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HOUSING FINANCE REFORM: ACCESS TO THE SECONDARY MARKET FOR SMALL FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING ACCESS TO THE SECONDARY MARKET FOR SMALL FINANCIAL INSTITUTIONS

JUNE 28, 2011

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HOUSING FINANCE REFORM: ACCESS TO THE SECONDARY MARKET FOR SMALL FINANCIAL INSTITUTIONS

TUESDAY, JUNE 28, 2011

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

The Committee met at 10:03 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

The Committee meets today to continue our series of hearings on housing finance reform. This hearing will examine how small banks and credit unions currently sell mortgages on the secondary market and how any potential changes to the housing finance system would affect their access to that market.

Community banks and credit unions play a crucial role in local economies across the country, particularly in rural areas, and as 90 percent of FDIC-insured institutions hold less than $1 billion in assets, any action by Congress must not ignore small institutions.

The current system is unsustainable and the need for reform is clear, but I am concerned that proposals for the future of the secondary market could lead to bank concentration and unintentionally limit access for these institutions. This hearing will help us better understand the possible consequences of such proposals as well as their potential impact on the rest of the housing market, local communities, and the broader economy.

There are several questions we must consider. If small institutions do not have access to the secondary market, will they be able to offer mortgages to their customers and at what cost? How would it affect those institutions and their surrounding communities? Would some proposals provide more equitable secondary market access than others?

I look forward to hearing from our panel and thank them for their testimony and their time. I would also like to submit testimony for the record on behalf of the National Association of Federal Credit Unions.

With that, I will turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Small and community banks play a unique and vital role in our housing finance market. Historically, small banks were the primary source of mortgage lending. If you wanted to buy a home, you went to your local bank to get a mortgage. Today, however, the financial landscape is quite different.

First, the banking industry has witnessed substantial consolidation. In 1984, there were 15,000 banking and thrift organizations in this country. Today there is less than half that number. In addition, mortgage lending is concentrated in just a few banks. Last year, three banks—yes, three banks—originated 56 percent of all mortgages while 8 institutions serviced 63 percent of all outstanding mortgages.

Another shift in the mortgage landscape is the dependence on capital markets to finance mortgage lending. Before the advent of securitization, the vast majority of single-family residential mortgages were held by banks. In 1970, banks held over 70 percent of single-family residential mortgages while 30 percent were held by the Government and other investors. By 2008, those numbers had flipped, with banks holding less than 30 percent of mortgages. The days when your local bank actually owned your mortgage generally have long passed.

Despite these significant changes, small banks have proven to be remarkably resilient and able to adapt to the new environment. Because they are close to their communities, small banks are often able to find profitable lending opportunities overlooked by the big mortgage lenders. Therefore, there is no economic reason why small institutions cannot compete with large ones. I believe we just have to make sure here that we do not create regulatory barriers that place small banks at an unfair competitive disadvantage.

Accordingly, as we consider how to reform our housing finance system, it is critical that we devise a system that works for all banks, not just large institutions. Any reform should recognize that small banks have very different business models. Failing to account for the distinct needs of small banks could needlessly accelerate the consolidation of our banking industry to the detriment of consumers and taxpayers.

For generations, small banks have been the backbone of the communities throughout our Nation, and as we undertake housing finance reform, we must ensure that they remain so for generations to come.

Chairman JOHNSON. Thank you, Senator Shelby.

Senator Hagan wants to say something briefly in that we have a witness from North Carolina.

STATEMENT OF SENATOR KAY HAGAN

Senator HAGAN. Thank you, Mr. Chairman, and thank you for holding this hearing on the role of the secondary mortgage market for small financial institutions.

As we look at ways to reform our housing finance system, it will be critical to understand the issues faced by small financial institutions and the communities that they serve. I would also like to thank the Chairman for inviting Peter Skillern, the executive director of Community Reinvestment Association of North Carolina, to testify before the Committee today. CRA–NC, as the association is known, is dedicated to promoting and protecting the community wealth in underserved areas. Since its creation in 1986, it has played a key role in regional advocacy and development for underserved areas.

Mr. Skillern is a graduate of the Kenan-Flagler School of Business at UNC–Chapel Hill, came to work at CRA–NC after serving as the executive director of the Durham Affordable Housing Coalition, and under his guidance CRA–NC has pioneered innovative outlets to promote financial education to residents in underserved areas, and this is something that I have championed for many years, especially during my time in the North Carolina General Assembly. I look forward to his testimony and the deep knowledge he can bring to today's discussion on access to the secondary market for small financial institutions.

Thank you, Mr. Chairman.

Chairman JOHNSON. Before I introduce the witnesses, would any of my colleagues like to make a brief opening statement?

[No response.]

Chairman JOHNSON. If not, then we will proceed.

Mr. Jack Hartings is the president and CEO of the People's Bank headquartered in Coldwater, Ohio. Mr. Hartings is also the treasurer of the Independence Community Bankers Association.

Mr. Edward Pinto is a resident fellow at the American Enterprise Institute, a private, nonprofit institution dedicated to the research and education of a host of different policy issues.

Mr. Rod Staatz is the president and CEO of SECU, a North Carolina-based credit union founded in 1937. Mr. Staatz is also a member of the Board of Directors for the Credit Union National Association.

Mr. Christopher R. Dunn is the executive vice president of South Shore Savings Bank, a Massachusetts-based full-service mutual savings bank.

Finally, we have Mr. Peter Skillern, executive director of the Community Reinvestment Association of North Carolina, which is a nonprofit community advocacy and development group.

We welcome all of you here today and thank you for your time. Mr. Hartings, you may proceed.

STATEMENT OF JACK HARTINGS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE PEOPLES BANK COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. HARTINGS. Chairman Johnson, Ranking Member Shelby, Members of the Committee, I am Jack Hartings, president and CEO of The Peoples Bank Company and a member of the Executive Committee of the Independent Community Bankers of America. The Peoples Bank Company is a $350 million asset bank in Coldwater, Ohio, and I am pleased to represent community bankers and the ICBA's nearly 5,000 members at this important hearing.

Any broad-based recovery of the housing market must involve community bank mortgage lending. Community banks represent approximately 20 percent of the mortgage market, but more importantly, our mortgage lending is often concentrated in rural areas and small towns not effectively served by large banks. For many borrowers in these areas, a community bank loan option is the only option. The Peoples Bank Company serves a community of about 5,000 people and has been in business for 105 years. We survived the Great Depression and numerous recessions—as have many other ICBA member banks—by practicing conservative, commonsense lending.

Today I would like to talk about my bank's mortgage lending and the importance of the secondary market access. Mortgage lending is about 80 percent of my business. About half the mortgage loans I make are sold, mostly to Freddie Mac, with a smaller portion going to the Federal Home Loan Bank of Cincinnati. The secondary market allows me to meet customer demand for fixed-rate mortgages without retaining the interest rate risk these loans would carry. As a small bank, it is not feasible for me to use derivatives to manage interest rate risk. Selling into the secondary market frees up my balance sheet to serve customers who prefer adjustable rate loans as well as small businesses which play a vital role in our community.

The mortgages I sell perform extremely well. None of my mortgages that I originated for Freddie Mac have gone into foreclosure. Currently, none of my loans in my $75 million Freddie Mac portfolio have been 30 days or more delinquent in the past 3 months. Although my bank's performance may be exceptional, it is typical of community bank-originated mortgages to perform well, and it shows in the data.

The key to the performance of community bank mortgages is diligent, community-based underwriting and servicing. Again, using my bank as an example, while Freddie Mac's automated underwriting, Loan Prospector, provides a set of ratios and statistics that are useful in the initial screening, our underwriting is enhanced with the direct and personal knowledge of the community and the lifestyle of the borrower. A grasp of these intangibles is what makes the difference between community-based relationship lending and remote transactional lending done by the megabanks.

When it comes to servicing—and we service all of our loans that we sell to Freddie Mac—again, our community connection makes the difference. We know, for example, when an employer closes in our community and how that may impact the income of our borrowers. We intervene early and work out mutually agreeable solutions with struggling borrowers.

My written testimony has a comprehensive list of features that make the secondary market entity attractive to a community bank. I will limit my discussion here to the essential ones.

First, equal access and equal pricing. A sustainable and robust secondary market must be impartial and provide equitable access and pricing to all lenders, regardless of size and lending volume.

Second, originators must have the option to retain servicing after the sale of the loan. While servicing is a low-margin business, in fact I would make more by releasing servicing rights. It is a crucial aspect to my relationship lending business model, giving me the opportunity to meet additional banking needs of my customers. What is more, when I release servicing, I release proprietary consumer data that is highly valuable for cross-selling products. Community banks must be able to preserve customer relationships and franchises after transferring loans.

As we listen to the debate over the secondary market reform, community banks are particularly alarmed by proposals that would transfer the functions of Fannie Mae and Freddie Mac to a small group of megabanks, the very ones whose abusive loan terms, slipshod underwriting, and exotic securitization contributed to the most recent financial catastrophe. Such proposals would intensify systemic risk and moral hazard through concentration of assets. I urge this Committee to reject any proposal that does not provide equal representation for community banks and lenders of all sizes and does not ensure that communities and customers of all varieties are served.

Thank you again for holding this hearing and for the opportunity to testify.

Chairman JOHNSON. Thank you, Mr. Hartings.

Mr. Pinto, you may proceed.

STATEMENT OF EDWARD J. PINTO, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. PINTO. Chairman Johnson, Ranking Member Shelby, thank you for the opportunity to testify today.

In mortgage lending, community financial institutions face two continuing but related threats. While community financial institutions did not cause the financial crisis, it appears now that they will be subjected to regulatory overload. The 12 pages of statutory provisions related to qualified residential mortgage and qualified mortgage have now ballooned to over 800 pages of proposed regulations. This adds insult to injury. Fannie Mae and Freddie Mac, the GSEs, had a long history of giving their largest and riskiest customers lower guarantee fees. This denied community financial institutions fair and equal access to the secondary market. It disadvantaged them economically and in many cases resulted in handing over their best customers to their large bank competitors.

As far back as 1995, Fannie Mae's top 25 customers, led by Countrywide, benefited from substantially lower guarantee fees than Fannie's 1,200 smallest customers. Large lenders like Countrywide also benefited from looser underwriting standards, many times undertaken to meet affordable housing goals. In 1995 Fannie Mae was frank about the risks and why it was willing to take them. Countrywide liked to test the limits of investment quality underwriting and had a major impact on Fannie Mae's affordable housing goals.

In my written testimony is a chart that speaks volumes about the risks posed by too-big-to-fail financial institutions as compared to regional and community banks. There are over 6,000 banks in this country with less than $10 billion in assets. Virtually all of them are community banks, and there are virtually no community banks over $10 billion. They had a current nonperforming loan rate of a little over 2.5 percent. The four banks that are over $1 trillion have a rate of over 16 percent nonperforming loan rate, and all banks over $20 billion have a rate of approximately 12 percent, about 5 times what community banks experience.

The nonperforming loan rate is a delinquency in excess of 90 days, 90 days or more, or a loan that has already been moved into foreclosure. You have heard similar statistics from Jack Hartings on the sales to Fannie Mae.

A white paper I coauthored with Peter Wallison and Alex Pollock has principles, many of them similar to those suggested by Mr. Hartings' testimony.

First, a limited scope of conservatively underwritten products available for securitization. We advise repealing QRM and QM and replacing them with a statutory definition of prime loan, and that is outlined in my written testimony. We have already been beset with problems emanating from the broad delegation in the original legislation to regulators, lobbying by industry groups against the proposed regulations, and claims by many Members of Congress that their intent was thwarted.

Second, adequate private capital would insulate taxpayers. Risk-based pricing needs to be adequate for long-term cycles, and that would help assure equal access regardless of loan volume. Any replacement structure must avoid re-creating the moral hazard represented by Fannie and Freddie by not replacing them with a few too-big-to-fail banks.

We need strong supervision. Relying on a regulatory structure that incorporates countercyclical capital accumulation and other self-implementing features rather than expecting regulators to be all knowing and all seeing, with somehow having the ability to reset capital levels on the fly based on market conditions or put brakes on at just the right time is not reasonable of feasible.

And, last, accommodate a joint venture structure that will aggregate the mortgages produced by community financial institutions.

There is one area that we think special caution should be taken. Many industry participants call for the Government to guarantee mortgage loans for catastrophic loss. History suggests that that guarantee will end up costing the taxpayer dearly. Why? Because the reserves necessary will not be accumulated, the Government will not be able to successfully price the risk, and you will have distortion of prices, resource allocation, and competition, and there will be political interference, which leads to weakened credit standards.

The private market that would develop under a more privatized approach would be entirely different from the distorted market created by the GSEs. A high preponderance of the mortgage would be prime loans, loans of the kind that community financial institutions usually originate. These loans will be highly sought after because not only are they good investments, but the type of mortgages that can be securitized.

Thank you and I would be happy to answer questions at the appropriate time.

Chairman JOHNSON. Thank you, Mr. Pinto.

Mr. Staatz, you may proceed.

STATEMENT OF ROD STAATZ, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECU OF MARYLAND, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

Mr. STAATZ. Mr. Chairman, Ranking Member Shelby, Members of the Committee, thank you very much for the opportunity to testify at today's hearing.

A healthy, efficient, and accessible secondary market is vital to credit unions and the millions of consumers we serve. The problems that led to the conservatorships of the Fannie and Freddie need to be addressed in a comprehensive and meaningful manner. However, as Congress and the Administration undertake this effort, it is critical that a widespread availability of mortgage credit, housing affordability, consumer protection, financial stability, and strong regulation are maintained. We urge Congress to take reasonable time to complete GSE reform and to ensure that an effective foundation will be responsive to the needs of borrowers and lenders.

Credit unions are increasingly important players in the residential mortgage market. Since 2007, we have originated over a quarter of a trillion dollars in mortgages. I will focus my testimony on our principles of housing finance reform and our concerns with the proposed definition of a qualified residential mortgage.

Quite frankly, many credit unions fear a world in which the secondary market is occupied by a handful of very large banks. Concerns about access to and pricing in such a market are frequently expressed. We believe that it is very important that there be a neutral third party whose sole role would be as a secondary market conduit.

The Federal Government has a very important role to ensure that the secondary market operates efficiently, effectively, and fairly for all borrowers and lenders alike. We believe that there are seven principles that are essential to consider as you develop comprehensive housing finance reform:

Number one, equal access. The paramount concern for credit unions is equitable access to the secondary market. It is essential that the Federal Government's regulation ensure that terms, rates, and conditions for selling loans are affordable and fair to all lenders, regardless of their size or charter type.

Number two, strong oversight and supervision. Secondary market services must be subject to appropriate oversight to ensure safety and soundness, including strong capital requirements.

Number three, durability.

The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times.

Four, financial education. Credit unions are leaders in providing quality financial education to their members, which may help account for credit unions' low loss rates. If other lenders did the same, borrowers could make better decisions.

Preservation of the 30-year fixed-rate mortgage. This product is the centerpiece of the mortgage lending market, and the new system should facilitate its availability to qualified borrowers. Federal support should remain to preserve this product, and the costs should be borne by the financial mortgage finance system, not by the taxpayers.

Affordable housing, number six. The important role of Government support for affordable housing should be a function separate from the responsibilities of the secondary market entities. Programs to stimulate the supply of credit to lower-income borrowers are not the same as those for the broader mortgage market. Combining both goals in a single vehicle can frustrate the achievement of each goal individually.

And, number seven, transition. Changes to the housing finance system must be reasonable and orderly to avoid further disrupting a housing market that is in a fragile State of recovery.

