they agree to purchase a home. In this case, the bank uses a hedging strategy to make sure that when the funds are called upon it will be able to supply them at the interest rate originally agreed to with the homebuyer, even if market rates have changed. The bank's hedging strategy has a cost, and it will be included in the rate that the bank quotes for the loan. The additional hedging cost is not a major factor in the interest

rate. There is no reason for the government to be involved in this, or for the taxpayers to support a whole system of government housing finance in order to make sure it is available.[15]

6. Is a government guarantee is necessary to sell MBS to institutional investors and others? Finally there is the argument—sometimes explicit and otherwise implicit—that institutional investors will only buy US mortgages, or MBS backed by US mortgages, if they are supported by a government guarantee. This is probably the key reason for the support that government backing of housing finance continues to enjoy in Washington. It would certainly be a weighty argument if the quality of the mortgages were generally low; in that case, delinquency rates and defaults would be high, and the risks of investment in mortgages or MBS could well be unacceptable for institutional investors such as insurance companies, pension funds, mutual funds and others. But as discussed below, there is no reason why mortgages have to be of low quality, especially the mortgages allowed into the securitization system.

Until the introduction of the affordable housing requirements for Fannie and Freddie, the GSEs maintained high underwriting standards and never suffered substantial losses on the mortgages they held or guaranteed. Indeed, their charter required them to purchase only prime loans. Section 1719 of Fannie's charter stated: "[T]he operations of the corporation…shall be confined…to mortgages which are deemed by the corporation to be of such quality, type, and class as to meet, generally, the *purchase standards imposed by private institutional mortgage investors*."[16] [emphasis added]

Even in the current crisis, their delinquency rates among *prime* mortgages have been less than 3 percent, while their delinquency rates on the subprime and Alt-A loans they acquired because of the affordable housing goals have ranged from 13.3 to 17.3 percent.[17] Accordingly, the key to a successful mortgage market is not a government guarantee—which will inevitably cause serious losses to the taxpayers—but ensuring that the mortgages that are made in the market are of prime quality.

II. To the extent that regulation is necessary, it should be focused on ensuring mortgage quality

Many people have noted that when Congress adopted the Dodd-Frank Act (DFA) it failed to address the real causes of the financial crisis—the government housing policies that enhanced the size and duration of the housing bubble and encouraged the creation of 27 million subprime and Alt-A loans. When the bubble finally began to deflate, these weak and high-risk loans began to default at unprecedented rates, weakening financial institutions in the United States and around the world that were holding either these mortgages or the MBS they backed. If Congress had properly diagnosed the causes of the financial crisis before it began drafting the enormously complicated and unnecessary DFA, it would instead have enacted legislation to correct the

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[15] See Kevin Villani, "The Future of US Housing Finance: Why a Competitive Market Oriented Housing Finance System Is Still Best," November, 2010, http://chicagoboyz.net/blogfiles/TheFutureVIL.pdf (accessed January 14, 2011).

[16] http://www.law.cornell.edu/uscode/html/uscode12/usc_sec_12_00001719----000-.html

[17] Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," November 4, 2010, chart 53, http://www.aei.org/docLib/Government-Housing-Policies-Financial-Crisis-Pinto-102110.pdf.

deficiencies in government policy and the mortgage market that were the source of the financial crisis of 2008.

The general conclusion of economic theory is that regulation is only appropriate when there is a market failure, and recent (and not so recent) experience demonstrates that normal market conditions—and such key elements as market discipline—are not capable of preventing the downward slide in mortgage underwriting standards as a bubble develops.

It is typical to see increasing leverage (and thereby expanding or maintaining demand) during the growth portion of the cycle. This is done through reduced down payments, increased reliance on so-called affordability products such as adjustable-rate loans and interest-only loans, increased leverage on income, and expanding eligibility to borrowers with impaired credit. At the same time, existing homeowners seek mortgages that will enable them to buy larger homes with nearly the same monthly payment. As prices outpace incomes, nontraditional lending expands to meet the new or greater affordability gap. Lenders accede to these requests because they believe that rising home prices limit their risk of loss. This may keep the "up" portion of the cycle growing, but it weakens the underlying strength of the market, adding particular vulnerability for the most recent borrowers. We have enough experience with housing bubbles now to realize that, although they will occur to some extent no matter what we do, we can reduce their likelihood by ensuring the maintenance of sound credit standards.

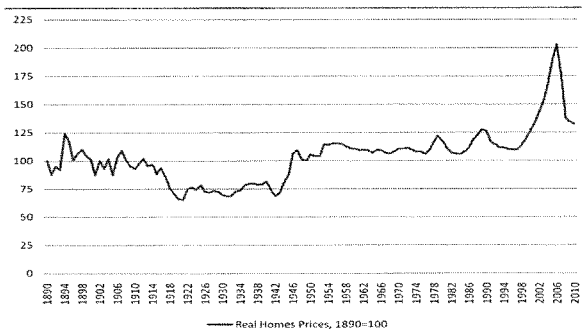
One of the characteristics of bubbles is that they are difficult to recognize while you are inside, but very easy to recognize in hindsight. Also, the fact that they occur in many assets other than mortgages suggests that they reflect the human tendency to explain away unusual circumstances on the ground as "this time it's different." However, real estate bubbles have been particularly harmful to the US economy when they collapse; the prescriptions in this paper—while they will not entirely prevent bubbles—will go a long way toward making them less likely.

Since the 1920s, there have been at least four real estate booms followed by two serious corrections and two busts.[18] The boom periods were the 1920s (17 percent real home-price increase), the late 1970s (16 percent real home-price increase), the late 1980s (20 percent real home-price increase), and 1997–2006 (85 percent real home-price increase).

Figure 1 shows the trend of real home prices since 1890. The real-price trend clearly shows the recent bubbles in 1979, 1989, and 1997–2006.

[18] The real-price boom that occurred over 1942–1955 (72 percent real-price growth) is excluded given the unusual circumstances relating to World War II and the postwar baby boom. By 1955, real prices had recovered to their late 1890s to early 1900s trend line.

Figure 1: Real Home Prices, 1890–2010



There are common elements in all these episodes: government support for increasing homeownership, widespread use of second mortgages to reduce down payments, excessive leverage, reliance on adjustable-rate and negatively amortizing loans, higher debt-to-income ratios, and extensive use of low- and no-doc loans. This suggests that with limited regulatory intervention, the effects of bubbles in the United States can be mitigated. That is, bubbles will occur, in housing as in other fields, but when they deflate they will not be as destructive as in the past. If we can address these common elements through regulation focused on credit quality, we can accomplish what the DFA will fail to do: prevent another financial crisis arising from a proliferation of weak mortgages.

Accordingly, beyond removing government subsidies and guarantees from housing finance, much can be accomplished simply by adopting six policies for the regulation of housing finance in the future:

1. Ensure that a high preponderance of loans are prime. We should adopt policies to ensure that a preponderance of all mortgages in the future will be of prime or high quality. This should not be difficult. According to a Federal Reserve study, over 70 percent of all individuals with credit records in the US (not just all homeowners with credit records) have FICO credit scores that are 660 or above—the foundation for a prime loan. Well over a majority (58 percent) have credit scores above 700.[19] Nevertheless, to ensure the continuing quality of mortgage loans, it is appropriate to define the characteristics of loans with relatively low default rates. The characteristics of a prime loan do not generally change over time, an experience confirmed over long periods in the United States and other developed countries. Historically, prime loans had a default rate of less than one in one hundred loans.[20] Loans with private mortgage insurance have experienced a default rate of about five in one hundred loans.[21] Loans with FHA insurance have

[19] Federal Reserve Board, "Federal Reserve Report to Congress Credit Scoring and Its Effects on the Availability and Affordabilityof Credit," http://www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf, August 2007

[20] Derived from Freddie Mac data.