I would also like to briefly address our concerns with the proposed definition of QRM. This definition is narrower than what was contemplated under Dodd-Frank, which requires a credit risk retention rule. We are concerned that the stringent definition of QRM could not only shut out an entire class of qualified borrowers from the market, but could also drive up mortgage liquidity for small lenders. Further, QRM could be a template that regulators will impose on all home mortgage loans, whether they are securitized or not. We urge Congress to insist that the regulators go back to the drawing board and issue a new proposed QRM definition for public comments.

Mr. Chairman, reform of the housing finance system has already proven to be a very difficult challenge, but failing to make necessary changes to improve the system will result in even greater challenges for the economy, lenders, and borrowers.

Thank you for taking credit unions' concerns into consideration. I appreciate the opportunity to testify, and I am happy to answer any questions the Committee may have.

Chairman JOHNSON. Thank you, Mr. Staatz.

Mr. Dunn, you may proceed.

STATEMENT OF CHRISTOPHER R. DUNN, EXECUTIVE VICE PRESIDENT, SOUTH SHORE SAVING BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. DUNN. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, my name is Christopher Dunn. I am executive vice president and chief operating officer of South Shore Savings Bank in South Weymouth, Massachusetts. I appreciate the opportunity to testify on behalf of the ABA.

The issue of GSE reform is a critical one for banks, particularly for community banks like mine, which use the GSEs as the primary mode of access to the secondary markets. I have been in the mortgage lending business since 1972 and sold my first loans to Fannie Mae in 1974, so I know the importance of secondary market access for smaller banks. Without that access, my bank could not be an active player in the mortgage market because our balance sheet could not support the demand. Further, we would not be able to offer long-term fixed-rate loans due to the increased interest rate risk that this would create for our portfolios.

The ABA believes that a private market for the vast majority of housing finance should be encouraged with a much smaller Government role. To distinguish our position from others, we define a private market as one without a Government guarantee of any sort, not private ownership of companies that operate with a Government backstop. Therefore, the role of Fannie Mae and Freddie Mac should be reduced and transformed. We believe that the Government's role in housing finance should be to ensure stability and accessibility of the capital markets in the event of a market failure. In addition, FHA should return to its traditional role of servicing first-time homebuyers and borrowers who may not qualify for conventional financing.

The overarching principle is to ensure that banks of all sizes have access to the secondary market financing. The ABA has not endorsed a specific structure for the GSEs and the private secondary market, and finding the right system will be challenging. In the meantime, there are steps that can be taken and should be taken to reduce governmental involvement, foster private sector financing, and still assure equitable access to all secondary markets for the banks. These steps are essential to begin an orderly transition from the failed market structure.

First, the compensation being paid for what amounts to full Government backing is simply not priced correctly in the market. These G-fees, as they are called, should be dialed up in an orderly manner so that eventually the private market will be able to price for risk in a fashion that allows for safe and sound lending at comparable and eventually better rates than the GSEs. The increased G-fees will also help to offset losses and repay the Government for its investment in Fannie Mae and Freddie Mac.

The second mechanism for a transition to a private market is to set more reasonable loan limits for GSE purchases. The current maximum loan limits are dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide.

Underpinning all of this must be workable and clear underwriting standards for all mortgage loans. We must get the underwriting standards correct today if we hope to transition to a stable system for secondary market instruments.

The current regulatory proposals for risk retention define a narrow qualified residential mortgage exemption. As a result, many high-quality loans posing little risk will end up being excluded. This will inevitably mean fewer borrowers will qualify for loans to purchase or to refinance a home. Moreover, should this proposal be adopted as proposed, it will drive many banks out of mortgage lending. ABA strongly believes that this rule should be substantially rewritten and reproposed. Specifically, we recommend that most mortgage loans with lower risk characteristics, which include most of the loans being made today by community banks, should be exempted from the risk retention requirements regardless of whether they are sold to Fannie Mae and Freddie Mac or private securitizers. The imposition of risk retention requirements is a significant change to the operation of the mortgage markets and must not be undertaken lightly. Driving community banks from the mortgage marketplace and shutting out many borrowers from the credit market entirely is completely counter to having a vibrant mortgage market. ABA urges Congress to exercise its oversight authority to assure that logical, consistent rules are adopted.

Thank you for the opportunity to testify, and I would be pleased to answer any questions.

Chairman JOHNSON. Thank you, Mr. Dunn.

Mr. Skillern, you may proceed.

STATEMENT OF PETER SKILLERN, EXECUTIVE DIRECTOR, COMMUNITY REINVESTMENT ASSOCIATION OF NORTH CAROLINA

Mr. SKILLERN. Thank you. Thank you very much, Chairman Johnson and other Members, for allowing me to speak today on reforms in the secondary market.

On September 6, 2000, I testified before the House Financial Institutions Subcommittee on Government Sponsored Enterprises and I stated, quote, "For the record, these high-cost loans will become a significant problem in the coming years. In the future, this Committee will return to discuss how the financial markets played a role in spurring high default rates and the decline of our neighborhoods." That proved to be true. Subprime lending was bad for our neighborhoods and for our economy, and the purchase of those high-cost subprime loans was the primary cause for the GSEs' failure.

Today, I am concerned that reform proposals that eliminate the GSEs and convert to a solely private capital market will also be harmful for our communities and housing sector as a whole. We support reforms to increase private mortgage capital with adequate oversight. However, the GSEs are needed as public purpose agencies that provide stability for our Nation's housing and financial markets.

We are concerned that megabanks will dominate the mortgage market from origination to securitization, to the detriment of consumers and small banks. In the rural areas of Alabama, North Carolina, Oregon, Ohio, and South Dakota, megabanks originated 75 percent of conventional loans and 88 percent of FHA loans. By comparison, small institutions, under $10 billion, originated 16 percent of conventional loans.

Small lenders shop their loans among the secondary buyers of GSEs and financial banks. Loans are underwritten to a standard established by the GSEs and sold as commodities to those who are offering the best price and services. If the GSE is eliminated, the secondary capital markets will become dominated by megabanks, which will further concentrate capital in a vertical integration of the mortgage market. This will disadvantage small lenders' access to capital, underwriting, and technology that is controlled by their competitors. If megabanks are too big to fail now, imagine their size, power, and vulnerability as they become guarantors and holders of the mortgage-backed security market.

Capital is greedy and scared. Its volatility adds to swings during booms and busts. Private capital is the primary source of liquidity, will not act countercyclically to provide credit in a recession or to slow things in a boom.

By analogy, mortgage credit is like water. We are concerned about the quality of water that comes out of our tap, but we also want to know who controls the water's availability and its price. Who owns the plumbing from the water source of the glaciers to the spigot at home? Mortgage credit, like water, is too critical and should not be entirely controlled by private interests.

But if we should not privatize the secondary market, what should be done? We believe that the GSEs should be converted into public purpose entities that are accountable to Congress but are not a department of the Government, such as the Federal Housing Administration. The agency would provide liquidity for 30-year mortgages that are explicitly guaranteed or price adequately for reserves. The agency would provide liquidity for multifamily financing. The agency would act as a provider of underwriting standards and technology for the benefit of the whole market. It would balance private influence by providing choice on the secondary market.

As an example, the North Carolina Housing Finance Agency is not a Government department. It is independent, but yet it serves a public purpose of financing affordable housing and rental. While appointed by the Governor and State legislature, the board is independent, self-supporting, and operates without appropriations. Likewise, the GSEs can serve the public purpose in the secondary market for rental and home ownership financing.

We concur that the *status quo* is not acceptable in the long term for a healthy secondary market. We support reforms that include reducing the portfolio of GSE loans and liabilities. They have grown too large and the sale of assets can help to strengthen the capital base of the institutions. Pricing for explicit Government guarantees on 30-year mortgages is needed. Reforming FHA to provide adequate infrastructure and oversight to its portfolios is part of a broad reform.

We oppose the GSEs' current loan level pricing program and recommend that it be amended to better utilize private mortgage insurance. This will lower FHA volume, yet increase lending to creditworthy households who have low downpayments.

The financial meltdown was caused in large part by private label mortgage-backed securities. Private institutions should be involved in mortgage securities, but on the condition they are recognized as systemic risks and have adequate oversight for safety and soundness.

Let me state for the record, if the proposal to eliminate the GSEs succeeds, this Committee will meet in the future to address new problems. We will have more volatile capital markets, greater inequality in the access to mortgages, and disinvestment from low- and moderate-income communities. The real estate market will struggle as it becomes more difficult for renters to become first-time homebuyers. Small lenders will be less competitive with megabanks. We will lack financing for affordable rental housing for our workforce.

If mortgage financing is not inclusive of low- and middle-income families, we will have a system that works very well for some, but not for too many others, and ultimately not for the greater good. Our agency affirms the vision of an inclusive and healthy housing market.

Thank you very much.

Chairman JOHNSON. Thank you, Mr. Skillern.

For Mr. Hartings, Mr. Staatz, and Mr. Dunn, an article in the HousingWire last week stated in its headline, "Big Four Top Contenders to Replace Fannie and Freddie," and went on to name

Bank of America, Citigroup, JPMorgan Chase, and Wells Fargo as the likely replacements. Can you discuss the challenges or benefits this might present to small institutions? Mr. Hartings.

Mr. HARTINGS. To answer that, I guess I cannot see any benefit to moving it from a Fannie and Freddie and just moving it to the four or five largest megabanks. It just moves that risk. I think the key to at least our success in underwriting loans has been being able to be close to our customer base, some common-sense lending, and whatever program would be improved on, I guess for Freddie and Fannie, would have to have those same guidelines to have that equal access and fair access and fair pricing. That is part of it. You know, you can have—you can be able to sell to a larger institution, but you could be priced out of the market, either because you charge more for servicing or a higher rate to sell that loan to those larger institutions.

Chairman JOHNSON. Mr. Staatz.

Mr. STAATZ. First of all, one of our principles was that we want—we would like to see equal access, and I am just not sure that if those four very large banks are the conduit or are the ones that are participating in this, do you really think that we will have equal access? In other words, do we believe that pricing would not be affected and it would be different for them versus us smaller institutions?

So, again, would we have equal access? I am not sure that we would. And would the pricing be different? I am almost positive, because you are putting in the hands of for-profit institutions control of the marketplace and I am not sure that is a wise idea. We need an independent third party.

Chairman JOHNSON. Mr. Dunn.

Mr. DUNN. There is no question that large banks have a decided advantage, and that is why one of the principles that we have had, as the other speakers have stated, is that replacement of the GSEs needs to provide for access by all lenders. The mortgage markets nationally have been well served by community banks and other lenders other than the big four over the years and we think that is a very important ingredient for a successful, stable mortgage market going forward.

Chairman JOHNSON. Mr. Skillern, in your written testimony, you raise a concern that phasing out the GSEs will disadvantage smaller institutions, making them less competitive and less independent from large institutions while creating even greater concerns about institutions being too big to fail. Would you elaborate on those concerns.

Mr. SKILLERN. Yes, sir. Access to capital is not only about the money, it is about access to the technology and the business services that allow you to sell on the secondary market. One can imagine large lenders saying, if you would like to have capital access through our channel, you will need to adopt our business operations to do so and our underwriting, trapping small institutions into one channel or the other and, therefore, becoming less competitive, unable to shop their loan among different players. So that is one of our primary concerns about its impact on the local institutions.

Chairman JOHNSON. Mr. Hartings, Mr. Staatz, and Mr. Dunn, we have heard from previous witnesses that without a Government guarantee, the 30-year fixed-rate mortgage would not exist, but that adjustable-rate mortgages or rollover mortgages would develop. Would limiting access to the secondary market create a similar reduction in the availability of the 30-year fixed-rate mortgage? Mr. Hartings.

Mr. HARTINGS. It is hard for me to answer that theoretical question. I can tell you from my customer base, we are in the secondary fixed-rate mortgage market because that is what the customers are demanding out there. It stabilizes their budgets. They do not have to worry about interest rate fluctuations. So whatever is done going forward, I think providing a secondary market for a 30-year fixed-rate mortgage is of the utmost importance.

Chairman JOHNSON. Mr. Staatz.

Mr. STAATZ. Like my colleague here, we do quite a business in 30-year mortgages because that is what our members want, and for the very same reasons, and it avoids future issues. Now, does it need to be priced differently in the future? That is a possibility. But I also tell you that with our 30-year mortgages, again, the ones that we have sold to Freddie, there have been no losses whatsoever. So from a credit standpoint, they have been fine. Only interest rate risk has been an issue for us. But there ought to be a way to price that in the future.

Chairman JOHNSON. Mr. Dunn.

Mr. DUNN. Tying the fixed-rate mortgage, the elimination of that to the changes in the secondary market, I do not think they necessarily go hand in hand. I think that the key determinant long-term of the existence of the 30-year mortgage is really the correct risk pricing of that loan. I think that increasing the G-fees as presently discussed in our testimony is really the key. Without a proper risk premium in a 30-year fixed-rate, I think you do see a possibility of the 30-year fixed-rate going away.

Chairman JOHNSON. Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you, and let me start out by saying to all the members of the panel, thanks for being here. Your testimony and your comments have been very, very interesting.

Let me, if I might, come at this from a little bit different direction. One of the things I hear from our bankers back in Nebraska—and I am not talking about the big four or five, obviously, I am talking about bankers like a couple of you represented at the table—is that you have a small bank out there, limited ability to respond to the requirements of Dodd-Frank, *et cetera, et cetera,* stacks of paperwork to understand, the potential liability that occurs in making a real estate loan, and on and on, and they are saying to me that they are kind of getting to a point where they are saying, why are we doing this? It does not make any sense for us to be in the mortgage business.

Mr. Dunn, I would like to hear your thoughts about those comments from Nebraska bankers. Are they overreacting, or are they pretty much hitting the nail on the head?

Mr. DUNN. It has crossed our mind.

Senator JOHANNS. I think you are being diplomatic. You do not have to be here.

[Laughter.]

Mr. DUNN. The regulatory burden is significant. I think that probably the most important issue that we see before our bank right now in terms of determining whether or not we are going to be in the mortgage business or not is this whole discussion circulating around the Qualified Residential Mortgage. If that stays as currently proposed, we have—we have talked to a number of our fellow community bankers and we have no doubt that the move toward a safe harbor protection will be there, and quite frankly, a lot of loans that otherwise are being made today to qualified borrowers will not be made in the future.

The regulatory burden itself overall has become pretty significant, and quite honestly, it is hard to keep them straight and many of the bills overlap, or many of the regulations overlap and contradict and it is a challenge.

Senator JOHANNS. Mr. Hartings, do you have some thoughts about that?

Mr. HARTINGS. Well, I would agree with the comments of Mr. Dunn. I think, you know, as a banker, as a community banker, we are very good at understanding credit and qualifying credit, and I always tell everybody, there are two documents I need on every loan. I need a note and a mortgage. The rest of the items are just disclosures and slows down the process.

Now, a lot of those are very well intended, but one of the interesting emails I have received, or several of the interesting emails were from bankers, actually, one from your State, that said, tell them about the regulatory overload. A lot of the smaller institutions are just not able to stay up with the paperwork and are leaving the market just simply because it is too cumbersome to close a real estate mortgage, and it seems sad to me, because that is really the heart of our business as community lenders is to take care of our communities.

Senator JOHANNS. Now let me add another feature to this, if I could. Everybody, I think, wants a robust mortgage industry. We have got a struggling housing market. We can only benefit by having community bankers involved in the process, and the more the better for a guy like me, you know. I go to these local banks. These are community leaders. These are the people that are asked first to contribute to new uniforms for the high school football team, whatever it is that is going on, and they are always the first to say yes. I mean, they lead the effort.

What I see happening, and I would like you to react to this, too, is that the smaller banks who have limited ability to respond to the burden of additional regulations and requirements and oftentimes have a difficult time getting the expertise to come to a small town to live, *et cetera,* are just starting to look around and say, you know what? I know we have been around 100, 125 years, but quite honestly, it is time to sell. Are you seeing that in your States? Let me start again with Mr. Dunn.

Mr. DUNN. We are not a publicly owned institution, first of all, but there is no question that it has been more difficult for us to compete, but I think we are a little bit more optimistic about our ability to do that, particularly now that—one of the reasons we lost a lot of market share over the course of the last several years is the playing field is not level and a lot of that had to do with lack of enforcement of regulations that were already in place. And we were disadvantaged in the marketplace to a great extent by people who did not play by the same rules that the community banks play by.

We, as a bank, and I think most community banks, are comfortable with the whole concept of ability to pay. In fact, we like to have people pay us back when we lend them money. And the standards of ability to repay are good. What we do not like is regulations that come down and they are "check the box" underwriting that removes all discretion and does, in fact, challenge our ability to perform in the marketplace the way we have done.

Senator JOHANNS. Mr. Hartings, do you have a thought on that?

Mr. HARTINGS. In our State, I know a lot of community bankers getting up in age a little bit, looking for succession planning, and are having a difficult time being able to find a qualified individual to bring into that bank to continue. I do not know that they have made that decision to sell out, but, you know, we look at regulations as kind of a pile-on. Sometimes we are asked, what regulation would you like to see eliminated? It is not one regulation. It is every regulation and it continues to pile on, and that is really the difficulty that we have.

When I have examiners come in, they look at my institution and I will occasionally ask them a question and they will say, well, we are not the expert of that. We will get back to you. Well, I have to be the expert of all of those regulations and every community bank has to be. So size is not a determining factor. So that is definitely pushing some individuals to reconsider their franchise.

Senator JOHANNS. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman. I also want to echo those remarks. Thank you all for being here. I very much appreciate all your testimony and thank you for your perspective on this issue.

You all talked about access, all talked about equal access to the secondary market, and it is something that is very, very important in rural America, as I think it is important across the country. As we look at the secondary market and Fannie Mae and Freddie Mac in particular, what can we do to ensure that you have that access? I will start with Mr. Hartings and then Mr. Staatz and then Mr. Dunn—on equal access.

Mr. HARTINGS. I think that is the biggest concern that I have about going from a GSE market to a private market. You have to have some kind of a system in place, and I do not have the answer for you for that today. I know ICBA has talked about a co-op, and that is an idea, to own part of that company. But that concerns me very much, Senator.

Senator TESTER. OK. Go ahead, Mr. Staatz.

Mr. STAATZ. I cannot tell you exactly how it should be structured, but I can tell you that it should not—should not be structured where it is just in the hands of the largest institutions.

Senator TESTER. Amen.

Mr. DUNN. ABA does not have, nor do I, a silver bullet solution to this, and it is why we also believe that the direction of a private market is the way to go, but maybe some governmental role in that process.

Senator TESTER. I have got you, and I thank you all for your comments. It is not an easy situation, but the fact is that with input from folks like you all, I think that we can get around it.

You know, we all want a stable, liquid market. I think we all want more private investment in that market. Can a 30-year note—30-year fixed-rate, let me put it that way—can it exist without a Federal Government backing? And the same three, and we will start in reverse order, go with Mr. Dunn first.

Mr. DUNN. I believe I tied the future of the 30-year fixed-rate really to the pricing of the 30-year fixed-rate. I believe that, properly priced, there is probably a market out there for the 30-year fixed-rate without a guarantee.

Senator TESTER. OK.

Mr. STAATZ. I think that is a possibility. I think it is a possibility, but there may need to be some sort of guarantee, certainly not what we have been used to in the past.

Senator TESTER. OK. Mr. Hartings.

Mr. HARTINGS. I think it is also possible to do without some type of guarantee. It is really the equal access I would be more concerned about. Is that 30-year fixed-rate mortgage offered in small towns and rural areas if you let it controlled by the four or five largest banks.

Senator TESTER. And let us go back down the line again. Is the 30-year note something that is important, 30-year fixed-rate?

Mr. DUNN. The consumer pretty much decides that, and right now, it is very important to them. But I know the models have worked differently in other countries, so—and in terms of not having 30-year fixed rates.

Mr. STAATZ. It is——

Senator TESTER. Go ahead.

Mr. STAATZ. It is what our members want, the majority of our members.

Senator TESTER. OK.

Mr. HARTINGS. Fifteen years ago, I sold no mortgages to the GSEs. I started about 15 years ago. We were all adjustable-rate products. Today, I have $75 million in that portfolio. That tells me that my residential borrowers want the 30-year fixed.

Senator TESTER. OK. Mr. Dunn, on a previous question that was asked, you talked about lack of regulatory consistency and I very much appreciate those comments. I think they are critically important. I think we all want to have a level playing field for everybody, and I think the consolidation of the banking industry that we have seen over, as the Vice Chairman talked about, over the last 25 years or so, has not been healthy for the industry as a whole and is certainly not healthy for the consumer.

As we—the percentages are there. I mean, we talked about the percentages. Four percent of the largest banks currently have 70 percent of the originations. That is up. Is there anything we can do, and I do not mean to pick on the same three guys all the time, and I apologize to the two I have not asked—is there anything we can do to have you play a bigger role, because I, quite frankly, feel the same way you guys do. The role you play in rural America is critically important, and I think I should not just say rural America, the role you play in America is critically important. Are there ways that we can make it so you can have a bigger piece of the pie?

Mr. DUNN. Well, I think that if you look at the replacement or whatever is going to replace the GSEs——

Senator TESTER. Yes.

Mr. DUNN. ——we really do need some type of vehicle to allow the community bank access. We cannot just let it be through the big four lenders. I think that is one of the principles that we have talked about in approaching the whole subject. Again, it is not an easy solution. I think we are all pretty cognizant of the fragile state of the housing market. So any kind of a quick solution is not going to be there. The co-op structure may be a way to go, and I think that—I know the ABA is very open to looking at all sorts of different possibilities in helping shape that.

Senator TESTER. OK. Anything you would like to add, Mr. Staatz?

Mr. STAATZ. No, just equal access. I cannot stress that enough.

Senator TESTER. Same thing, Mr. Hartings.

Mr. HARTINGS. I would say, you know, it is a little bit like regulation. I do not want a bigger piece of the pie. I just want to keep my piece of the pie——

Senator TESTER. I have got you.

Mr. HARTINGS. ——and it is starting to leave, the way it looks to me. Thank you.

Senator TESTER. I, once again, want to thank you all for being here. I very much appreciate your testimony. I apologize to Mr. Pinto and Mr. Skillern for not asking you guys questions, but maybe next time. Thank you.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair, and thank you all for addressing this issue because it is really a key one.

I thought I would try to concentrate on this concept of the lender-owned cooperative. Mr. Hartings, in your written testimony, you elaborated a bit on how covered bonds would consolidate the market among, really, to the advantage of just a few large financial institutions. So I wanted to get a better sense of how you picture the lender-owned cooperatives. Do you picture this being essentially a cooperative in which it is all financial institutions, or primarily the smaller banks, the community banks, the credit unions, *et cetera?* What would be the—who would own them? What lenders are we talking about here?

Mr. HARTINGS. I do not know that I can answer that by going into quite that detail, but the idea of the cooperative is a little bit the way that I think we are successful today in the Freddie and Fannie market. We rep and warrant what we sell to Fannie and Freddie. That means that if Fannie and Freddie looks at our applications and they are incorrect or we falsified or we did not cross every "t" and dot every "I", it comes back to us. We have capital to back that up.

That is the idea of the cooperative a little bit. The other point of the cooperative is equal voices, having one vote per bank. So I am not sure that you limit it or not. Again, I do not know that we have gone into that detail. It is one proposal and it is the proposal that I think we have out on the table today.

Senator MERKLEY. OK. And in your written testimony, you talk about strategy for insulating taxpayers and note, and I quote, "Government catastrophic loss protection would be paid for by an appropriately priced co-cop premium." So it sounds like you are expecting the Government to stand behind the co-op as the insurer of last resort, essentially, but I want to make sure I understood that structure.

Mr. HARTINGS. I am not—I really would not like to comment on that. I mean, I am not sure that is exactly our theory. I think the idea would be—again, at this point in time, our proposal out there. I think when you get into the details, I think that is when you have to look at that a little bit more seriously, how you would take care of that backstop.

Senator MERKLEY. OK. So I wanted to invite other folks to weigh in on this. This is part of the challenge we are all trying to figure out here, is how do we create a functional secondary market in which the taxpayers are not on the hook or are on the hook in a very defined and responsible manner of some sort. But I think it makes me a little nervous to see the Government being the insurer, because how do you know that you have an appropriately priced co-op premium? If the premium is completely appropriately priced, you would not need that insurer to begin with. You could just put it into a fund to the side. So a little expansion on this role would be helpful. Mr. Pinto.

Mr. PINTO. Yes, Senator. I think that is a good point. If you could price it properly, you would not need it. I think the problem with real estate financing is it is cyclical and there are boom-bust periods and there are the normal losses, and those losses can be actuarially calculated based on the normal risk factors. And then there are the imponderables, which occur as a result of some economic event. This past one was very unusual because it was led by very weak mortgage lending. Normally, it is led by some type of other economic event, like unemployment, and then that impacts the weaker loans. We had the reverse this time.

But what you can be sure of is that there will be these catastrophes periodically. When, is the problem. We do not know. All we know is they will occur and you need to accumulate enough capital to deal with the largest event you can anticipate. It is kind of like the 100-year flood, and you accumulate that capital.

The problem with a Government guarantee is the history of accumulating that level of capital is not very good. Pricing it, the impacts on, as I said, the impacts on the marketplace that are unintended, the political pressures to reduce the amount of capital. Oh, we have not had any claims in three or 4 years. Therefore, we should not do anything. That happened with the FDIC. They did not charge any premiums for 96 or 97 percent of the banks in this country for about 10 years because it was thought that they had accumulated enough capital. Those are the risks that really put the taxpayer in the cross-hairs.

Senator MERKLEY. One thing about that FDIC model, though, is that it does allow them to go back out and increase their rates to recoup it and, therefore, not have the Government as the ultimate backstop, but I am running out of time and I wanted to go on.

Mr. Skillern, you talk about something modeled more or less on the North Carolina Housing Finance Agency, that is, a public purpose entity, and you note in your written testimony that you get rid of the conflicting private profit motive which may have driven some of the practices in the GSEs that came back to haunt us. Does the idea of a lender co-op perhaps fit into that, or is this kind of a different, completely different structure?

Mr. SKILLERN. I think it would be a different structure. In addition to my concern about access to capital for small financial institutions, I also have it for low- to moderate-income households and communities of color, and that the pricing of that risk and how we define the boundaries could be very narrow or more expansive as long as they are more responsible and sustainable. So I also think that the Housing Finance Agency model would be a smaller role to play, if you look at the total, what is really happening in North Carolina. It fits a particular range where there is an appropriate role for Government to help facilitate home ownership and rental housing.

So there is a—we really embrace this concept of both private and public participation, but that public has to be intentional. And I guess my concern about the cooperative model is that that is not intentional enough to assure us that we are going to have enough access to a range of communities across the country.

Senator MERKLEY. Do you see the Government standing behind such a public purpose entity, an independent nonprofit, if you will, that is playing this secondary market role?

Mr. SKILLERN. Yes, sir, I do. You know, I believe that, while as much as we want to put taxpayer money behind private money, that we want to assign risk to the decision maker so that we are not putting taxpayers to insure someone else's moral hazard, the reality is is that our Government and our taxpayers stand behind our society as far as the risk that we take and our cost. So there is a role for that and I think we should be up front about it, but also then be clear about defining what those limits are, and I think that this finance agency model allows us to define that more clearly, to say who pays once private dollars are taken.

Senator MERKLEY. Thank you. Thank you, Mr. Chair. I am going to continue for a moment here.

Mr. Pinto, you observed that the community banks and credit unions were producing better loans but paying higher guarantee fees, and I am trying to picture how this unfolded and I assume it was volume discounts and the competition between Fannie and Freddie, but can you elaborate a little bit on how it is that a better product had to pay a higher insurance fee?

Mr. PINTO. Yes, I would be happy to. Back—I actually went back into the late 1980s and the guarantee fees were level regardless of lender, and then starting in about—I had data from 1993, 1994, 1995, the guarantee fee started diverging, and I mentioned—that is in my written testimony. What was going on was this competition with Fannie and Freddie for customers and also for affordable housing loans. I found credit policy meeting minutes that talked about the fact that the credit variances were being approved. I also found evidence that there were lower guarantee fees being offered to the larger customers.

Over time, those widely diverged, and so Mr. Hartings' testimony is correct. The losses on the community bank loans were much lower at much higher guarantee fees than experienced the other way around. Countrywide and the other large lenders were paying much lower guarantee fees but had much higher default rates. Again, it was driven by a combination of competition and the goals that were looking for the kinds of loans that were most easily gotten from the large lenders.

Senator MERKLEY. Were those fees denominated in terms of percentage rates for the size of the loan? Is that how it was done?

Mr. PINTO. Yes. It is termed in basis points, so it was called a guarantee fee, and normally guarantee fees would range from, you know, 20 to 25 basis points, and things got down as low in the mid-aught years around 10 basis points, 11 basis points, somewhere in there for the largest lenders as their base fee. So you can see the disadvantage. That does not sound like a lot, ten basis points, but when you multiply it every year, it ends up being something on the order of close to half-a-percent. Well, given the profit margin that one has on a loan, a half-a-percent looms large.

Senator MERKLEY. So if I am an investor, would I not want to pay a higher price, if you will, for loans originated by community banks and credit unions where they have a tradition of kind of honest underwriting, if you will?

Mr. PINTO. One would think so. I actually had conversations with Freddie Mac on this precise topic about 5 years ago and asked that question from the head of marketing and I was told, well, we already have their business. Why would we pay up for it? And I made the exact point that the quality was better, and there were lots of different reasons why it was better, and the answer was, we already have that business. Why would we pay up for it?

Senator MERKLEY. Well, and in essence, the investor was looking at pools that mixed the loans from many sources, so they did not have really a choice of discriminating as far as I am aware.

Mr. PINTO. Well, when you said investor, I was talking about Fannie Mae or Freddie Mac.

Senator MERKLEY. Yes.

Mr. PINTO. But as far as the investor, the end investor's concern, everything got, as you said, put together and the investor had the implicit guarantee of Fannie and Freddie. So they really did not look below to see what was going on below that guarantee by Fannie and Freddie.

Senator MERKLEY. Thank you all. Thank you very much.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

Mr. Skillern, in your testimony, you mentioned that the GSE loan level pricing adjustment policy impacts on low- to moderate-income borrowers. This appears to be similar to what is being proposed in the Qualified Residential Mortgage proposed rule. Loans with low downpayments become less affordable as conventional loans and are forced into FHA. Can you explain this program to me and what lessons can be learned from it in regards to pricing loans according to the size of the downpayment rather than the ability to pay?

Mr. SKILLERN. To echo the comments of the bankers who feel like they have the ability to understand risk because they know their customer and to do the loan file review, the ability to repay is really the primary underwriting that we should have in approving loans.