[21] Standard & Poor's Ratings Direct Report, December 27, 2008.

experienced a default rate in excess of ten in one hundred loans.[22] See Appendix 1 for details on defining a prime loan.

2. Correspondingly, nonprime loans should be a relatively small percentage of all loans. Given that the market share of nonprime loans tends to grow as a boom develops, these loans—characterized by low or no down payments, increased debt ratios, impaired credit, reduced loan amortization, loans to investors or speculators, and other underwriting standards not present in prime loans—must be limited to a relatively small percentage of all mortgage loans. It is the accumulation of these loans that first buoy, then capsize a regional or national housing market. Nonprime loans are unsuitable to serve as collateral for private MBS, covered bonds, and FHLB advances.[23] This provision would be enforced by the Securities and Exchange Commission in the case of securities and bonds and FHFA in the case of FHLB advances. See Appendix 2 for further details.

3. Allow securitization only for prime loans. The DFA proposes a cumbersome and possibly unworkable system of risk retentions in cases where loan securitizations do not involve a Qualified Residential Mortgage (QRM), which is to be defined by regulation. In light of the earlier discussion of bubbles—in which we described the relationship between declining underwriting standards and the growth of bubbles—it makes more sense simply to require that the securitization system be used only for prime loans. That would do away with retentions and the need for a QRM. Nonprime loans could then be held in the portfolios of banks, insurance companies, pension funds, and other financial institutions, but only if the market transparency described in number six below allows investors, rating agencies, and others to understand how many such nonprime loans are outstanding.

4. Require a one-page mortgage-information disclosure form. This form would present clear, straightforward key information that allows borrowers to answer the question, "Can I afford this loan now and in the future?" See Appendix 3 for an example of what this form should contain.

5. Counter government expansionary policy choices that promote overexpansion by increasing the availability of credit while reducing lending standards. For many years, government policies have focused on expanding homeownership by reducing the cost of credit while at the same time promoting looser credit standards. This resulted in increased demand, debt levels, leverage, and inflation in adjusted and real home prices. These policy choices reinforced the tendency of the market to rely increasingly on nonprime loans as a boom progresses and the bubble grows. Regulation is necessary, then, to counter the propensity of the government to enact only expansionary policies and limit the government and private sector's origination of nonprime mortgages.

We need counterexpansionary and countercyclical policies such as the following, which automatically apply the brakes as risk levels rise.

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[22] FHA's 2010 and 2003 Actuarial Studies.

[23] Ginnie Mae securities backed by government agency loans would be exempt.

- **Countercyclical leverage requirements for high LTV or CLTV loans.** Homeowner and investor leverage tend to grow as housing prices rise; lenders respond to homebuyer demands for loans that will allow them to buy a more expensive house while keeping low monthly payments. Not only are down payments reduced, but loan-to-value ratios are also increased by combining first and second mortgages to create high combined loan-to-value ratios (CLTVs). A well-designed countercyclical policy would require, for example, that LTVs and CLTVs be automatically reduced (that is, down payments would be increased) when housing prices have risen by a given percentage in a local area. This would slow housing-price growth by directly reducing the leverage that homeowners can use to increase the price they will pay for homes. As housing prices return to normal levels, LTVs and CLTVs would do the same. In addition, second mortgages or other junior lien mortgages should only be permitted where the first mortgage holder has given its consent.

- **Countercyclical loan-loss reserves.** Under current accounting standards, loan-loss reserves for banks and others are set based on recent delinquency and loss rates. However, bad loans are made in good times, when they seem good. The lean years inevitably follow the fat years, but under current reserve practices reserves are at their lowest levels at the beginning of a bust. Reserves should be built during good times, not bad.

- **Better appraisal practices.** Appraisers should report an estimated value using both the principle of substitution based upon comparable sales[24] and the principle of income capitalization based upon investment value as a rental.[25] Additionally, appraisals have long suffered from a lack of transparency in the selection of comparables.[26] This process would be remedied by identifying all appropriate comparables and using statistical techniques to help the appraiser select and reconcile all appropriate comparables. Transparency would allow the reader to validate and re-create the appraiser's comparable selection process. These provisions would be applicable to all federally related mortgages[27] and mortgages serving as collateral for private MBS and covered bonds.

6. Provide market transparency so investors, rating agencies, and guarantors are always able to determine the number of mortgages outstanding and their quality both at the point of origination and over time. Mortgage markets work best when aggregate risk levels are low and stable, but market participants must understand the true conditions in the market so they can properly assess the risk of investment. Nonprime loans increased rapidly over the period 1991–2007. This is best demonstrated by the rapid growth of home purchase loans with little or no downpayment. In 1990 one in two hundred home purchase loans had a downpayment of 3% or less, by 1999 it was one in ten, 2003 one in seven and 2007 one in two and a half. The extraordinary level of nonprime lending created a fragile market that adversely affected

[24] The cost of acquiring a comparable property fixes the upper limit of valuation. This is accomplished by identifying and evaluating suitable comparable properties that recently sold.
[25] The capitalization of expected income (rents) fixes an upper limit of valuation.
[26] Edward Pinto 1991 unpublished study.
[27] Generally, loans originated by institutions regulated by banking regulators or purchased or guaranteed by a federal agency or sponsored enterprise.

homeowners, mortgage insurers, and mortgage investors. It is not clear that anyone in the market or in government in 2007 and 2008 understood the dimensions of the nonprime mortgage problem. Fannie and Freddie did not disclose the number of subprime and other nonprime mortgages they were buying, holding, and securitizing, and thus even close students of the mortgage markets did not know what they did not know. Accordingly, the first line of defense is to make sure that the mortgage finance market has the information necessary to understand the amount of nonprime lending that is occurring.

The following keys would reduce the tendency of people, lenders, and investors to believe that just because housing prices are rising, it is sensible or prudent to originate or buy a mortgage loan that will only be repaid if housing prices *keep* rising:

- Better disclosure of the characteristics and delinquency rates of mortgages originated, sold, and held by investors is essential for an informed market.

- Due diligence from the lending and securitization industry to confirm that originated loans are as described as related to owner occupancy and the presence of second mortgages. The results of this due diligence would be disclosed.

III. All programs for assisting low-income families to become homeowners should be on budget and should limit risks to both homeowners and taxpayers.

There are good policy reasons for government to assist low-income families to become homeowners, but the value of this policy has to be weighed against the failure rate imposed on those ostensibly being helped and the cost to the taxpayers. Referring to the affordable housing requirements imposed on Fannie and Freddie, even former House Financial Services Committee chair Barney Frank has noted that "it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it."[28] Moreover, any program of this kind must be on budget and contain mortgage-quality standards that do not create market conditions similar to those that brought on the financial crisis. Finally, after all the years of trying and failing to increase homeownership without adding risk to the markets, perhaps it is time for Congress to rethink whether homeownership really should be given so many advantages over renting. With a more even-handed policy, rental properties would offer improved housing for people who are unable to—or should not be required to—take on the obligations of homeownership.

Much of the support for a government role in mortgage finance comes from groups that see housing finance as an opportunity to advance a social policy that expands homeownership. This is a worthwhile goal, but it must be carefully controlled if we are to avoid the problems that eventually forced Fannie and Freddie into insolvency. Fannie and Freddie successfully facilitated the development of a liquid secondary market in middle-class mortgages. In 1992, they were

[28] Larry Kudlow, "Barney Frank Comes Home to the Facts," GOPUSA, August 23, 2010, www.gopusa.com/commentary/2010/08/kudlow-barney-frank-comes-home-to-the-facts.php#ixzz0zdCrWpCY (accessed September 20, 2010).

given an affordable-housing mission, which eventually required them to take on the credit risk of almost $2 trillion in subprime and other weak mortgages.

What set US losses apart from those in other countries was the fact that—before the financial crisis began—about half of all mortgages in the United States, 27 million loans, were weak and liable to default when the housing bubble deflated. Of the 27 million high-risk mortgages, 19 million were on the books of Fannie and Freddie, FHA, insured banks and S&Ls under the Community Reinvestment Act, and other lenders under additional government programs. All of these programs were intended to increase homeownership by low-income families, but they were instituted and operated without any controls over the risks that were being taken under government mandates. Eventually, their high rates of default drove down housing prices nationally and crippled the financial system.

Government assistance to low-income families must not be undertaken through affordable-housing mandates without quality standards to limit the risks to the government and taxpayers. By prescribing an outcome without limiting the means, the government encouraged loans and underwriting standards that were "flexible and innovative." This inevitably led to greater lending with minimal down payments along with lending to borrowers with impaired credit and higher debt ratios.

These policies assumed that borrowers who benefited from these flexibilities would be nearly as safe as borrowers with good or unimpaired credit. However, the risks that resulted from these underwriting concessions were well documented. A 1996 Fed study entitled "Credit Risk, Credit Scoring, and the Performance of Home Mortgages"[29] pulls together unequivocal evidence from multiple sources on the high risks posed by "innovative or flexible" loan features such as low down payments and impaired credit/low FICO scores. It clearly shows the link between the government's insistence on loosened and flexible lending and the certainty of heightened mortgage default risk. See Appendix 4.

Thus, if Congress wants to encourage homeownership for low-income families, then the mortgages intended to implement this social policy must be subject to a defined set of quality standards—not standards as high as those for prime mortgages, but standards that will ensure that losses do not get out of hand or, as they did with Fannie and Freddie and the FHA, cause substantial burdens for the taxpayers. The nation's experience with the FHA demonstrates not only that standards are essential, but also that Congress has to avoid the political and other pressures that tend to erode the standards over time. See Appendix 5.

Any social policy intended to increase homeownership, including the FHA, should be operated to achieve Congress's social policy goals while limiting homeowners' and taxpayers' risks. This can be achieved through the following steps.

1. On budget. Necessary subsidies must be on budget, so they are visible to members of Congress and the voters. In the past, through Fannie and Freddie and the Community Reinvestment Act, the subsidies have been hidden in the financial statements of GSEs and private-sector entities, which were required to make subsidized loans and pay for them with

[29] Federal Reserve, Division of Research and Statistics, "Credit Risk, Credit Scoring, and the Performance of Home Mortgages," *Federal Reserve Bulletin*, July 1996, www.federalreserve.gov/pubs/bulletin/1996/796lead.pdf (accessed January 14, 2011).

more expensive loans to prime borrowers. This, of course, is unfair to prime borrowers, who are being forced to pay for a social policy the cost of which should be borne by all taxpayers. But perhaps even more important, hiding the cost of the subsidies in private and GSE balance sheets obscures the cost to society. There are very good policy reasons for supporting low-income housing subsidies, but those costs should be made clear.

2. A sustainable loss rate. Although the FHA contends that it covers its losses adequately with fees, there are many who disagree with this view. A recent Barclays study concluded: "[W]e project cumulative default rates in the 20% area on average, with loss given default rates of 60%. This represents average losses of about 12pts, of which 8.5pts could flow back to taxpayers. On an original balance of $1.4trn, this translates to $130bn."[30]

3. Assist low-income borrowers without competing with private-sector lending. Lending to low-income borrowers is done to increase the opportunity for families that cannot meet prime lending standards to gain the benefits of homeownership. Since it is done for social policy reasons, the taxpayers should take some risk in order to achieve the benefits of increasing homeownership among low-income families. However, the taxpayers' risks must be subject to some limits. The following low-income mortgage lending standards would provide credit for families that cannot meet prime loan standards but would still enable low-income families to become homeowners without exposing them or the taxpayers to excessive foreclosure risk:

- **Limit to low-income borrowers.** The FHA's benefits should be limited to low-income borrowers who are demonstrably unable to meet prime lending standards. This is important to ensure that the FHA is fulfilling its social policy purposes rather than becoming a backdoor way for people who could otherwise meet prime lending standards to obtain mortgages at government-backed rates. Accordingly, the mortgage limit should be capped at 100 percent of median house values measured on the local level, the income limit should be capped at 80 percent of the area median income, and loans should be limited to home purchases and rate and term refinances.

- **A sustainable lending underwriting standard.** As outlined in Appendix 5, the FHA seems to believe that a 10 percent average claim rate is acceptable. It is a shocking idea that, year in and year out, homeowners with an FHA loan should be forced to endure a failure rate of 10 percent on FHA loans. Congress should establish a sustainable loan underwriting standard that achieves an expected cumulative risk of default not to exceed 4 percent during good times and 9–10 percent during bad times.[31] This would result in an average expected claim rate of about 5 percent, which is about half of FHA's historical average of over 10 percent. The standards needed to achieve this claims level include the accumulation of adequate borrower equity by way of a reasonable downpayment from the borrower's own funds, scheduled amortization during the first five years of the loan, evidence of a willingness to pay, and debt-to-income ratios that do not leave borrowers burdened with excessive debt right from the start. This supports a major goal of single-

[30] Barclays, "US Housing Finance: No Silver Bullet," 6.

[31] During the boom years of 1995–2003, the FHA's cumulative claim rate averaged nearly 8 percent. During the bust periods (1980–1985 and 2005–2008), it averaged 18 percent. See the FHA's 2010 Actuarial Study.

family affordable housing programs—wealth building through increased equity in a home.

4. Transition. Because the FHA currently has such a large portion of the home-lending market, transitioning to a sustainable lending standard will take a few years. Table 3 presents a possible path to achieve this result.

Table 3: FHA Transition to Sustainable Lending Standards

	LTV	Maximum seller concession	Maximum total debt ratio	Purpose	Mortgage limit (high/normal)	Income	Credit
2010	96.5% (current level)	6%	>45% for 37% of borrowers	Home purchase and refinance	$729,750/ $271,050	No limit	Current
2011	96%	3%	45%	Home purchase	$500,000/ $250,000	100% of area median	620–660 FICO[32]
2012	95.5%	3%	43%	Home purchase and rate and term refinance	$400,000/ $200,000	80% of area median[33]	620–660 FICO
2013	95%	3%	41%	Home purchase and rate and term refinance	$250,000/ $200,000	80% of area median	620–660 FICO
2014	95% at twenty-three-year term* 90% at thirty-year term*	3%	41%	Home purchase and rate and term refinance	100% of median home price by area	80% of area median	620–660 FICO

* By setting a twenty-three-year loan term on 95 percent LTV loans at an interest rate of 5 percent and a thirty-year loan term on 90 percent LTV loans at an interest rate of 5 percent, each borrower would have about 18 percent equity (based on original sales price) at the end of five years.

5. Down payments and savings. The FHA provides its benefits through the traditional means used in the United States—by subsidizing the cost of a mortgage loan. However, that is not the only way—and possibly not the most effective way—to achieve its purposes. Studies by the US Census Bureau have shown that the greatest obstacle to homeownership among low-income families is not the monthly cost of the mortgage but the savings necessary for a down

[32] As noted previously, the FHA's serious delinquency rate on loans with a FICO score of 580–619 is 19.6 percent.
[33] The goal is to reduce the FHA's dollar limit back to a level commensurate with its low- and moderate-income housing mission. The FHA should serve homebuyers with an income less than or equal to 80 percent of the median. While regional adjustments would be appropriate, nationally, for a family of four, this equates to an income of $54,000 and below. A household with an income of $54,000 getting a 6 percent fixed-rate thirty-year mortgage could afford the median-priced house in the United States—about $175,000.

payment.[34] Accordingly, one of the ways for Congress to assist homeownership among low-income families within the lending standards we suggest would be to establish a program for providing down payment assistance to these families. Such a program should be designed to promote saving by the potential homebuyer. For example, Congress could set up a tax-preferred savings plan to which the government contributes an amount each year that matches a family's savings. The funds in the account could be used only as a down payment for a home. If established to complement the contractual saving system described under principle 4, it might prove to be a better way to serve a portion of the low-income homebuyer population.