The loan level pricing program of GSEs is essentially pricing much higher for loans that have downpayments less than 10 percent and credit scores less than 720. And while we certainly applaud stringent underwriting, safe underwriting, the result, though, is that as you start to add price to anything outside that narrow band, you push folks over to FHA, which has a bigger impact of more credit being direct—more risk directly on the taxpayer as the Government guarantees FHA loans, or you start to price people completely out of the home ownership market and deny them. And it starts to shrink who is able to purchase a home, particularly on the first-time homebuyer.

The QRM is similar in that it is even a greater definition. It starts to—it is setting the benchmark at 20 percent downpayment, further narrowing who the eligible, creditworthy borrowers are, and as my fellow bankers have said, there are a lot of good borrowers out there who do not necessarily have ten or 20 percent down. And when you look at who in that category does not, it often tends to be low- and moderate-income households or communities of color who do not have that downpayment or wealth to be able to meet that criteria.

So part of our housing policy has to be based on sound economics, sound underwriting, protecting the taxpayer. It also should be done with some sense about how do we have social inclusion that allows credit across the spectrum of our communities. That is the intentionality that I referred to earlier.

So we are opposed to the QRM because it draws that band of what is prime much too narrow and is not good for the housing market as a whole, nor for the local communities.

Senator HAGAN. When I look at the average income in North Carolina and I think about a 20 percent downpayment, it appears that people would have to save upwards of 15 years plus in order to be able to afford a 20 percent downpayment on an average house in North Carolina, and I just think that is definitely pricing people out of the market——

Mr. SKILLERN. Yes——

Senator HAGAN. ——and unreasonable.

Mr. Pinto, the FDIC before the passage of Dodd-Frank put in place its own risk retention regulation. Has the FDIC risk retention provision that predates Dodd-Frank ignited mortgage securitization, and how important is the return of a vibrant mortgage securitization market for the return of private capital?

Mr. PINTO. Senator, you are referring to the one that was passed in 2001?

Senator HAGAN. No, I was referring to the most recent Dodd-Frank.

Mr. PINTO. No, the FDIC——

Senator HAGAN. Yes.

Mr. PINTO. ——pre-Dodd-Frank——

Senator HAGAN. Right.

Mr. PINTO. Was that in 2001, that securitization? They had a rule that changed the weighting——

Senator HAGAN. I presume so.

Mr. PINTO. OK. If that is the one, the regulators, and it was not just the FDIC, I think, banking regulators changed the weighting for AAA private mortgage-backed securities. The research I have done has shown that that did not have any immediate impact on what was going on in the mortgage-backed securities market. Whatever happened, happened with about a 3-year lag. So I could not tie the two together.

Regarding your second question, yes, I believe it is necessary for the financial markets to have a vibrant mortgage-backed securities market because the banking system is not large enough to handle it, number one, and number two, the too-big-to-fail problems in the banking system, we do not want to end up just moving mortgage risk from Fannie and Freddie, where it was not very well managed, to, as has been talked here today quite a bit, three or four large banks.

Senator HAGAN. Thank you. And, Mr. Hartings, how reliant are small community bankers on the ability to originate, to sell a mortgage, and how problematic is the proposed rule for the risk retention language in Section 941 if the regulators do not get the QRM right?

Mr. HARTINGS. Well, we look at our balance sheet when we have risk retention. We have interest rate risk in our—we are rated as banks under CAMEL. They added CAMELs a couple of years ago, which was sensitivity, risk rate sensitivity. If we have to retain some of that mortgage on our books, then we have a whole another issue with capital. So, yes, I think that would be devastating to community banks.

Senator HAGAN. I do, too. And, Mr. Hartings, currently, small lenders are able to participate in the mortgage market by selling loans to Fannie Mae and Freddie Mac without having to go through one of the big banks to accumulate enough loans, as we were talking about, to create a securitization pool. What would the Administration's proposals do to the ability of smaller lenders, such as community banks, to compete in the mortgage market and what would this do to the concentration of the market?

Mr. HARTINGS. You know, my belief would be it would concentrate it to the, certainly the larger megabanks, again, without equal access, and it is equal pricing. Mr. Pinto touched on it a little bit. Every day, we go out to Freddie and Fannie and we price our loans accordingly. They give us—we sell at a par or par plus a half-a-percent. If that pricing gets raised, how often does my customer want to come to me if I have to charge him a half-a-percent higher or a full 1 percent higher? We would lose it either immediately or as a slow burn, as we call it.

Senator HAGAN. Thank you. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, gentlemen, for your excellent testimony.

Mr. Pinto, I want to follow up on something that you commented upon in your testimony, and that is the need for both strong supervision and adequate capital. You know, we have a debate right now about adequate capital. I think you also suggest that it has to be countercyclical, that capital has to be built up. So if you could elaborate on those points, I would appreciate it.

Mr. PINTO. Thank you, Senator. I would be happy to. As I said, the mortgage business is countercyclical, has these two components of risk, the second of which is this catastrophic risk that occurs because of, generally, some external event. And back in the early 1980s, it was the collapse of oil prices which then led to high unemployment in Texas and elsewhere. So you do not know what it is going to be. You just know you have to be prepared for it.

And the problem, and Fannie Mae is the perfect example. Fannie Mae had a static capital requirement that was 45 basis points on—less than half-a-percent on its guaranteed loans. That stayed pretty constant. They were accumulating very little in the way of loss reserves because of the way the accounting works for that. And so as the risk was building up in the system—but it did not look like risk was building up in the system because delinquency rates looked very low. Well, that was being fed by the boom that was keeping them down and everybody was thinking everything was fine.

What happened was they were not accumulating any additional capital, and then when the boom ended and they collapsed, *A,* they were very thinly capitalized. The mortgage-backed securities were 220-to-one. And their actual capital was very weak. Half of their capital was tax advantaged. Well, again, if you are a financial guarantee entity, to invest your money in something that you need to make money in order to have your capital be worth something, it seems, is backwards. So those are the kinds of——

Senator REED. Right. But in the context today, when we are talking about capital rules for these large megabanks and for—particularly large megabanks, my sense is that you would suggest that there needs to be more than less capital.

Mr. PINTO. In general, more, and in general, if the entities are too big to fail, they should be smaller.

Senator REED. Thank you very much.

Mr. Hartings, one of the issues here on the Qualified Residential Mortgages, what is the downpayment and what is the sort of percentage of your income that you are devoting to housing. And I think one of the reactions across America, not on Wall Street but on Main Street, was as this housing crisis evolved was people were shocked, saying, they did not put any money down and 45 percent of their income was a mortgage payment?

So now, looking at this proposed regulation—and it is a proposed regulation—we were very general in our description of what the QRM should be. There seems to be—there has got to be some notion of a, I think in the minds of people on the street, of a minimum downpayment to make this a safe loan, a traditional loan. So just what is the average downpayment that you would insist upon in your very well-run community bank? Is it 10 percent? Is it 15 percent?

Mr. HARTINGS. We have a couple of different programs. Certainly, most of everything we sell to Freddie Mac has got the 20 percent down, the Federal Home Loans, and we actually have a program we do internally in our bank called Homebuyers Assistance that we have five, ten, or 15 percent down.

What you really find out is it is not the downpayment. It is other things, like payment-to-income ratio. It is, did you come up with your own downpayment? What is your credit card debt? It is not one silver bullet that decides if that is going to be a good loan or not. Our concern would be if you just look at downpayment, you do not want to be an asset lender, and that is the way you are going to get paid back. You really want to look at the probability of payment from your customer through a regular source.

Senator REED. Can I presume that you would think appropriate that when this regulation is finally approved, it would have some combination, as you suggest, of minimum downpayment—in fact, my sense is most people are still shocked that people were getting—I grew up in the 1950s, 1960s, 1970s, where you had to put money down—some combination of downpayment and also some percentage of your housing per income and also other expenses per income. Are we just arguing about what the proper sort of numbers are——

Mr. HARTINGS. My concern——

Senator REED. ——because you——

Mr. HARTINGS. My concern is this. I saw the market a couple years ago when we did not participate in the subprime, and what I would see happen is I would see someone selling a home for $100,000. They would increase the price to $110,000 or $115,000. That person, that seller, would give the buyer the downpayment and he had the downpayment. So they gamed the system——

Senator REED. No, I——

Mr. HARTINGS. ——so that is what I am concerned about when you put some hard ratios in there——

Senator REED. Of course, the other concern is if you do not have any of these rules of the road, you get exactly what we had, which was gaming, no money down, great products, *et cetera.* So I think, you know, the challenge we gave to regulators was come up with an appropriate balanced mechanism that exempts certain loans from the requirement to hold, and you would not have to hold a loan. You could sell anything you want to the securitizer. They would have to hold 5 percent. And we thought, and I think, again, the logic we can examine, is that if they had to hold some of these, they would not be quite as willing to buy terrible products that were emanating from many different sources. So I am just trying to get a sense from a community banker of what you are doing and what we have to do.

Mr. HARTINGS. Well, I think what we are doing is when we see less of a downpayment, we have somewhat of different standards, maybe a little higher standards in some of these other areas, and we hold them a little firmer to those, because it is all risk and we do not want our customer not to be able to make their payment. We do not want them to have to leave their home and have it foreclosed or sell it out from underneath them. So I think prudence says that if you have less of a downpayment, Senator, you probably have to have a little bit more stringent underwriting with those lesser downpayments.

Senator REED. Thank you.

Chairman JOHNSON. Thanks again to all of our witnesses for being here with us today. Steady access to the secondary market for small financial institutions is a necessary component to any proposal for reforming the housing financial system. Your testimony today will, without a doubt, serve as a resource to this Committee as we continue to work toward creating a stable and sustainable housing market for American families.

The hearing record will remain open for 7 days for additional statements and questions.

This hearing is adjourned.

[Whereupon, at 11:22 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF JACK HARTINGS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE PEOPLES BANK COMPANY, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

JUNE 28, 2011

Chairman Johnson, Ranking Member Shelby, Members of the Committee, I am Jack Hartings, President and CEO of The Peoples Bank Company and a member of the Executive Committee of the Independent Community Bankers of America. The Peoples Bank Company is a $350 million asset bank in Coldwater, Ohio. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on "Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions." Community bank mortgage lenders have a great deal at stake in the future of housing finance in this country. Any proposal for reform must support fair and robust access to the secondary market for community banks.

Community Banks Strengthen the Mortgage Market

Any broad based recovery of the housing market must involve community bank mortgage lending. Community banks represent approximately 20 percent of the mortgage market, but more importantly, our mortgage lending is often concentrated in the rural areas and small towns of this country, which are not effectively served by large banks. For many rural and small town borrowers, a community bank loan is the only mortgage option.

A vibrant community banking sector makes mortgage markets everywhere more competitive, and fosters competitive interest rates and fees, better customer service, and more product choice. The housing market is best served by a large and geographically dispersed number of lenders. We all witnessed the danger and devastating fallout that resulted when mortgage lending became concentrated in a few major market players. We must promote beneficial competition and avoid further consolidation and concentration of the mortgage lending industry.

Quality Community Bank Mortgage Lending

The Peoples Bank Company has been in business for 105 years. We survived the Great Depression and numerous recessions before and since—as have many other ICBA member banks—by practicing conservative, common-sense lending. We make sure loans are affordable for our customers and they have the ability to repay. Loans are underwritten based on personal knowledge of the borrower and their circumstances—not based on statistical modeling done in another part of the country. Community banks generally did not make subprime loans with the characteristics that have led to recent problems, such as "teaser" rates and lack of appropriate documentation. As responsible community-based lenders, community banks require appropriate documentation of borrower income and do not make loans that compel borrowers to refinance or sell in order to remain solvent. As a result, our borrowers are less likely to default.

When community banks sell their well-underwritten loans into the secondary market, they help to stabilize and support that market. Community bank loans sold to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (the GSEs) are underwritten as though they were to be held in portfolio. We often go beyond the ratios and statistics used by the GSE automated programs and underwrite based on direct and personal knowledge of the community and the lifestyle of the borrower him or herself. This relationship underwriting makes a striking impact on the performance data. In a typical year, before the GSEs accelerated their purchases of riskier loans, community bank-originated loans became "seriously delinquent" (*i.e.,* more than 3 months delinquent) at about one-third the rate of all GSE loans. In the most frenzied, exuberant years of mortgage lending, 2005 through 2007, the general pool of GSE loans was seriously delinquent at a rate four or five times higher than loans originated by community banks and sold to GSEs. In the wake of the financial crisis, with the general tightening in underwriting standards, community bank loans have continued to perform better—with a delinquency rate one-third to one-half that of other loans. Community bank loans perform better in all market conditions and contribute to the safety and soundness of the secondary markets. Our role must be preserved in any reform.

Better underwriting is complemented by better servicing—the two sides of the lending equation. Community bank servicing, which is also based on our close ties to customers and communities, is more effective at keeping mortgages out of default. We know, for example, when an employer closes in our community and how that closure impacts the income of our borrowers. A servicer based 1,000 miles away won't have such knowledge. Smaller servicing portfolios and better control of mortgage documents also provide an advantage over the large servicers. For these reasons, community banks have generally been able to identify repayment problems at the first signs of distress and work out mutually agreeable solutions with struggling borrowers.

As Congress and the agencies consider how to address the abusive servicing standards of some large lenders, they must recognize community banks have fundamentally different standards, practices, and risks. Overly prescriptive servicing requirements should not be applied across the board. For example, if the State attorneys general foreclosure settlement term sheet were applied to all banks, regardless of size, it would cause many community banks to exit the mortgage servicing business and accelerate consolidation of the servicing industry, leaving it to the largest too-big-to-fail lenders.

Fair Access to the Secondary Market

While community banks choose to hold many of their loans in portfolio, it is critical for community banks to have robust secondary market access in order to support lending demand with their balance sheets. My bank's access to Freddie Mac, for example—I have a $75 million servicing portfolio of loans we originated and sold to Freddie Mac—allows me to support the broad lending needs in my community, fixed-rate lending in particular. As a community bank, it is not feasible for me to use derivatives to offset the interest rate risk that comes with fixed-rate lending. Secondary market sales eliminate this risk. In addition, I have the assurance that Freddie Mac won't appropriate data from loans sold to solicit my customers with other banking products.

While many community banks remain well-capitalized following the financial crisis, others are being forced by their regulators to raise new capital, even above minimum levels. With the private capital markets still largely frozen for small- and mid-sized banks, some are being forced to contract their lending in order to raise their capital ratios. In this environment, the capital option provided by the secondary markets is especially important. Selling my mortgage loans into the secondary market frees up capital for other types of lending, such as commercial and small business, which is critical to our communities.

In addition to selling mortgage loans to Freddie Mac, for the past 2 years my bank has participated in the Mortgage Purchase Program (MPP) through the Federal Home Loan Bank of Cincinnati. While our sales to the MPP are only a fraction of our sales to Freddie Mac, we're pleased to have this alternative secondary market access. The Federal Home Loan Banks (FHLBs) are an important source of liquidity to support community bank mortgage lending. The FHLBs were particularly important during the financial crisis when they continued to provide advances to their members without disruption while other segments of the capital markets ceased to function. The FHLBs must remain a healthy, reliable source of funding.

Key Features of a Successful Secondary Market

The stakes involved in getting housing-finance market policies right have never been higher. Given the fragile state of the housing market across America, there is no room for policy missteps and no luxury for experimentation. Housing and household operations make up 20 percent of our economy and thousands of jobs are at stake. Proven, practical solutions must take precedence over the theoretical.

With regard to the secondary market, the critical questions of corporate structure, governance, and mission will determine whether, and to what extent, community banks are able to participate. If the terms are not right, the secondary market could be an impractical or unattractive option for community banks. Below are some of the key features community banks seek in a first-rate secondary market.

Equal access. To be sustainable and robust a secondary market must be impartial and provide equitable access and pricing to all lenders regardless of their size or lending volume. Without the appropriate structure, a secondary market entity will have a strong incentive to offer favorable terms to only the largest lenders. Such an outcome would drive further industry consolidation, increase systemic risk and disadvantage the millions of customers served by small lenders.

Financial strength and reliability. A secondary market must be financially strong and reliable enough to effectively serve mortgage originators and their customers even in challenging economic circumstances. Strong regulatory oversight is needed to ensure the secondary market is operating in a safe and sound manner.

No appropriation of customer data for cross-selling of financial products. When a community bank sells a mortgage to a secondary market entity, it transfers proprietary consumer data that would be highly valuable for the purposes of cross-selling financial products. Without large advertising budgets to draw in new customers, community banks seek to deepen and extend their relationships with their current customer base. Secondary market entities must not be allowed to use or sell this data. Community banks must be able to preserve our customer relationships and our franchises after transferring loans.

Originators must have option to retain servicing and servicing fees must be reasonable. Originators must have the option to retain servicing after the sale of a loan. In today's market, the large aggregators insist the lender release servicing rights along with the loan. Transfer of servicing entails transfer of data for cross-selling, the concern identified above. While servicing is a low margin business—in fact I would make more by releasing servicing rights—it is a crucial aspect of my relationship-lending business model, giving me the opportunity to meet the additional banking needs of my customers.

Because the income provided by servicing is only enough to cover costs, ICBA is very concerned about a recent Federal Housing Finance Agency (FHFA) proposal to significantly reduce servicing fees and, by rewarding servicers of nonperforming loans, remove the incentive for diligent servicing that keeps loans current. This would be unfair to community banks that predominantly service performing loans. Additionally, some of the proposed fees do not reflect the cost of loan servicing at a community bank.

Limited purpose and activities. The resources of any secondary market entities must be focused on supporting residential and multifamily housing. They must not be allowed to compete with originators at the retail level where they would enjoy an unfair advantage. The conflicting requirements of a public mission and private ownership must be eliminated.

Private capital must protect taxpayers. Securities issued by the secondary market entities must be backed by private capital and third party guarantors. Any Government catastrophic loss protection must be fully and explicitly priced into the guarantee fee and the loan level price. This guarantee would not only provide credit assurances to investors, sustaining robust liquidity even during periods of market stress.

The Future of the Secondary Markets

For decades the housing GSEs worked well and supported high-quality mortgage lending by banks of all sizes. However, conflicting demands of investor expectations and arbitrary affordable housing goals, combined with weak oversight and inadequate risk management, sent the GSEs off track, ending a long and successful run. The steep and sudden drop in the value of GSE preferred shares had staggering consequences for many community banks that purchased these shares with the support of their regulators. My bank held Freddie Mac preferred shares, so I speak from first-hand experience. This injustice must be corrected by restoring the dividend payments on the preferred shares and paying injured holders the amount of suspended dividends.

There is widespread agreement that this troubled model must be reformed. Any reform cannot simply reestablish the GSEs or recreate them under a different name with the same scale and risks. An aggressive role for Government in housing is no longer a viable option. The private sector should and will take the lead in supporting mortgage finance. ICBA welcomes this new reality as an appropriate response to the moral hazard and taxpayer liability of the old system. Community banks are prepared to adapt and thrive in this environment. But however different are the successors to Fannie Mae and Freddie Mac are from the legacy of those institutions, we believe they must retain the key features and principles that allowed community banks to thrive as mortgage lenders and to serve their communities.

The worst outcome in GSE reform would be to allow a small number of megafirms to mimic the size and scale of Fannie and Freddie under the pretense of creating a private sector solution strong enough to assure the markets in all economic conditions. This would create a new moral hazard, just as pernicious as the one it replaced. The concentration of assets would make them too big to fail. The market would know full well that the Government would bail them out (as it did in 2008) rather than let the housing market and the economy collapse. These lenders would in effect become privatized "Fannies" and "Freddies," with all the benefits and the risks that come with TBTF status. Moral hazard derives from the concentration of risk, and especially risk in the housing market because it occupies a central place in our economy. Any solution that fuels this consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

The GSEs must not be turned over to the Wall Street firms that fueled the financial crisis with sloppy underwriting, abusive loan terms, and an endless stream of complex securitization products that disguised the true risk to investors while generating enormous profits for the issuers. These firms have exploited the trust of investors and brought the economy to the brink of collapse. Lack of trust in these firms has hindered private investment in the mortgage market and prolonged Government dominance of it. They must not be allowed to reclaim a central role in our financial system.

A Note on Covered Bonds

While covered bonds have been advanced as an alternative to the secondary markets in providing liquidity to loan originators, they have, to date, enjoyed little investor interest. Also, these bonds are capital intensive which makes them infeasible for all but the largest banks. Banks like mine would have to sell their loans to larger banks thus fueling further concentration and consolidation.

With the conservatorship of Fannie Mae and Freddie Mac, there is some legislative interest in making covered bonds more attractive to investors by enhancing investor claims over the pool of assets that secures (or "covers") a covered bond. ICBA continues to analyze the legislative proposals that have been put forward. We are concerned the covered bond system may provide covered bond investors superior rights in receivership that aren't provided to other secured creditors. We have expressed our concerns with how this "super priority" status for the covered bond investor could affect the Deposit Insurance Fund (DIF) in the event an FDIC institution that held these covered bonds failed. Therefore, like all secondary market proposals, more analysis and rigorous debate is warranted to avoid unintended consequences.

ICBA Concept for Secondary Mortgage Market Reform[1]

One option for reform, which would address the criteria outlined above, would replace Fannie Mae and Freddie Mac with lender-owned cooperatives.

We believe this proposal would protect taxpayers from another bailout, ensure equal access and pricing for lenders of all sizes, deter further consolidation, ensure liquidity during periods of market stress, preserve the significant benefits of the "to-be-announced" (TBA) market, and minimize disruption in the market by providing for the direct transfer of Fannie Mae's and Freddie Mac's infrastructure to the new co-ops. While ICBA is prepared to advance the co-op option, other options that address our principles may be equally appealing to community banks.

Cooperative governance would ensure broad access and deter excessive risk taking

The key securitization role of Fannie and Freddie could be done by cooperative entities owned by mortgage originators who purchase stock commensurate with their loan sales to the co-ops. This is similar to the capitalization of the Federal Home Loan Banks (FHLBs) and provides a capitalization source that can be adjusted based on market conditions and risk profile and performance of the co-ops' book of business. Members would have an incentive to transfer only soundly underwritten loans to the co-ops because any losses would adversely affect their own capital investment.

The co-ops would be governed on a one-company-one-vote basis. Big banks would not be allowed to dominate the new co-ops. Further, directors would be appointed to represent various sizes and classes of members, while a minority number of seats would be reserved for outside independent directors with financial expertise.

The advantage of this form of governance is that all co-op members would enjoy open and equal access and benefits in terms and pricing, regardless of their origination volume. This would prevent industry consolidation and preserve access to credit for the millions of small town and rural borrowers served by community banks. The co-ops would be required to provide liquidity to all home mortgage markets on a continuing and equitable basis. Guarantee fees and reinsurance fees would be set by the co-op boards and would be the same for all members. However, any mortgage originators with substandard loan performance would be subject to additional surcharges and restricted access until their loan performance improved.

The co-ops would guarantee a limited range of conservatively underwritten products: 15- and 30-year fully amortizing mortgage loans.

The co-ops would only be engaged in the secondary market and would be barred from operating in the primary market. They would not unfairly compete with mortgage originators.

A privately capitalized guarantee fund would insulate taxpayers

Mortgage-backed securities issued by the co-ops would be guaranteed by a fund capitalized by co-op members as well as 3rd party guarantors. Resources would be mandatorily set aside in good times to prepare for challenging times. Any Government catastrophic loss protection would be paid for by an appropriately priced co-op premium. Any guarantee, must be fully and explicitly priced into the guarantee

[1] ICBA's cooperative model is similar to a proposal favorably analyzed by the New York Federal Reserve and the Government Accountability Office.

fee and loan level price, and would not only provide credit assurances to investors, sustaining robust liquidity even during periods of market stress, but—a point less often noted—it would enable the co-op securities to be exempt from SEC registration and trade in the "to-be-announced" (TBA) forward market.[2] Without the TBA market, which allows lenders to sell loans forward before they are even originated and to hedge their interest rate risk during the rate "lock" period, the typical 30-year fixed-rate loan as we know it and on 8 8 which our housing market is based will become a rarity. Again, private capital from members, mortgage insurers, and private reinsurers would absorb all but catastrophic losses to ensure taxpayer would be well insulated.

The infrastructure of Fannie and Freddie—including their personnel, patents, systems, automated underwriting engines—could be transfer to the new co-ops. This is an important and essential feature of the proposal as it would minimize disruption in the market and reduce the cost of the transition to the new system.

The outstanding debt and securitizations of Fannie and Freddie would maintain the current guarantee.

Strong Supervision

The Federal Housing Finance Agency (FHFA) would regulate and supervise the co-ops. FHFA would be responsible for setting and monitoring capital levels based on market conditions, portfolio performance and overall safety and soundness. FHFA would approve all new mortgage products purchased by the co-ops.

Closing

Private entities must play a more robust role in the mortgage securitization market. That much is all but settled. Still to be determined is what form those entities will take—instruments of Wall Street or those in which community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.

The co-op proposal is one option that encompasses our principles for a successful secondary market. ICBA looks forward to working with this Committee, the Administration, and our industry partners to examine proposals that can support quality, competitive mortgage lending and are in the best interest of the communities we serve.

Thank you for holding this hearing and for the opportunity to testify.

[2] In a TBA trade, participants agree to exchange a given volume of mortgage-backed securities at a specified date and at an agreed-upon price. This allows lenders to sell mortgages forward before they are even originated. Because it facilitates hedging of interest rate risk, the TBA market also allows lenders to offer borrowers an interest rate "lock" for as long as 90 days. TBA trades are based on an assumption of homogeneity among the securities that will actually be included in the MBS. This assumption is facilitated by standardization in the underwriting of mortgages and by a Government guarantee, implied or explicit.

PREPARED STATEMENT OF EDWARD J. PINTO

RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

JUNE 28, 2011

American Enterprise Institute for Public Policy Research

Statement before the U.S. Senate Banking, Housing, and Urban Affairs Committee

Hearing on

"Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions"

Edward J. Pinto

Resident Fellow

American Enterprise Institute

June 28, 2011

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Johnson and Ranking Member Shelby, thank you for the opportunity to testify today.

This hearing is a timely one. For many years community financial institutions have been denied fair and equal access to the secondary market.

Earlier this year Jay Brinkmann , chief economist for the Mortgage Bankers Association, summed up the impact this had on competition:

> "...[t]he pricing strategies that Fannie and Freddie pursued contributed to the concentration of mortgage lending within the largest banks. The GSEs offered reduced 'guarantee fees' for their largest customers, which placed smaller lenders at a competitive 'disadvantage.'" "NY Fed Thinks Megabanks May Be the New GSEs," *National Mortgage News*, March 16, 2011.

Banks prosper by making prudent loans with an adequate return and maintaining a reasonable cost structure. Community banks have long prospered by establishing and maintaining a relationship with their customers. This traditionally was accomplished with equal parts of small-business, consumer, and commercial real estate lending, plus some fee income on serviced loans. Today 97% of our banks are community banks and they are increasingly finding this business model under siege.

In the mortgage lending arena our nation's community financial institutions face two continuing but related threats to their future. While community financial institutions did not cause the financial crisis, they are being subjected to what will likely amount to ten thousand or more pages of regulations spawned by the Dodd Frank Reform Act. The Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM) statutory provisions totaling just 12 pages have already ballooned to about 800 pages of proposed rules. These regulations disproportionately impact community financial institutions and are a threat to their profitability since they needlessly add costs that act the same as a capital surcharge.

Second, this regulatory overload adds insult to injury. Fannie and Freddie (the "GSEs") had a long history of giving their largest and riskiest customers lower guarantee fees, while charging community lenders much higher fees. This denied community financial institutions fair and equal access to the secondary market, disadvantaged them economically, and in many cases resulted in their handing over their best customers to their large bank competitors. Discounting for volume is a recipe for disaster in the credit guarantee business. Additionally their government guarantee allowed the GSEs to accumulate huge portfolios and distort pricing for all competing mortgage investors. For years this disadvantaged community financial institutions and now the taxpayers have been disadvantaged to the tune of over $160 billion.

As far back as 1995 Fannie's top 25 volume customers, led by Countrywide, benefited from substantially lower guarantee fees than Fannie's 1200 smallest customers. This trend intensified over the course of the next decade. In 2007 Countrywide accounted for one in four loans purchased by the GSEs.

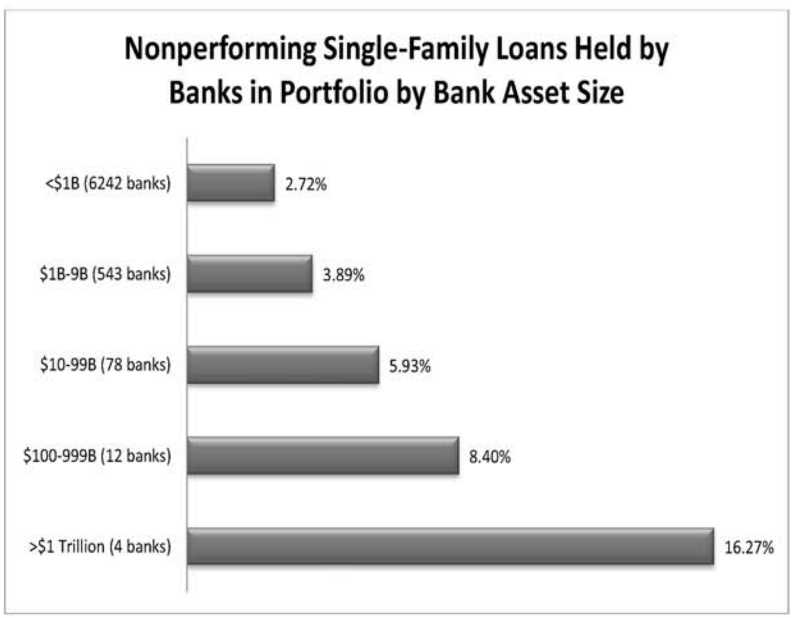
Countrywide and other large customers also benefited from looser underwriting standards, many undertaken in order to meet affordable housing goals. In 1995 Fannie was frank about the risks and why it was willing to take them:

> "However, it must be recognized that Countrywide is very aggressive in its origination practices, and **they like to test the limits of investment quality underwriting (emphasis added).** ...As it stands, Countrywide has a major impact on Fannie Mae's [affordable housing] goals...." Fannie Mae Credit Variance Action dated 8.15.95

It is now clear that the government's involvement in the housing finance market through Fannie and Freddie distorted the market's structure. Because the GSEs were able to bid more for mortgages than any competitors, they drove competitors from the secondary mortgage market and created a duopsony (a market with only two buyers). They were then able to discriminate among their suppliers, providing better returns to those, such as Countrywide, who provided the mortgages that they wanted, and penalizing with higher guaranty fees those—primarily the small banks and thrifts—that provided higher quality loans. Community banks were victims, rather than beneficiaries, of the GSEs.