IV. Fannie Mae and Freddie Mac should be eliminated as GSEs over time.

Fannie Mae and Freddie Mac violate every principle of sound and sustainable housing finance. The history of these two hybrid firms, and the immense costs they have imposed on taxpayers, provides the best argument for the principles we have outlined in this paper. Through Fannie and Freddie, government policies exponentially increased taxpayer risks, now realized as actual losses, by using the two firms to compete with the FHA in pursuing a political strategy of high-risk loans. Fannie was "privatized"—really, GSE-ized—in 1968 for the explicit purpose of keeping its costs out of the federal government's budget. Freddie copied the model. But the costs have returned to the budget with a vengeance. Fannie and Freddie distorted resource allocation, prices, and credit and were leading contributors to inflating the disastrous housing bubble. As a result, almost everyone now agrees, including almost everyone in Congress, that Fannie and Freddie's GSE status should be eliminated. This leaves two questions: What should replace the GSEs? How should the transition be structured? We conclude that the GSEs should be—and can be—replaced by a housing finance market that is for the most part free of government guarantees and the distortions they create.

No private-sector system of financing mortgages will be able to develop fully until competition from Fannie and Freddie is first reduced, and then disappears. However, a sensible transition away from the dominance of Fannie and Freddie must be designed, allowing private banking, securitization, and covered bond markets in mortgages to grow. Accordingly, while we target the elimination of Fannie and Freddie as GSEs, we propose a gradual wind-down, with mandatory congressional decisions after three and five years.

A key transition feature should be a gradual reduction in the conforming loan limit that sets the maximum size of the mortgages that Fannie and Freddie can purchase. As this limit is reduced, Fannie and Freddie will be taken out of the market for loans above the limit. This will enable the private market to expand its activity gradually.

The elements of the transition away from GSE status should include:

- **Reduce conforming loan limits.** Lowering the conforming loan limit by 20 percent of the previous year's cap each year, starting with the current general limit for one-unit properties of $417,000 and the high-cost area limit of $729,750. These limits, for loans with 80 percent LTV, mean house prices of over $500,000 and over $900,000,

[34] Howard A. Savage, *Who Could Afford to Buy a House in 1995?* (Washington, DC: US Department of Commerce and US Census Bureau, August 1999).

respectively, are financed by the government. In contrast, according to the National Association of Realtors, the median US house price is $171,300. The general limit for a one-unit property would decrease to $334,000 in year one; $267,000 in year two; and $214,000 in year three. The high-cost area limit for a one-unit property would decrease to $584,000 in year one; $467,000 in year two; and $374,000 in year three. At this point, the first formal review of the GSE transition would take place. If the transition is judged to be proceeding successfully, and unless the Congress votes to the contrary, the 20 percent annual reductions would continue through year five. Final termination or "sunset" of GSE status would take place at the end of year five.

- **Phase out portfolios.** Prohibit the holding of loans or mortgage securities in the GSEs' portfolios, except for short periods as necessary to support MBS issuance during the transition period. The GSEs' current mortgage portfolios and corresponding debt should be put in run-off mode, steadily decreasing as loans and MBS in their portfolios are repaid. To the extent a GSE has portfolio assets remaining at the fifth-year sunset, these should be put in a liquidating trust or sold to other investors.

- **Limit acquisitions to prime loans.** During the wind-down period, allow Fannie and Freddie to buy only prime loans.

- **Limit nonmortgage investments.** Limit the GSEs' nonmortgage investment portfolio to short-term Treasury bills. This prevents them from arbitraging their GSE status.

- **Privatization structure.** At the sunset date, mirror the privatization structure used for the former GSE, Sallie Mae, creating a liquidating trust containing all remaining mortgage assets, guaranty liabilities, and debt. The GSE net worth shortfall will unjustly—but at this point unavoidably—be borne by taxpayers, including Treasury's writing off its preferred stock. Any additional losses would be on budget pursuant to the Credit Reform Act.

- **Dispositions of other properties.** All of Fannie and Freddie's intellectual property, systems, securitization platforms, goodwill, customer relationships, and organizational capital should be auctioned off in a privatization. The proceeds would reduce the Treasury's and taxpayers' losses.

- **Repeal affordable housing goals and taxes.** Consistent with principles 1 and 3 above, repeal the GSE (including the FHLB) affordable-housing goals and taxes and move all affordable-housing programs into the Department of Housing and Urban Development and onto the federal budget.

1. Coincident with the wind-down of Fannie and Freddie, Congress should establish a legal structure that allows for a number of private financing options. Although we believe a combination of a market based on portfolio lending and securitization of loans would be the most effective immediate replacement for a government-backed housing finance system, there are many other alternatives. Covered bonds would make a sensible additional fixed-rate funding alternative for mortgages. With covered bonds, banks issue debt for which they remain liable

(thus, having 100 percent "skin in the game"), secured by loans.

This could include incorporating some of the benefits of the Danish system, which divides the credit and interest-rate risks on mortgages, and the German system, which has strict mortgage credit standards. In the Danish system, the interest rate on mortgages is set by the market directly, and the credit risk is taken by specialized mortgage banks that also function much like mortgage guarantors. Throughout the more than two-hundred-year history of German covered bonds, there has never been a default of a German Pfandbrief or covered bond[35] or a default by a Danish mortgage bank. For such a system to work, there must be statutory (not just regulatory) protection of the right of the bondholders to the collateral in the event of the failure of the issuer, as well as a requirement that the mortgages covering the bonds be of prime quality. Thus, any framework that establishes requirements for mortgage quality should be compatible with a variety of mortgage financing structures, all of which should be able to operate simultaneously in the US market.

The political obstacle in the United States has been the objections of the Federal Deposit Insurance Corporation, which fears that in the event of a failure, it will lose assets that would otherwise be part of a bank and thus increase its losses to its deposit-insurance scheme, like what happens with FHLB advances. This concern can be addressed by limiting the extent of collateralization of the covered bonds (for example, the percentage of overcollateralization might be limited to the capital ratio of a bank, so that the excess collateral is in effect funded by capital, not deposits).

2. The four principles outlined in this white paper are equally applicable to multifamily housing finance. The federal government has long supported the multifamily housing finance market. This support includes government insurance (FHA), MBS guarantees (Fannie, Freddie, and Ginnie), on budget subsidies (HUD and Department of Agriculture), off-budget mandates (Fannie and Freddie), off-budget subsidies (FHLBs), and low-income tax credits (prior to Fannie and Freddie's collapse, they were the largest purchasers). Historically, life insurance companies, pension funds and banks supported a robust conventional multi-family lending market.

In the late-1970s HUD pushed Fannie and Freddie to undertake multifamily lending as part of its early efforts to enforce a GSE affordable housing mission. These programs proved to be high risk, with Freddie completely exiting the multifamily business in the late-1980s after sustaining substantial losses.[36] The 1992 act, by imposing affordable housing requirements for multi-family as well as single-family mortgages, forced Freddie back into multifamily finance and both GSEs were required to greatly expand their programs. As was the case with single-family financing, the private sector had an ever more difficult time competing with GSEs' charter advantages. Today Fannie and Freddie,[37] along with FHA, have now largely taken over the multifamily finance market.