If a picture is worth a thousand words, Chart 1 speaks volumes about the risks posed by too big to fail financial institutions as compared to regional and community banks:[1]

Chart 1 – Nonperforming Single-Family Loans Held by Banks in Portfolio by Bank Asset Size (as of March 31, 2011):



[1] **Source:** bankregdata.com. A nonperforming loan is one 90 days or more delinquent or in foreclosure.

The 6242 community banks with assets of less than $1 billion had a 2.72% nonperforming loan rate. Compare this to a rate of 16.27% for the 4 banks with assets over $1 trillion. I believe if a similar analysis were done on the basis of loans sold to the GSEs the relative results would be substantially the same.

What are some of the lessons learned from the financial crisis that would help level the playing field for community financial institutions?

1. Rely on risk based credit pricing regardless of loan production volume, not the crony capitalism practiced by Fannie and Freddie;
2. Don't subject community financial institutions that already know how to originate good loans to thousands of pages of mortgage red tape;
3. Don't substitute too big to fail banks for the too big to fail GSEs;
4. Avoid the moral hazard that results from implicit and explicit government guarantees;
5. Private capital should be the primary source of credit and should absorb all losses;
6. Capital must be built in good times to cover losses in bad times; and
7. Don't loosen lending requirements to meet social policy goals.

This Committee can help community financial institutions by implementing housing finance reform that results in fair and equal access to the secondary market. This will provide these institutions the opportunity to earn profits from the high quality mortgages they originate:

A white paper[2] I co-authored with Peter Wallison and Alex Pollock has principles similar to those as suggested by ICBA:

1. **A limited scope of conservatively-underwritten products available for securitization:**
    - This would ensure mortgage quality so as to reduce the frequency and severity of catastrophic losses. These are the kinds of loans that community financial institutions originate, loans that have performed well. Repeal the Qualified Residential Mortgage (QRM) and Qualified Mortgage (QM) statutory provisions and the nearly 1000 pages of proposed QRM and QM rules and replace with a statutory definition of a prime loan (see Appendix 1) and
    - Any securitized loans would need to meet this prime standard. Any loan not meeting this standard would be a non-prime loan.
2. **Adequate private capital would insulate taxpayers:**
    - While we can agree that adequate capital is required, accomplishing it is another matter;
    - It requires the utilization of risk based pricing designed for long term cycles. This recognizes the cyclical nature of mortgage lending by setting prices based on credit features rather than volume and allows for the building of capital in good times to cover losses in bad times. Risked based pricing would be beneficial to community financial institutions;
    - Accumulated private capital must be sufficient to meet both actuarially based normal loss expectations and catastrophic losses. We know catastrophic losses will happen, we just don't know when. They have occurred twice in recent history – first in the mid-1980s and second during the current crisis; and

[2] Wallison, Pollock, and Pinto, "Taking the Government Out of Housing Finance: Principles for Reforming the Housing Finance Market", http://www.aei.org/docLib/AEI-White-Paper-FINAL-3-22-11.pdf

- The potential for catastrophic loss may be calculated and planned for by building private capital counter-cyclically.

3. **Any replacement structure should avoid recreating the moral hazard represented by Fannie and Freddie:**
   - Taxpayers will not be protected if we merely shift secondary market risk to a few big banks under the banking system or to new special purpose entities which the market assumes will have an implicit government guarantee in addition to any explicit guarantee.
4. **Strong supervision:**
   - While we agree on the need for strong supervision, it is best to rely on a regulatory structure that incorporates counter-cyclical capital accumulation and other similar self-implementing features rather than expecting regulators to be all-knowing and all-seeing with the ability to periodically set capital levels based on market conditions or put the brakes on at just the right time; and
   - As noted, catastrophic losses are normal in real estate lending and they will occur when least expected. Any regulatory structure must anticipate this fact at the beginning of a cycle not near the end.
5. **Accommodate a joint venture structure that will aggregate the mortgages produced by community financial institutions.**
   - This could take the form of a privately capitalized cooperative formed by ICBA or its members;
   - Current banking law allows for the establishment of bank service companies. With minor adjustments it could be used to provide the needed legal entity(ies);
   - These would prepare securities for sale through underwriters or to institutional buyers who want to hold whole mortgages; and
   - Community banks would capture the profits that they previously had to give up to Fannie, Freddie and others and keep the customer relationships they lost to their competitors.

A private market may be created without a government guarantee covering catastrophic loss. Prudence would suggest catastrophic losses resulting from an economic event are likely to occur sometime in the next 15-25 years and would constitute a call on such a government guarantee. Is it plausible that any government guarantee will have accumulated the necessary reserves to fund such losses? Experience tells us the answer is no and that taxpayers will once again be required to fund an expensive bailout. This is because the government cannot:

- Successfully price for risk;
- Accumulate the necessary counter-cyclical reserves;
- Avoid distorting prices, resource allocation, and competition; and
- Avoid political interference which leads to weakened credit standards.

The choice between putting trillions more on the taxpayer's credit card and developing a robust private capital solution is an easy one. Adding the fact that guaranteeing most private mortgages will raise the cost of financing our burgeoning national debt makes it a no brainer.

A potentially valuable private capital alternative would utilize the mortgage insurance (MI) industry. It operates under a long established regulatory structure that utilizes risk based pricing designed for long term cycles - capital is built up in good times to cover losses in bad times and pricing is based on credit features rather than volume. The fundamental strength of this approach was demonstrated when the MI industry survived and Fannie, Freddie, Countrywide, Lehman, AIG, and many others suffered catastrophic losses that either led to bankruptcy or bailout. A better approach is to build upon the MI model, rather than risk recreating the failed GSE model. Unlike any of the bailed out or bankrupt entities, the MI industry over the boom cycle counter cyclically reduced its leverage. In 1992 risk to capital was 22.2 to 1 while in 2006 it was 8.9 to 1. The MI structure would add additional capital strength to community financial institutions and help them create their own secondary market vehicle.

Indicative of the potential for the MI industry to provide reliable, long-term accumulation of private capital to fund of infrequent - but expected - catastrophic losses is a proposal recently put forth by Old Republic International, parent of Republic Mortgage Insurance Company.[3] Old Republic has proposed the establishment of an industry-wide mutual reinsurance company. The goal is to further strengthen the MI structure by counter-cyclically accumulating an additional capital reserve fund large enough to reimburse mortgage insurers for much of their extraordinary losses should the next crisis be as large as the current one.

The private market that will develop under the overall approach outlined above will be entirely different than the distorted market created by the GSEs. A high preponderance of mortgages will be prime loans—the kind of loans that community financial institutions usually originate. Their loans will be highly sought after because they will not only be good investments, but also the only type of mortgages that could be securitized. Since most mortgages will have the same prime characteristics, the key function in this new market will be aggregating the mortgages into pools for securitization.

The more competitors in this field, the more innovation there will be and the lower they will push mortgage rates. This will be possible because this approach relies on prime loans, a core competency of community financial institutions. It also relies on risk-based pricing which properly values prime loans originated by community financial institutions.

Thank you and I would be happy to answer any questions at the appropriate time.

[3] "Old Republic Proposes Plan to Ease Insurers Woes in Next Crisis". May 27, 2011, Dow Jones News Wire,

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.

Prime first mortgage loans are defined as loans with the following characteristics:

- Conventional loans on properties occupied as a primary or secondary residence.
- Home purchase loans with an LTV of 90 percent or less commencing on January 1, 2016. During the five-year GSE wind down and private-market transition period we recommend, an LTV limit of 95 percent would be permitted until December 31, 2012, and an LTV limit of 92.5 percent would be permitted until December 31, 2015.
- Rate and term refinances with an LTV of 80 percent or less with a maximum loan term of twenty-five years.
- Cash-out refinances with an LTV of 75 percent or less with a maximum loan term of twenty years.
- As noted, research shows that loans with an LTV of 60 percent or less sustain virtually no losses. Therefore, any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.
- No second mortgage at loan origination and prohibited by the mortgage documents for a period of six months after origination. The mortgage documents also grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage shall:
  - Require the borrower to declare his or her intent regarding owner occupancy;
  - Require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
  - Advise the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage; and
  - Provide that if the borrower fails to notify the lender, the lender may call the loan and require its immediate repayment, and such loan, if not already recourse to the borrower, becomes recourse and not dischargeable in bankruptcy.
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively (28 percent and 33 percent on 95 percent and 92.5 percent loans during the five-year transition period).
- Underwritten based upon verified income, assets, and credit.
- 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, and the originating lender must offer the applicant the option of a similar loan with no prepayment fee.

The following are the standards that federal regulation should require of mortgage insurers for prime loans:

- Maintain minimum risk-to-capital ratios by amortized LTV based on the lesser of sales price (if applicable) or original appraised value, as set forth below:

Amortized LTV (%)	Suggested risk-to-capital ratio for thirty-year fixed-rate loans[4]	Current risk-to-capital ratio
92.51–95.00	8 to 1	25 to 1
90.01–92.50	10 to 1	25 to 1
85.01–90.00	13 to 1	25 to 1
80.01–85.00	16 to 1	25 to 1
75.01–80.00	29 to 1	25 to 1
70.01–75.00	31 to 1	25 to 1
65.01–70.00	38 to 1	25 to 1
60.01–65.00	41 to 1	25 to 1

- As noted, MI is required on all thirty-year term loans with an LTV above 60 percent up to the prime loan LTV limit of 90 percent (except as provided for the five-year period during which the GSEs are wound down). This coverage is required down to 60 percent.[5] For example, on a 90 percent LTV loan, MI would provide 34 percent coverage, which would insure down to 59.4 percent. Under the above risk-to-capital requirement, MI would be required to maintain a minimum equal to 7.7 percent (the inverse of the thirteen-to-one risk-to-capital ratio) times coverage of 34 percent or 2.62 percent against this prime-loan risk. This compares to 4 percent (the inverse of the twenty-five-to-one risk-to-capital requirement) times coverage of 25 percent or 1 percent against loans that in the last decade consisted of many nonprime loans.
- Fifty percent of gross premiums required to be placed in statutory contingency reserve (same as current requirement) for a fixed period (current period is ten years) and may only be used to pay nonnormal or catastrophic stress-based losses due to periodic but unpredictable general economic risks as described earlier. The other 50 percent of premium revenue is required to support normal claims related to specific or actuarially based credit losses, general and administrative expenses, taxes, other expenses, dividends, and profits.
- Monoline (same as current). A monoline insurer's business is limited to one line of insurance, in this case mortgage guaranty insurance on prime single-family first mortgages.
- Coverage is loan based with a maximum coverage of 35 percent after 2015 and a maximum coverage of 38 percent during the five-year transition period (current practice). No pool coverage or guaranty of securities (new provision). MI companies are limited to covering individual loans rather than pools of loans.

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[4] Fixed-rate loans with shorter amortization periods pose a lower risk of default due to faster buildup of borrower equity and therefore would have somewhat higher risk-to-capital requirements (requires that less capital be held). For example, fifteen-year term loans at an 80 percent LTV might have a thirty-eight-to-one risk-to-capital ratio, the same as for a 70 percent LTV loan with a thirty-year term.

[5] Coverage must be maintained until the original loan balance amortizes to 60 percent based on the lesser of original sales price (if applicable) or original appraised value.

- No originator, aggregator, conduit, or issuer (or affiliates or parents) may own or operate a private mortgage insurer (new provision). The Alger report noted a need to avoid conflicts of interest between originators and credit enhancers.[6]
- Restricted to prime loans (new provision). This limits MI companies to prime loans, which have more predictable and lower default rates than nonprime loans. No sharing of premiums with lenders or investors (a new provision designed to prohibit captive subsidiaries) and any discounts must be risk based, not volume based (current practice). A captive subsidiary is an MI reinsurer controlled by the loan originator. Countrywide was an early and large participant in the practice. Its prohibition helps eliminate conflicts of interest. In terms of pricing, Fannie and Freddie offered large volume-based discounts, whereby lenders such as Countrywide were charged a guaranty fee of about ten basis points, while community banks were charged twenty basis points or more.

[6] Report to the governor of New York by Commissioner George Alger (Alger Report) regarding the operation, conduct, and management of mortgage guaranty corporations dated October 5, 1934. Document contained in the authors' files.

PREPARED STATEMENT OF ROD STAATZ

PRESIDENT AND CHIEF EXECUTIVE OFFICER, SECU OF MARYLAND, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION

JUNE 28, 2011

CUNA & Affiliates

Credit Union National Association, Inc.
601 Pennsylvania Avenue NW
South Building, Suite 600
Washington, D.C. 20004
(202) 638-5777

TESTIMONY OF

ROD STAATZ
PRESIDENT AND CHIEF EXECUTIVE OFFICER
SECU OF MARYLAND
ON BEHALF OF THE
CREDIT UNION NATIONAL ASSOCIATION

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING ON
HOUSING FINANCE REFORM: ACCESS TO THE SECONDARY MARKET FOR SMALL FINANCIAL INSTITUTIONS

JUNE 28, 2011

A member of the Credit Union System℠

Testimony of
Rod Staatz
President and Chief Executive Officer
SECU of Maryland
On behalf of the
Credit Union National Association
Before the
United States Senate
Committee on Banking, Housing and Urban Affairs
Hearing on
Housing Finance Reform: Access to the Secondary Market for
Small Financial Institutions
June 28, 2011

Mr. Chairman, Ranking Member Shelby, Members of the Committee, thank you very much for the opportunity to testify at today's hearing and to present the views of the Credit Union National Association regarding housing finance reform.[1] My name is Rod Staatz and I am president and chief executive officer of SECU of Maryland.[2] I am a member of both CUNA's Board of Directors as well as its GSE Reform Task Force.

A healthy, efficient and accessible secondary market is vital to credit unions and the millions of consumer they serve. In the wake of the financial crisis, we agree that the problems that led to the conservatorships of the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) need to be addressed in a comprehensive and meaningful manner. The institutional, regulatory and incentive structures that resulted in the taxpayer bailout of Fannie Mae and Freddie Mac must not be replicated. However, as Congress and the

[1] CUNA is the nation's largest credit union advocacy organization, representing approximately 90 percent of the 7,500 state and federal credit unions in the United States and their 93 million members.
[2] SECU of Maryland is a state chartered, federally insured credit union headquartered in Linthicum, MD. It serves 242,800 members and has $2.09 billion in total assets as of December 31, 2010.

Administration undertake this effort, it is critically important that the widespread availability of mortgage credit, housing affordability, consumer protection, financial stability within the system and strong regulation are maintained and enhanced.

My testimony will focus on the state of credit union mortgage lending, credit union principles for housing finance reform, our concerns with the federal regulators' proposed rule related to qualified residential mortgage and our concerns with new mortgage servicing standards.

Credit Union Mortgage Lending

Credit unions are increasingly important lenders in the residential mortgage market. After averaging just over 2% of all residential first mortgage originations in the decade and a half ending in 2007, the credit union share of originations more than doubled to 5% during the past three years, and more recently has risen to almost 6% (Chart 1). This increase was brought on by credit unions' resiliency during the recent financial crisis when other lenders, particularly those that relied most heavily on the secondary market, had to curtail lending. As the secondary markets collapsed in 2008, credit unions were able to continue lending, in part because they made loans for their own portfolios. Since 2007, credit unions have originated over a quarter of a trillion dollars in residential first mortgages ($266 billion). (Chart 2)

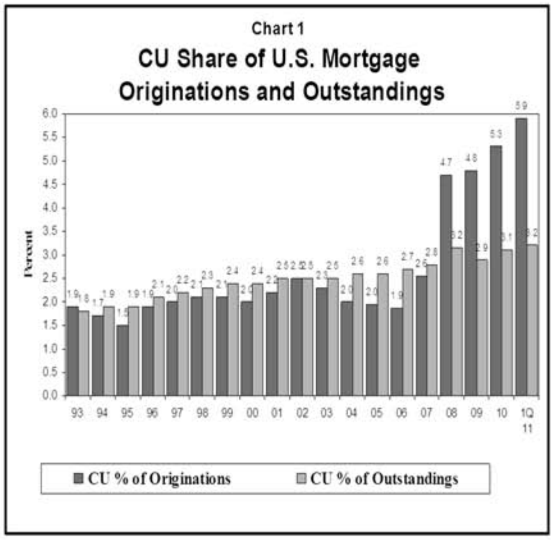


Chart 1
CU Share of U.S. Mortgage Originations and Outstandings
Percent
93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 1Q 11
CU % of Originations
CU % of Outstandings

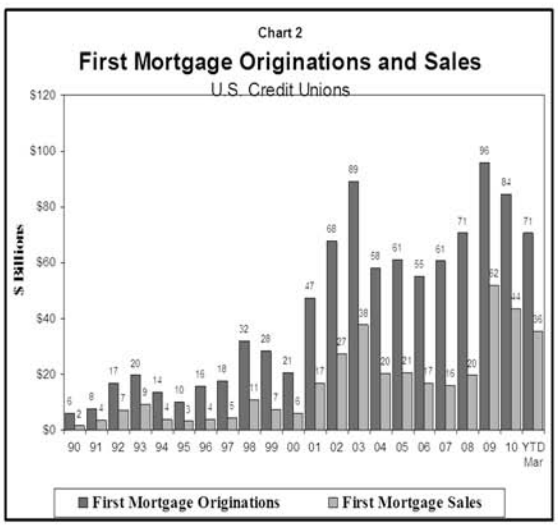
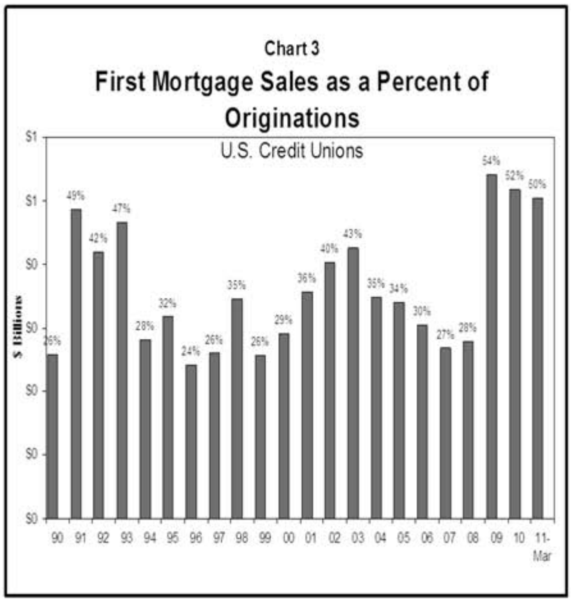


Chart 2
First Mortgage Originations and Sales
U.S. Credit Unions
$ Billions
$120
$100
$80
$60
$40
$20
$0
90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 YTD Mar
First Mortgage Originations
First Mortgage Sales

Traditionally, credit unions have been primarily portfolio lenders, typically only selling between a quarter and a forty percent of their originations (Chart 3).



However, this does not mean that credit unions are not heavily reliant on a smoothly functioning and accessible secondary market. There have been times, such as during the past two years, when credit unions have sold over half their new loans. The decision by a credit union on whether to hold or sell a mortgage is primarily one of prudent asset/liability management (ALM). As evidenced by the S&L debacle in the 1980's, financial institutions funded by mostly short-term retail deposits must be very cautious about the interest-rate and liquidity risks of holding long-term, fixed rate mortgages on their balance sheets. Most credit union ALM policies, which are required and substantially influenced by state and federal examiners, stipulate the amount of their assets that can be devoted to fixed-rate and adjustable-rate mortgages (ARMs), typically with much lower limits for fixed-rate loans. Depending on the stage of the interest rate cycle and member preferences, there are many times when a credit union's ability to hold fixed rate mortgages in portfolio is much less than the demand for such loans from members.

Whenever members take out ARMs, or when a credit union is below its policy limit on fixed rate loans, that credit union is likely to portfolio rather than sell new originations so long as interest rates are acceptable. On the other hand, when members are demanding primarily fixed-rate loans, credit unions may need to sell most of their new production. Under these circumstances, whether or not a credit union can hold or sell it new loans is largely out of its control. It depends instead on member behavior, interest rates, and regulator-influenced policy limits. Therefore, access to a smoothly functioning and accessible secondary market is vital to a credit union's ability to meet its members' mortgage borrowing needs.

These ALM issues are behind the recent swings in credit union loan sales to the secondary market. In 2007 and 2008, as the financial crisis deepened and other lenders had to curtail lending, credit unions increased their first mortgage lending, from $55 billion in 2006 to $61 billion in 2007 and $71 billion in 2008. At the beginning of 2007, credit unions' fixed-rate mortgages amounted to a fairly modest 14.5% of assets, and during 2007 and 2008, interest rates on 30-year, fixed- rate mortgages averaged about

6%. In that environment, credit unions could prudently hold the bulk of new loans in portfolio, and sold only 27% of originations in 2007 and 28% in 2008.

Circumstances had changed dramatically by the beginning of 2009. The proportion of credit union assets in fixed rate mortgages had risen by 2.6 points to 17.1%, member demand for mortgages was rising, and interest rates had fallen to around 4.5%. In this new environment, access to a secondary market was vital. Credit unions were able to originate a record $96 billion in new loans in 2009 and almost as much ($84 billion) in 2010 by doubling their secondary market sales to 54% of originations in 2009 and 52% in 2010. They were able to meet their members' needs without creating undue exposure to interest rate risk by accessing the secondary market. Indeed, despite the very high mortgage loan production during 2009 and 2010, the proportion of credit union assets in fixed-rate mortgages actually declined slightly during the period, from 17.1% to 16.8%. That was appropriate interest-rate risk management in a period when long term mortgage interest rates were near all-time lows.

In addition to ALM considerations, credit unions must also be mindful of potential liquidity issues, even when granting adjustable rate mortgages. Because most deposits in credit unions are much shorter term than a portfolio of thirty-year mortgages, it is imperative that if a credit union holds a substantial portfolio of AMRs, whose variable rate feature protects against the risk of rising funds costs in the future, that credit union must also be able to sell those loans in the future if liquidity needs arise. A liquidity need could result from future member behavior beyond the control of a credit union, such as a surge in loan demand or an outflow of deposits. Therefore, even those loans that a credit union intends to hold in portfolio must be salable on the secondary market. Again, access to a smoothly functioning and accessible secondary market is vital for credit unions.

Credit Union Principles for Housing Finance Reform

The federal government has a very important role to ensure the secondary market operates efficiently, effectively and fairly for borrowers and lenders alike. As Congress and the administration consider comprehensive changes to the housing finance system, it is imperative that the entities that fill the market space currently occupied by Fannie Mae and Freddie Mac continue to facilitate credit union lending so that credit unions may continue to be a source of reliable mortgage credit for their members.

Quite frankly, many credit unions fear a world in which the secondary mortgage market is occupied by a handful of very large banks. Concerns about access to and pricing in such a market are frequently expressed. Will the large banks want to deal with small financial institutions such as credit unions? If so, will the pricing be competitive with larger financial institutions? Will large banks favor their own mortgage originating divisions or subsidiaries? While these are among the most significant concerns credit unions have with respect to a large-bank dominated market, they are not the only concerns.

Credit unions value the relationship they have with their members. The mortgage application – especially under the new underwriting guidelines – is rich with borrower information. If the only conduits to the secondary market were the largest banks in the country, credit unions would be in the position of selling their mortgages – and their members' financial information – to complex financial institutions that compete with them in other markets. Credit unions are skeptical that regulatory firewalls sufficient to prevent the banks from mining credit union member data could be constructed and enforced. Furthermore, some credit unions may be reluctant to sell a loan to a large bank if that meant that they would also lose the opportunity to service the loan. Preservation of the member relationship is very significant to credit unions.

The lack of uniform standards and procedures in a market operated by the largest banks is also a concern for credit unions. Each bank is likely to have different underwriting standards, documentation requirements and procedures, in the absence of regulation requiring them to operate in a similar manner. This will severely limit the ability of small financial institutions to shop their loans to multiple secondary market participants. Therefore, credit unions would likely engage in a relationship with just one secondary market participant, which would have to make it very difficult for the credit union to move its business.

We believe that it is very important that there be a neutral third party in the secondary market: an entity which is independent of any firm that has any other role or business relationship in the mortgage origination or securitization process. Its sole role would be as a conduit to the secondary market.

Having noted our concern with any proposal that would result in a secondary market operated exclusively by the largest banks, we believe the following principles are important to consider as comprehensive housing finance reform proposals are developed.

- Equal Access: The secondary market must be open to lenders of all sizes on an equitable basis.
- Strong Oversight and Supervision: The entities providing secondary market services must be subject to appropriate regulatory and supervisory oversight to ensure safety and soundness; they should also be subjected to strong capital requirements.
- Durability: The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times.
- Financial Education: The new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans.
- Preservation of the 30-year fixed rate mortgage: This product is the centerpiece of the mortgage lending market and the new system should facilitate its availability to qualified borrowers.
- Affordable Housing: The important role of government support for affordable housing should be a function separate from the responsibilities of the secondary market entities.
- Reasonable and Orderly Transition: The transition from the current system to any new housing finance system must be reasonable and orderly.

Equal Access

The paramount concern for credit unions is equitable access to the secondary market in whatever form it may take.

Whether the functions of the GSEs are privatized or remain public to some degree, it is essential that the federal government's regulation of the secondary market ensure lenders of all types and sizes, including credit unions, have access to a secondary market that is equitable. This means that terms, rates, and conditions for selling loans in the secondary market must be affordable and fair to all lenders, regardless of their size or charter type.

Consistent with this objective, to the extent the participation of other institutions in the secondary mortgage market is enhanced by investments such as covered bonds, regulators should not encumber the ability of healthy credit unions to offer such investments. Further, credit unions should be able to have access to supplemental capital as other financial institutions are permitted to do, which will help provide additional resources to protect the National Credit Union Share Insurance Fund (NCUSIF) from any losses at credit unions, including those in connection with their mortgage lending or related activities.

A widely expected feature of any reformed system to replace the current GSEs is more explicit pricing of any government guarantee of mortgage-backed securities. CUNA believes that future guarantee fees should accurately account for risk and fully insulate the taxpayer from loss. We would hope that in any reform, the pricing of guarantee fees will recognize in some way the historical performance or track record of different types of lenders. Perhaps once a loss absorbing pool has reached an adequate level, excess amounts could be refunded to issuers based on the performance of the loans they have sold. Credit union mortgages are demonstrably less risky than mortgages made by other lenders. Since the beginning of the financial crisis, the net charge-off rate on credit union mortgage loans has consistently been much lower than at banking institutions. From 2007 to 2010, the average net charge-off rate on mortgages held in credit union portfolios has been less than a third of the similar rate at banks: 0.4% compared to 1.3%.

Strong Supervision

One of the major weaknesses of the secondary market that contributed to the recession was the lack of appropriate supervision of the GSEs. Not only was the regulatory framework for the GSEs fragmented, the size and complexity and activities of these organizations and their activities made it extremely difficult for them to be properly supervised. Thus, when the GSEs increased their purchase of subprime mortgages prior to 2007, regulators did not step in to correct these practices, resulting in unbelievable losses and ultimately the conservatorship of FNMA and FHLMC.

Proper supervision of new secondary mortgage market entities would entail comprehensive regulations that address safety and soundness issues while allowing them to have flexibility to operate well and develop new programs in response to marketplace demands. Sufficient supervisory resources must also be provided to allow the regulator to recognize problems in a timely manner and work with the industry to develop feasible solutions. Appropriate regulation should also help ensure that all mortgage lenders have equitable access to the secondary market and that all types of participating lenders are fairly represented on the boards of secondary mortgage market entities.

New regulations for the reformed housing finance system should also ensure that the process of mortgage asset securitization is transparent and subject to appropriate supervision, for federally guaranteed as well as for private label securities.

Durability

The new system must ensure mortgage loans will continue to be made to qualified borrowers even in troubled economic times. This will improve macroeconomic performance and prevent job loss by dampening the pro-cyclicality of the housing sector. Without the backstop of a federally insured or guaranteed component of the revised system (whether that is an entity or an explicit federal guarantee of securities), we are concerned that private capital would quickly dry up during difficult economic times, effectively halting mortgage lending altogether.

Financial Education

Legislation and regulations implementing the new housing finance system should emphasize consumer education and counseling as a means to ensure that borrowers receive appropriate mortgage loans, without being overly prescriptive.

Credit unions are leaders in providing quality, accessible financial education to their members, which may help account for credit unions' generally low loan delinquency rates. If more lenders took steps to assure such information and training is provided to consumers, borrowers would have a much better understanding and awareness of how the mortgage loan process works, including their substantial risks and obligations as well as their rights. While such efforts will not eliminate problems relating to a borrower's lack of understanding, they would go a long way toward minimizing losses some lenders have experienced because the borrower did not understand his or her commitments. Borrowers would also benefit by avoiding the significant problems that arise from loans that they simply cannot afford. Efforts to emphasize consumer education in the mortgage loan process should be coordinated with the new Office of Financial Literacy.

Preservation of the 30-year Fixed Rate Mortgage

While unique to the United States, the 30-year fixed rate mortgage is the centerpiece of our housing market. The feedback we have received from credit unions throughout the country is that this is a product that credit union members favor. Without a federally supported secondary mortgage market, loan originators are unlikely to offer long term fixed rate mortgages because they do not want to bear the combined risk of fluctuating interest rates and long-term exposure to credit risk. We believe that any housing finance reform proposal should support the continued availability of this product. We understand that in the future, the costs of any federal support necessary to preserve the 30-year fixed rate mortgage should be borne by the mortgage finance system, i.e., lenders and borrowers, and not the taxpayer.

Affordable Housing

The reformed secondary mortgage market should distinguish between public policy goals with respect to affordable housing, and the broader issue of secondary market availability for mortgages. To be clear: we believe that the federal government has an important role to play in encouraging homeownership and access to mortgage credit for creditworthy lower income homebuyers. However, we feel that such help should be provided under the auspices of the federal government, such as the Federal Housing Administration, separately from the functioning of the conduit to the secondary market for standard mortgages. The requirements of a program to stimulate the supply of credit to lower income borrowers are not the same as those for the more general mortgage market. Combining both goals in a single vehicle can frustrate the achievement of both goals. In that regard, affordable housing mandates should be directed to and implemented by the federal or state governments, which will work with private lenders to achieve those objectives. That is not to say that the private secondary market should not be allowed to work with lenders such as credit unions to facilitate mortgage lending for lower income borrowers, but directives, goals, or quotas should not be applied by regulators to private secondary mortgage market entities.

Some have suggested a nexus exists between federal support for the general mortgage market and affordable housing goals in that the financial institutions that benefit from federal support for the general secondary should in return take on additional obligations to meet affordable housing goals. We believe this possible connection could best be addressed in two ways: first, by appropriately pricing guarantee fees to minimize the chance of taxpayer expense, and second, perhaps by adding a small supplement to guarantee fees, the proceeds of which could be used by some other federal agency in a more targeted fashion in furtherance of affordable housing goals.