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[35] Association of German Pfandbrief Banks, "The Pfandbrief—A Safe Investment," www.hypverband.de/cms/bcenter.nsf/docsbykey/65192645/$file/Flyer+EN_Pfandbrief_a+safe+investment.pdf?openelement (accessed January 14, 2011).

[36] Fannie also lost substantial sums on a $5 billion portfolio of 6% multifamily loans it had acquired from HUD when long and short term interest rates topped 15% in the early-1980s.

[37] "In the current market, the GSEs hold 35 percent of total outstanding multifamily mortgage debt and are providing nearly 90 percent of all mortgage capital to the market." Ellen, Tye, Willis, May 2010, "Improving U.S.Housing

Many of the proposals for reform of the housing finance system argue for continued federal government financial support for multifamily housing,[38] either through an explicit or implicit government guarantee of agency or private MBS or the need for a GSE or other similar entity with substantial ongoing portfolio capacity.

A detailed treatment of multifamily housing finance is beyond the scope of this white paper. However, the lessons from the single-family disaster have direct applicability to multifamily housing finance and the risks posed to taxpayers. While the multifamily lending business is less than $1 trillion in size or under 10 percent of the single-family finance market, it is even more complex and risky than the single-family lending business. Although the GSEs' recent multifamily lending efforts have resulted in low losses, there is a long history of costly multifamily failures at the GSEs and at FHA. It is also clear from the various industry proposals for future GSE participation in multifamily lending that there will be pressure to move the GSEs and FHA into riskier types of loans. Combine this with continued federalization of multifamily mortgage credit and the risks to taxpayers are substantial.

The four principles outlined in this white paper are equally applicable to multifamily housing finance. The inability to price risk, or create reserves for potential losses, and the moral hazard created by government financial support for the industry will have the same adverse effect in multifamily housing as it has had in the single-family market. The presence of federal guarantees and mandates will distort the incentives and the behavior of borrowers, lenders, and investors alike, and prevent the multifamily market from developing normally with private sector support.

As is the case with single-family finance, a gradual removal of government support by the GSEs and FHA, and the resulting price advantage, will be necessary in order to give traditional financing sources time to re-enter the business. This will allow a private multifamily financing sector to develop based on solid underwriting and the use of financing mechanisms already available.

Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options" http://furmancenter.org/files/publications/Furman_Center_GSE_Reform_White_Paper_May_2010.pdf

[38] Id. See also "MBA's Recommendations for the Future Government Role in the Core Secondary Mortgage Market", August 2009, http://www.mbaa.org/files/News/InternalResource/70212_RecommendationsfortheFutureGovernmentRoleintheCoreSecondaryMortgageMarket.pdf; Independent Community Bankers Association, "Housing Finance – What Should the New System Be Able to Do?" Testimony before the House Financial Services Committee April 14, 2010, http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-121.pdf; Michael J. Heid, Housing Policy Council (HPC), Testimony before the House Financial Services Committee, September 29, 2010, http://financialservices.house.gov/Media/file/hearings/111/Heid092910.pdf; Sheila Crowley, National Low income Housing Coalition, Testimony before the House Financial Services Committee, April 14, 2010, http://www.nlihc.org/doc/Testimony-of-Sheila-Crowley4-14-2010.pdf; and Center for American Progress, "A Responsible Market for Housing Finance", December 2009 http://www.americanprogress.org/issues/2009/12/pdf/housing_finance.pdf

Appendix 1:

Definition of a Prime Loan

A prospective prime borrower needs to be qualified based on a demonstrated ability to repay the loan, a demonstrated willingness to meet his or her obligations, and sufficient equity to reduce the likelihood of default to a reasonable level.[39]

We define *prime first mortgage loans* as loans with the following characteristics:

- Loans on properties occupied as a primary or secondary residence.[40]
- Home purchase loans with a CLTV of 90 percent or less.[41] [42]
- Rate and term refinances with a CLTV of 80 percent or less for conventional loans with a maximum loan term of twenty-five years.[43]
- Cash-out refinances with a CLTV of 75 percent or less for conventional loans with a maximum loan term of twenty years.[44]
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.[45]
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively.[46]
- Underwritten based upon verified income, assets, and credit.[47]
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.
- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third.
- A loan with a CLTV greater than 80 percent has mortgage insurance down to at least 65 percent or a second mortgage of sufficient size so the LTV on the first mortgage is 65 percent or less.

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[39] These represent the traditional Three Cs of mortgage risk:

Credit or willingness to pay—generally represented by evaluation of a credit report.

Capacity or ability to pay—generally represented by evaluation of income and liability information measured against housing and other debt ratios.

Collateral underlying the mortgage—generally represented by evaluation of amount and source of down payment information and an appraisal to determine the value of a property for lending purposes.

[40] In 1991, over 98 percent of Fannie's loans met this standard. Data from Fannie Mae's random sample review covering single-family acquisitions for the period October 1988–January 1992, dated March 10, 1992. Document contained in the authors' files.

[41] Ibid. In 1991, over 91 percent of Fannie's home-purchase loans had a CLTV of 90 percent or lower.

[42] To accurately evaluate risk, the combined loan-to-value ratio is used. This takes into account both the first and second mortgage and allows for the amount of down payment and borrower equity to be disclosed in a uniform manner and evaluated.

[43] Ibid. In 1991, over 93 percent of Fannie's loans had a LTV 80% or lower.

[44] Ibid. In 1991, over 92 percent of Fannie's loans had a LTV 75% or lower.

[45] Ibid. In 1991, over 98 percent of Fannie's loans had one or no mortgage late payments at origination and 85 percent had two or fewer nonmortgage late payments at origination.

[46] Ibid. In 1991, over 90 percent of Fannie's loans met this standard.

[47] Fannie stopped acquiring low-doc or no-doc loans in 1990. Freddie followed in 1991. See "Haste Makes . . . Quick Home Loans Have Quickly Become Another Banking Mess," *Wall Street Journal*, July 5, 1991.

As demonstrated by footnotes 20–27, in 1991 the preponderance of conventional loans (defined as being Fannie eligible, other than by loan size) would have met this definition.

Prime loans should be eligible for a minimum risk-based capital requirement of 4 percent; loans that do not meet the prime standard would have a higher risk-based capital requirement.

Appendix 2:

Nonprime loans

As noted under principle 2, nonprime loans are inappropriate for inclusion in private MBS, covered bonds, and FHLB advances. This will mean that nonprime loans will have to beheld in the portfolio or a bank or other leveraged entity.

Additionally, nonprime loans contained in the portfolios of levered entities such as depository institutions should be subject to a variable capital requirement that adjusts as the share of nonprime loans in the origination market changes.[48] This would be accomplished by setting capital requirements that automatically adjust as nonprime loans' share of the origination changes. Implementing this requirement necessitates tracking the quality characteristics of all mortgage loans. This will allow for a determination of the percentage of prime and nonprime loan originations entering the market on a quarterly basis.

Prime loans would be subject to a 4 percent capital requirement. The risk-based capital requirements for new nonprime loans placed in a depository institution's portfolio would be adjusted. For nonprime loans, when nonprime loans nationally comprise 25 percent or less of all mortgage originations the previous quarter, new nonprime loans placed in portfolio would be subject to an 8 percent capital requirement. If nonprime loans comprise more than 25 percent of all mortgage originations the previous quarter, the capital requirement on new nonprime loans placed in portfolio would be set at 30 percent of the nonprime percentage. For example, if the nonprime percentage were 30 percent, the capital level would be set at 9 percent. Likewise, if the nonprime percentage were 40 percent, the retention level would be set at 12 percent.

This countercyclical policy yields two results: increased capital as a cushion against loan losses and/or reduced originations of higher-risk nonprime loans to fuel an unsustainable boom.

[48] FHA and other social policy loans would be included in this calculation.

Appendix 3:

THE BASIC FACTS ABOUT YOUR MORTGAGE LOAN

Borrower:_____ Property address: _____
_____ _____
_____

Lender:_____
Amount of loan: $_____, which is_____ % of the property's appraised value.
Your loan is for _____ years.
The type of loan you have:_____

Your beginning interest rate is _____%. This rate is good for _____ months/years. The rate and your payment can go higher by up to ____% on and each _____ months after that.

One estimate of what your future rate could be, called the fully indexed rate, is _____ _____%.
The maximum possible rate on your loan is _____%. You were qualified for approval using a rate of _____%.

THIS LOAN IS BASED ON YOUR MONTHLY INCOME OF $_____.

Your beginning rate = a monthly loan payment of $_____ = _____% of your income.
-including taxes and insurance this is about $_____ = _____% of your income.

The fully-indexed rate = a loan payment of $_____ = _____% of your income.
-including taxes and insurance this is about $_____ = _____% of your income.*
*This is called your fully indexed housing expense ratio.

Special factors you must be aware of:
-A prepayment fee of_____ must be paid if_____.
-A "balloon payment" of $_____ to pay off your loan will be due on_____.
-You do/do not have a loan with possible "negative amortization". If you do, make sure you really understand what this means. Start with the definition on p. 3.

Total "points" plus estimated other costs and fees due at closing are $_____.

FOR QUESTIONS CONTACT: Name:_____

Phone:_____ e-mail:_____

See definitions of underlined terms and guidelines on pages 2–3.
DO NOT SIGN THIS IF YOU DON'T UNDERSTAND IT!

_____
Borrower Date

_____ _____
Authorized Signer of Lender Date Borrower Date

The Basic Facts about Your Mortgage Loan

This form gives you the basic facts, but some mortgage forms may use terms not listed here. For a good, borrower-friendly information source, try the Mortgage Professor online (www.mtgprofessor.com), which includes detailed explanations of the technical mortgage terms in its glossary and much other helpful information.

Definitions and Guidelines Used in This Form

The *appraised value* is what a professional appraisal estimates the house could be sold for in today's market.

The *type of loan* determines whether and by how much your interest rate can increase. If it can, your monthly payments will also increase—sometimes by a lot. For example, in a thirty-year fixed rate loan, the interest rate is always the same. In a one-year ARM, it will change every year. Other kinds of loans have various patterns, but the interest rate may go up a lot. Make sure you understand what type of loan you're getting.

The *beginning interest rate* is the interest you are paying at the beginning of the loan. It is the rate which you will hear the most about from ads and salespeople. But how long is it good for and when will rates increase? In many types of loans, the rate can go up by a lot. You need to know.

The *fully-indexed rate* is one indicator of what can happen to your interest rate and your monthly payments. It is calculated by taking a defined "index rate" and adding a certain number of percentage points, called the "margin." For example, if the rate formula on your loan is the one-year Treasury rate plus 3 percent, and today the one-year Treasury rate is 5 percent, your fully-indexed rate is 5% + 3% = 8%. This will almost always be higher than your beginning rate.

The index rates are public, published rates, so you can study their history to see how much they change over time. If the index rate stays the same as today, the rate on your loan will automatically rise to the fully-indexed rate over time. Since the index rate itself can go up and down, you cannot be sure what the future adjustable rate will be. In any case, you must *make sure you can afford the fully-indexed rate*, not just the beginning rate, which is often called a "teaser rate" for good reason.

The *maximum possible rate* is the highest your interest rate can go. Most loans with adjustable rates have a defined maximum rate or "lifetime cap." You need to think about what it would take to make your interest rate go this high. How likely do you think that is?

Your *monthly income* means your gross, pre-tax income per month for your household. This should be an amount which you can most probably sustain over many years. Make sure the monthly income shown on this form is correct!

Your *monthly payment including taxes and insurance* is the amount you must pay every month for interest, repayment of loan principal, house insurance premiums, and property taxes. Expressed as a percent of your monthly income, this is called your housing expense ratio. Over time, in addition to any possible increases in your interest rate and how fast you must repay principal, your insurance premiums and property taxes will tend to increase. Of course, your monthly income may also increase. How much do you expect it to?

Your *fully-indexed housing expense ratio* is a key measure of whether you can afford this loan. It is the percent of your monthly income it will take to pay interest at the fully-indexed rate, plus repayment of principal, house insurance, and property taxes. The time-tested market standard for this ratio is 28 percent; the greater your ratio is, the riskier the loan is for you.

A *prepayment fee* is an additional fee imposed by the lender if you pay your loan off early. Most mortgages in America have no prepayment fee. If yours does, make sure you understand how it would work before you sign this form.
A *"balloon payment"* means that a large repayment of loan principal is due at the end of the loan. For example, a seven-year balloon means that the whole remaining loan principal, a very large amount, must be paid at the end of the seventh year. This almost always means that you have to get a new loan to make the balloon payment.

A *"loan with possible negative amortization"* means that in the years immediately after securing a mortgage loan, you can pay even less than the interest you are being charged. The unpaid interest is added to your loan, so the amount you owe gets bigger. The very low payments in early years create the risk of very large increases in your monthly

payment later. Negative amortization loans are typically advertised using only the very low beginning or "teaser" required payment, which is less than the interest rate. You absolutely need to know four things: (1) How long is the beginning payment good for? (2) What happens then? (3) How much is added to my loan if I pay the minimum rate? 4) What is the fully-indexed rate?

"Points" are a fee the borrower pays the lender at closing, expressed as a percent of the loan. For example, two points mean you will pay an upfront fee equal to 2 percent of the loan. In addition, mortgages usually involve a number of *other costs and fees* which must be paid at closing.

Closing is when the loan is actually made and all the documents are signed.

The *For Questions Contact* section gives you the name, phone number, and e-mail address of someone specifically assigned by your lender to answer your questions and explain the complications of mortgage loans. Don't be shy: contact this person if you have any questions.

Finally, *do not sign this form if you do not understand it.* You are committing yourself to pay large amounts of money over years to come and pledging your house as collateral so the lender can take it if you don't pay. Ask questions until you are sure you know what your commitments really are and how they compare to your income. Until then, do not sign

Appendix 4:

Relative Foreclosure Rates

The following two tables set forth data from the 2005 Federal Reserve study. The first[49] covers loans from 1994 and demonstrates that it was well documented in 1996 that as FICO scores go down and/or LTV increases,[50] the risk of foreclosure increases dramatically.

Table A4.1: Relative Foreclosure Rates by Credit Score Range

LTV	FICO <621	FICO 621–660	FICO >660
<=80%	26.9	7.9	1.0
>80%	47.6	15.3	3.3

The second covers both conventional and government fixed-rate loans from 1990 to 1993 and demonstrates that in 1996 it was well documented that as FICO scores decline, the risk of foreclosure increases dramatically for both types of loans.[51] Common sense dictates that forcing conventional lenders and investors to emulate government (that is, FHA) lending could only lead to disaster.

Table A4.2: Relative Foreclosure Rates for Conventional and Government Loans by Credit Score Range

Loan type	FICO <621	FICO 621–660	FICO >660
Conventional fixed rate	28.5	7.3	1.0
Government fixed rate	45	12.8	3

These data date from the period before HUD began to increase affordable-housing requirements and encourage reductions in mortgage underwriting standards through the elimination of down payments, expansion of lending to credit-impaired borrowers, and other weakened lending standards. These efforts, taken pursuant to the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act), forced the GSEs and the entire market to emulate the FHA's already high-risk lending, which got even riskier as the FHA further weakened its lending from the early 1990s forward.

[49] Supra. Federal Reserve, derived from table 6. The index sets the average foreclosure rate equal to one for loans with a borrower FICO score of more than 660 and an LTV of <=80 percent. Data are from Freddie Mac over the period 1994–95.

[50] The relationship between high-LTV and lower-LTV loans is understated by these data. In 1994, almost all of Freddie's loans had an LTV of 90 percent or less, with a small percentage having LTVs of 91–95 percent. Virtually none had an LTV >95 percent. As a result of HUD's mandates, Freddie (and Fannie) began acquiring 97 percent LTV loans in 1994 and 100 percent LTV loans in 2000.

[51] Supra. Federal Reserve, derived from Table 2. The index sets the average delinquency rate equal to one for conventional fixed-rate loans. Data are from the period 1990–93.

Appendix 5:

FHA lending

From its creation in 1934, the FHA has been one of Congress's main tools to support low- and moderate-income single-family housing. Since its establishment in 1934, the FHA has led the entire market to ever-higher LTVs. The figures below[52] show LTV trends over the last sixty years:

Figure A5.1: Postwar Trends in New Home Mortgage Loan-to-Value Ratios, 1947-67

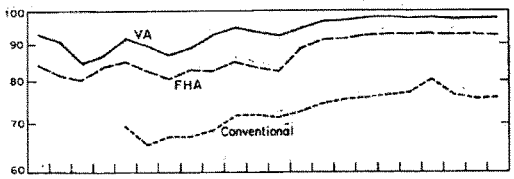


Figure A5.2: Postwar Trends in Existing Home Mortgage Loan-to-Value Ratios, 1947-67

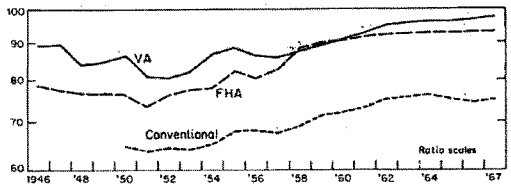
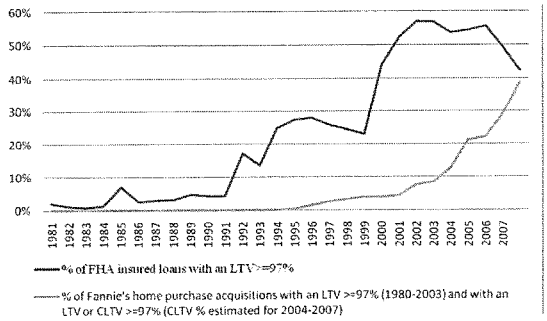


Figure A5.3: Trend of FHA and Fannie Loans with no Downpayments



[52] Thomas N. Herzog, "History of Mortgage Finance with an Emphasis on Mortgage Insurance," Society of Actuaries, www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history.pdf (accessed January 14, 2011)

Beginning its operations during the Great Depression, the FHA admirably performed its role through World War II and the postwar boom. As noted above, Congress periodically increased the FHA's LTV limit or extended its maximum loan term (or both). This was presumed to come at no cost and was likely justified on the basis of the FHA's previous experience. From 1934 through 1954, the FHA insured 2.9 million mortgages. For this period, during which house prices increased by 57 percent, the FHA paid claims on 5,712 properties for a cumulative claims rate of 0.2 percent[53] and had revenue of $494 million and expenses of $246 million.[54] The FHA's apparent success encouraged Congress to periodically loosen underwriting standards (see table A5.1):

Table A5.1: FHA's Transition to Unsustainable Lending

Year	Maximum LTV limit	Maximum loan term	Monthly payment*	Homeowner equity after five years (with no increase in house prices)	Mortgage payment-to-income ratio	Income needed to buy median-priced home*
1934	80%	20 years	$670	30%	Not available	Not available
1938	90%[55]	25 years[56]	$695	17%	Not available	Not available
1948	90%	30 years	$660	14%	17% (average)	$26,600 income/ $44,600 home[57]
1956	95%	30 years	$697	10%	Not available	Not available
1984	97%	30 years	$712	8%	38% (maximum) [58]	$23,000 income/ $80,000 home[59]

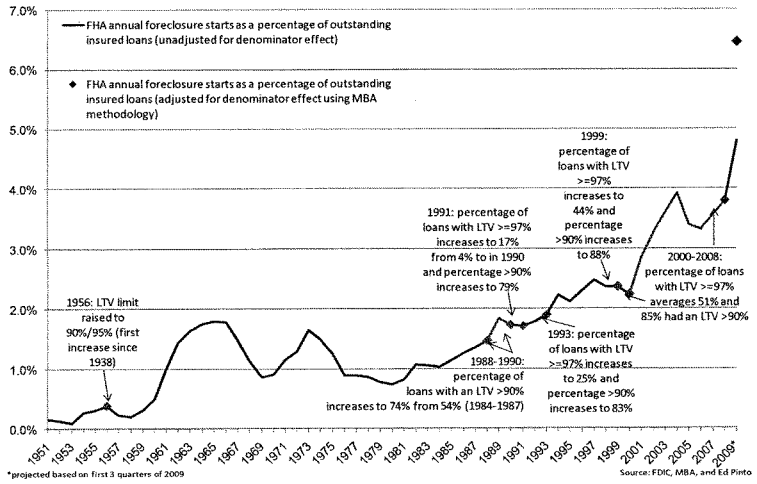
* For comparison, all examples are based on the purchase of a $100,000 home at the maximum LTV and term with an interest rate of 8 percent, except for median-home-price calculation, which uses applicable median home price.

[53] To put this in perspective, the FHA had twice this number of claims during the single month of October 2010. Federal Housing Administration, Department of Housing and Urban Development, "Monthly Report to the FHA Commissioner Department of Housing and Urban Development on FHA Business Activity," October 2010, www.hud.gov/offices/hsg/rmra/oe/rpts/com/10oct.pdf (accessed January 14, 2011).
[54] . Supra., Herzog and Earley
[55] Ibid.
[56] Ibid.
[57] Median price data for 1950. See US Census Bureau, "Census of Housing," www.census.gov/hhes/www/housing/census/historic/values.html (accessed January 14, 2011).
[58] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb," Heritage Foundation, July 29, 1986, 7, www.policyarchive.org/handle/10207/bitstreams/9281.pdf (accessed January 14, 2011).
[59] U.S. Census Bureau, "Median and Average Sales Prices of New Homes Sold in United States," www.census.gov/const/uspriceann.pdf (accessed January 14, 2011).

As seen from table A5.1, the FHA started out with both a substantial down payment (20 percent) and loan amortization, so by the end of the first five years of the loan, the homeowner had equity of 30 percent. Further, debt ratios were low. In the late 1940s, the FHA had an average mortgage-payment-to-income ratio of 17 percent.[60] By the early 1980s, a buyer would only have equity of about 8 percent after five years, and mortgage payments had about doubled relative to income.[61] Reliance on house-price inflation and lending to highly leveraged borrowers had become necessary parts of FHA's financing structure.

As figure A5.4 demonstrates, there was a cost. As FHA took on more risk, foreclosures increased.

Figure A5.4: FHA's Increasing LTVs on Annual Foreclosure Starts as a Percentage of Insured Loans



By 1961, the FHA was experiencing a foreclosure start rate of 1.00 percent per year—over six times the rate in 1951.62 Equally disconcerting was the fact that the private sector, in order to compete, followed the FHA's lead by increasing LTV, loan-term, and debt ratios.

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[60] John P. Herzog and James S. Earley, Home Mortgage Delinquency and Foreclosure (Cambridge, MA: National Bureau of Economic Research, 1970).

[61] Stephen Moore, "How Congress Can Diffuse the Federal Housing Time Bomb."

[62] This increase led *Time* magazine to observe: "Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as 'the walkaways,' they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear." Credit: Beware of the Walkaways," *Time*, July 27, 1962, www.time.com/time/magazine/article/0,9171,827500,00.html (accessed January 14, 2011).

As a result of the FHA's risky underwriting standards, its claim rate has been excessive for many decades. Over a thirty-five-year period (1975–2009), the FHA's cumulative claim rate averaged 10.5 percent, and over 1992–2009 it averaged 10 percent. Even during the boom years of 1995–2003, the cumulative claim rate still averaged nearly 8 percent. During bust periods (1980–85 and 2005–2008), it averaged 18 percent—over two times the rate in good times. For 2010–17, the FHA has projected an 8 percent average claim rate even with an expected 33 percent increase in home prices over 2011–20.[63] Relying on home-price inflation to attain a default rate of nearly one in ten is not sustainable lending.

[63] FHA Actuarial Studies for 2010 and 2000.

Appendix 6:

What Others Have Said about Reforming the Housing Finance Market

On September 22, 2010, former Federal Reserve chairman **Paul Volcker** was quoted as follows:[64]

> "The former Federal Reserve chairman [and special adviser to President Obama] said the mortgage industry is dysfunctional and a 'creature of the government' that needs reform. . . . He would want to avoid a 'hybrid' institution that is 'private when things are going well and public when things are going badly.'"

In a June 2010 speech, FDIC chair **Sheila Bair** stated:

> "The financial crisis was triggered by a reckless departure from tried and true, common-sense loan underwriting practices."

In comments made at a September 29, 2010, House Financial Services Committee hearing, Chairman **Barney Frank** said:

> "When you start subsidizing homeownership, you're getting into trouble. When people clearly can't afford it, you are imposing on them an obligation going forward that was shaky from the beginning."
>
> "Acknowledge as a mistake the setting up of private corporations, Fannie Mae and Freddie Mac, but infusing into their business decisions a social component so that they, because of the [affordable housing] goals, we could never be sure what the basis was."
>
> "[In terms of future entities] I would be opposed to any mandate to them. They will be making business decisions."

In an August 2010 interview, Representative **Frank** stated:[65]

> "I hope by next year [2011] we'll have abolished Fannie and Freddie . . . it was a great mistake to push lower-income people into housing they couldn't afford and couldn't really handle once they had it." He then added, "I had been too sanguine about Fannie and Freddie."

Representative **Jeb Hensarling** in an October 2010 interview stated:[66]

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[64] Daniel Bases and Kristina Cooke, "Obama aide Volcker says mortgage market reform crucial," Reuters, September 22, 2010.
[65] Larry Kudlow, "Barney Frank Comes Home to the Facts."
[66] Stacy Kaper, "Hensarling's Aggressive Agenda Starts with Housing Finance Reform," *American Banker*, October 27, 2010, www.americanbanker.com/issues/175_206/jeb-hensarling-1027690-1.html?ET=americanbanker:e4810:1353098a:&st=email&utm_source=editorial&utm_medium=email&utm_campaign=AB_Daily_Briefing_102610 (accessed January 14, 2011).

> "In general, we've had a lot of federal policies that incented, strong-armed, or cajoled financial institutions to loan money to people to buy a home that they could not afford to keep."

In an October 2010 interview, Representative **Hensarling** stated:[67]

> "And I think that frankly a lot of the housing policies that have taken place over both successive Republican and Democratic administrations are going to have to be re-examined."

In an October 2010 interview, Representative **Hensarling** stated:[68]

> "Slowly but surely, you ratchet down their [Fannie and Freddie's] conforming loan limits. Slowly but surely, you ratchet up their capital standards to that of a well-capitalized bank. You slowly but surely increase the down-payment requirement and you allow the private marketplace to come into those areas where Fannie and Freddie on an ongoing basis, begin to retreat so that a competitive market can begin to come in. A private market can't get started as long as there is a government guarantee for mortgage debt, whether implied or explicit. No one is going to compete with Uncle Sam—who's got a printing press, who can print money and can put untold trillions of liability exposure on the taxpayer. Nobody is going to compete with that."

In an October 2010 interview, Representative **Hensarling** stated:[69]

> "My principles are I want to err on the side of competitive markets that have disclosure and empower consumers with the information they need to make intelligent choices."
>
> "I believe housing should be part of the social safety net, but I want it designed for those who potentially are too old, too disabled, too young to help themselves. . . . And whatever we do, it probably ought to be done through an FHA-like structure. But it has to be actuarially sound and it needs to be on budget."

In comments made at a September 29, 2010, Financial Services Committee hearing, Representative **Ed Royce** said:

> "The US is the only country with government backed mortgage insurance, government backed MBS guarantees, and GSEs."
>
> "The mortgage finance system of tomorrow must be based, the lion's share of it, on private capital, private investment."

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[67] Ibid.
[68] Stacy Kaper, "Hensarling's Aggressive Agenda Starts with Housing Finance Reform."
[69] Ibid.

In an October 2010 interview, Representative **Spencer Bachus** stated:[70]

> "Using taxpayer money to subsidize the mortgage market is an addiction, and like all addictions it can't be cured overnight. There will be a reasonable transition period over a number of years to allow the private market to develop."

In comments made at a September 29, 2010, House Financial Services Committee hearing, Representative **Randy Neugebauer** said:

> "We can have a robust housing finance market without putting the taxpayers at risk."

Edward DeMarco, acting director of the Federal Housing Finance Agency, advised caution in September 2010 testimony:[71]

> "To put it simply, replacing [Fannie and Freddie's] 'implicit' guarantee with an explicit one does not resolve all the shortcomings and inherent conflicts in that model, and it may produce its own problems."
>
> "First, the presumption behind the need for an explicit federal guarantee is that the market cannot evaluate and price the tail risk of mortgage default. . . . [Is there] reason to believe that the government will do better? If the government backstop is underpriced, taxpayers eventually may foot the bill again."
>
> "Second, if the government provides explicit credit support for the vast majority of mortgages in this country, it would likely want a say with regard to the allocation or pricing of mortgage credit for particular groups or geographic areas."
>
> "Third . . . explicit credit support for all but a small portion of mortgages, on top of the existing tax deductibility of mortgage interest, would further direct our nation's investment dollars toward housing."

In testimony before the Financial Crisis Inquiry Commission charged with investigating our latest financial crisis, **Warren Buffett** made these observations about the power of rising prices to mesmerize virtually all concerned:[72]

> "Rising prices and discredited Cassandras from the past blunt the sensitivities and judgment of even people who are very smart. A home is a sound investment . . . and if you believe house prices are going to go up next year, you are going to stretch to buy one this year, and the world enabled people to stretch. After awhile, rising prices became their own rationale.

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[70] Sean Lengell, "GOP Targets Mortgage Bailouts," *Washington Times*, November 21, 2010.
[71] *Testimony of Edward DeMarco, Before the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises*, 111th Cong. (September 15, 2010).
[72] The original source for this quote was http://www.cspan.org/Watch/Media/2010/06/02/HP/R/33689/Financial+Crisis+Inquiry+Commission.aspx, however this link is no longer working. Much of Mr. Buffett's remarks may be found at: http://www.investingcontrarian.com/index.php/financial-news-network/warren-buffett-at-the-financial-crisis-inquiry-commission/.

People decided if buying one house is a good idea, then buying three houses is a good idea. Buying a house you can afford is a good idea, then buying a house you can't afford is a good idea because it is going to go up in price. And people who lent money said it really didn't make any difference if the guy's lying about his income. If the house goes up in price, we'll get our money back anyhow. So rising prices are a narcotic and affect the reasoning power up and down the line."

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