Transition

Any transition from the current system to a reformed housing finance approach must be carefully planned and well executed. Credit unions and other lenders will need sufficient time to prepare for the changes so that members are not negatively affected; they will need to change their computer systems, re-train staff, and change other operational processes, and this will result in significant expenses that must be recognized as part of this transition process.

Most important, Congress, the Administration and the regulators should avoid taking steps in the interim that may further disrupt a housing market in fragile recovery. We are particularly concerned with proposed definition of qualified residential mortgage (QRM), which we will discuss below.

CUNA Strongly Opposes the Proposed QRM Standard

An issue that could significantly impact the accessibility of credit unions to the secondary mortgage market is the proposed definition of a Qualified Residential Mortgage (QRM), which is included in the credit risk retention proposal issued for comments by the federal bank regulators and the Securities and Exchange Commission in March. CUNA is working with a coalition of lenders and other stakeholders to oppose the adoption of the QRM provisions. The proposed rule sets forth an extremely narrow definition of QRM, beyond what was contemplated under the Dodd-Frank Act, which requires a credit risk retention rule.

Under the credit risk retention proposal, a lender would not have to meet the requirement to retain a 5 percent interest in home loans that are securitized if its loans meet the QRM criteria. These provisions include: maximum debt- to-income ratio of 28% for borrowers at the start of the loan; at least 20% down payment from the borrower for purchase loans, with no provisions for private mortgage insurance that could be used to offset lower down payments; and borrowers must not have any 60-day delinquencies in the last two years, or bankruptcy, foreclosure or short sale in the last 36 months.

The QRM proposal is not directed at credit unions and the National Credit Union Administration was not one of the agencies mandated by the Dodd-Frank Act to develop the credit risk retention rules. Also, many credit unions hold a significant portion of their loans in portfolio and any loans they do sell to Fannie Mae and Freddie Mac, while the GSEs are in conservatorship, would be exempt. Nonetheless, credit unions are seriously concerned about the QRM proposal. As addressed below our overarching concern is that the QRM will become a template that regulators will seek to impose on all home mortgage loans, whether they are securitized or not. Such a result would severely limit the ability of credit unions to tailor mortgage loans to meet their members' particular needs. Moreover, the stringent definition of a QRM could effectively shut an entire class of otherwise qualified borrowers out of the mortgage market for low-cost financing and could potentially dry of mortgage liquidity for small lenders.

In crafting the concept of the QRM exemption, Senators Landrieu, Hagan and Isakson considered and intentionally omitted a minimum down payment requirement.[3] This is because there is strong evidence that high minimum down payments are not a significant factor in reducing defaults compared to underwriting and other mortgage product features.[4] Many factors combine to create a low-risk mortgage loan: down payment, credit history, employment history, ratio of payment to income, etc. Many well-underwritten loans have down payments of less than 20 percent.[5] Thus, provided each mortgage is properly underwritten, credit unions can and do structure very low-risk loans to meet their members' needs – even where a member does not have a 20 percent down payment. This is particularly important for credit unions as member-owned financial institutions. Under the proposed QRM standard, borrowers who are otherwise qualified but who haven't been able to save enough for a 20 percent down payment would likely be automatically denied access to the lowest rate loans with the safest features.

Along these lines, although the proposed QRM is intended to be the exception rather than the rule in the private mortgage market, it runs a significant risk of turning into the standard for mortgages – especially for credit unions. This is because the National Credit Union Administration (NCUA), which supervises the safety and

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[3] See February 16, 2011 letter from Senators Landrieu, Hagan and Isakson to the QRM regulators.
[4] See Qualified Residential Mortgage Coalition, "Proposed Qualified Residential Mortgage Definition Harms Creditworthy Borrowers While Frustrating Housing Recovery", May 2011 (note that CUNA is a signatory to this white paper).
[5] Indeed, as Senator Isakson reiterated in the June 22, 2011 press conference on this issue, "[w]e understood America didn't have a down payment crisis in housing we had an underwriting crisis in housing." Senate News Conference with Members of the Coalition for Sensible Housing Policy Transcript, June 22, 2011.

soundness of all federally insured credit unions, generally requires credit unions to adhere to Fannie Mae and Freddie Mac underwriting standards. As the status of GSE reform is unknown, in the absence of a replacement for the existing GSEs, a QRM standard could be viewed by NCUA as necessary to any potential safety and soundness concerns are met. Based on these serious concerns with the QRM standard, we believe it must be redesigned to incorporate the broadest criteria possible, consistent with the intent of Congress, to encourage responsible lending standards that will support a housing recovery while attracting private capital to the secondary market and reducing future defaults.

The QRM standard as currently proposed not only creates unnecessary barriers for qualified borrowers, but it also limits the flexibility credit unions have in tailoring loans to their members' needs, and could potentially make it difficult for small financial institutions like credit unions to make non-QRM loans. We urge Congress to insist that the regulators go back to the drawing board to redevelop the QRM and issue a new proposed QRM definition for public comments.

Mortgage Servicing Standards

Mortgage loan servicing is an important component of home mortgage loan process for lenders and borrowers. It is critical that servicing activities and those providing servicing be subject to necessary and effective supervision. We support the general principles contained in the Servicing Alignment Initiative (the "Initiative") announced by the Federal Housing Finance Agency earlier this Spring directing Fannie Mae and Freddie Mac to establish consistent mortgage loan servicing and delinquency management requirements for loan servicers acting on behalf of Fannie Mae and Freddie Mac.[6] The Initiative directs Fannie Mae and Freddie Mac to align servicing requirements in four key areas: (1) borrower contact, (2) delinquency management practices, (3) loan modifications, and (4) foreclosure timelines. Additionally, the Initiative introduces incentives and compensatory fees for servicers to reinforce effective execution in these areas. The Initiative also required the issuance of Servicing Standards for Delinquent Mortgages (the "Standards"), which were recently issued by the GSEs.[7]

We are concerned, however, that the potential effect of the Initiative on small financial institutions, including credit unions, may have the unintended consequence of becoming overly burdensome. With the multitude of existing regulatory burdens already placed upon small financial institutions, the increasing regulatory requirements pursuant to the Dodd-Frank Act and other government initiatives relating to housing finance and mortgage loan origination and servicing in general, additional guidelines and requirements such as the Initiative and Standards will likely require small financial institutions to retain additional employees and volunteers to comply with such requirements, stretch small financial institutional monetary resources to untenable levels, or worse, force more of these institutions, including credit unions, to cease to exist altogether.

[6] See April 28, 2011 News Release issued by Federal Housing Finance Agency at http://www.fhfa.gov/webfiles/21190/SAI42811Final.pdf.
[7] See June 6, 2011 News Release issued by Fannie Mae at http://www.fanniemae.com/newsreleases/2011/5408.jhtml?p=Media&s=News+Releases

As you know, credit unions are not-for profit financial cooperatives, and the only owners of a credit union are its members, who receive the benefit of ownership through reduced fees, lower interest rates on lending products, including mortgages, and higher dividends on savings products. Because of this structure, the cost of a credit union's compliance with overly burdensome regulations impacts its members directly. Every dollar that a credit union must spend on complying with overly burdensome regulations and requirements is a dollar that cannot be utilized to benefit the credit union's membership. And, because of this structure, credit unions have a strong incentive to act in the best interest of their members.

In contemplating the balance between providing accessibility to the secondary market for small financial institutions with the importance of effective supervision and regulation of any entity providing such secondary market services, we encourage the Committee to give strong consideration to the compliance burden that may be placed on the small financial institution servicers balanced against the very low incidence of abusive practices by credit unions. The end goal of serving consumers' needs in the housing finance market should continue to be met effectively and efficiently.

Conclusion

Reform of the housing finance system has already proven to be a very difficult challenge, but failing to make necessary changes to improve the system will result in even greater challenges for the economy, lenders, and borrowers. Mortgage lending is a significant activity for many credit unions and is a vital financial service for their members and for the economy, and we urge Congress to consider the concerns and recommendations raised in this testimony.

Mr. Chairman, on behalf of America's credit unions and their 93 million members, thank you for the opportunity to testify at today's hearing. I would be happy to answer any questions.

PREPARED STATEMENT OF CHRISTOPHER R. DUNN

EXECUTIVE VICE PRESIDENT, SOUTH SHORE SAVING BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

JUNE 28, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, my name is Christopher Dunn, Executive Vice President and Chief Operating Officer of South Shore Savings Bank, South Weymouth, MA. I appreciate the opportunity to present the views of the American Bankers Association (ABA) on the future of Government-sponsored enterprises (GSE) and particularly the access to the secondary market by community banks. ABA represents banks of all sizes and charters and is the voice of the Nation's $13 trillion banking industry and its two million employees.

The issue of GSE reform is a critical one for banks, particularly for community banks like mine, which use GSEs as the primary mode of access to the secondary markets. At South Shore Savings Bank, we have a proud heritage of commitment to the communities on the South Shore since 1833, with 13 branches and 187 employees. From a personal perspective, my entire career since 1972 has been in the mortgage lending business within the community bank world. I sold my first loans to Fannie Mae in 1974, so I know well the importance of secondary market access for smaller banks. Without that access, my bank could not be an active player in our primary mortgage market because our balance sheet could not support the demand in the market. Further, we would not be able to offer long-term fixed-rate loans due to the increased interest rate risk that this would create in the bank loan portfolio.

Over the course of the last year, ABA has gathered bankers like me to discuss the future of Fannie Mae and Freddie Mac and to consider an outline for a path forward. ABA has also engaged in discussions with regulators, which have helped us refine our views. In that process, ABA developed eleven principles to guide reform of the GSEs, which are attached to my testimony as an appendix. As Congress begins the next phase in shaping the future of the mortgage markets and the Government's role in them, I hope these principles, and the recommendations I will discuss below, will provide a base to build on.

ABA believes that the role of Fannie Mae and Freddie Mac should be reduced and transformed, enabling the private sector to shoulder more of the responsibility to assure an effective and efficient secondary mortgage market. In addition, the Federal Housing Administration (FHA) should return to its traditional role of serving first time homebuyers and other borrowers who may not qualify for conventional financing. 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. An ideal goal might be to have 10 percent of loans 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 with no Government aid.

The overarching principle is to ensure that banks of all sizes have access to secondary market financing. The ABA has not endorsed a specific structure for the GSEs and the private secondary market to achieve this going forward; finding the right mechanism will be challenging. In the meantime, however, there are significant actions that can provide a transition vehicle to reduce governmental involvement, foster private sector financing, and still assure equitable access to secondary markets for all banks.

Possible transitional structures for the GSEs or their successors include a well-regulated and controlled cooperative structure owned by the financing entities or a similarly controlled secondary market utility that is publicly owned. Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns, and potential taxpayer liability. Activities under that portion of the structure with Government support or backstop will need to be confined to a controlled mission that is intended, among other things, to foster and accommodate development and expansion of purely private sector mortgage financing alternatives.

Rather than develop 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. *Multiple sources of liquidity for private market (including portfolio) lenders will lead to a more diverse and ultimately safer housing financing system.* 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 would better help them continue to meet 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.

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.

That vision of transforming the GSEs and enhancing the role of the private sector 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 midcourse corrections as we progress.

Underpinning all of this must be workable and clear underwriting standards for all mortgage loans. We must get the underwriting standards correct today if we have any hope of transitioning to a stable system for secondary mortgage instruments. The current proposals defining a narrow Qualified Residential Mortgage (QRM) exemption from risk retention requirements fly in the face of workable and clear standards. *In fact, should this proposal be adopted as proposed, it will surely drive many banks from mortgage lending and shut many borrowers out of the credit market entirely.* ABA strongly believes that this rule should be substantially rewritten and reproposed in a new form.

Not only is the proposal ill-conceived and will have long-term negative impacts on mortgage lending, but it comes at a particularly bad time with the housing market still struggling to recover. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, it is important that risk retention requirements be rational and nondisruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

In the remainder of my testimony, I want to focus on three key things:

- The role of the Government in housing finance should be dramatically reduced from its current level. Guarantee fees should be used to encourage private sector involvement.
- The transition to a private market should be carefully managed to protect taxpayers and ensure continued credit availability.
- New proposed mortgage rules on risk-retention are likely to drive many community banks out of mortgage lending and cut off mortgages to some borrowers.

I will discuss all three of these points in turn.

I. Government's Role in Housing Finance Should Be Dramatically Reduced

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. Therefore, ABA proposes that the *Government's role in housing finance should be focused primarily on ensuring stability and accessibility of the capital markets in the event of market failure.*

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.

Guarantee Fees Should Be Used to Encourage Private Sector Involvement

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. As I mentioned in the introduction, getting the underwriting standards correct and consistent is the first and most important step toward any transition of the GSEs. I will cover this in detail in my third point below.

II. The Transition to a Private Market Should Be Carefully Managed To Protect Taxpayers and Ensure Continued Credit Availability

The critical question in creating a private market is how to mitigate costs as the transition is made. Any successor entity to the housing GSEs must provide market stability and liquidity, and be adequately capitalized. 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 the formation of privately owned successors.

It is not realistic 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 the remaining losses realized. However, as the economy recovers some troubled assets may yet be salvaged and losses 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 or all 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 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 smaller 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, nonguaranteed mortgage markets. To be clear, this is not the only possible approach, but we believe this offers a path from the current environment of Federal support for the mortgage markets to a more realistic and sustainable private sector driven mortgage market.

III. Proposed Mortgage Rules Will Harm Creditworthy Borrowers and Drive Community Banks From the Market and Must Be Revised

ABA has grave concerns that the risk retention proposal issued by the regulators will drive many banks from mortgage lending and shut many borrowers out of the credit market entirely. Responding to widespread objections from consumer groups, banks, and Senators and Congressman, the regulators extended the comment period from June 10th to August 1st. While more time for commenting on such a far-reaching regulatory proposal is welcome, *what is really necessary is for the rule to be substantially reconsidered and reproposed.*

It is true that the proposal's immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac, while they are in conservatorship, escape risk retention. However, once the rule's requirements are imposed broadly on the market—should they be adopted—they would likely shut out many borrowers entirely and act to destabilize the housing market once again. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, and since ending the conservatorships and the related GSE exemption would expand the proposal's negative impact, it is important that risk retention requirements be rational and nondisruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, *ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly.* Specifically we recommend:

A. Exemption from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change, and

B. Risk retention requirements should be conformed to GSE underwriting standards.

I will explain each of these recommendations in more detail:

A. Exemption From Risk Retention Provisions Must Reflect Changes in the Market Already Imposed Through Other Legislative and Regulatory Change

In the Dodd-Frank Act, Congress determined that some form of additional risk retention was desirable under certain circumstances to ensure that participants in a mortgage securitization transaction had adequate "skin in the game." The goal was to create incentives for originators to ensure proper underwriting (*e.g.,* ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages and more are pending with new "ability to pay" rules. The result is that mortgage loans with lower risk characteristics—*which include most mortgage loans being made by community banks today*—should be exempted from the risk retention requirements, regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers.

Exempting such "qualified residential mortgage" loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, the *QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer borrowers will qualify for loans to purchase or refinance a home.* Instead, the QRM definition should closely align with the proposed "Qualified Mortgage" (QM) definition promulgated by the Federal Reserve Board. The QM definition (as proposed) focuses on a borrower's ability to repay and allows originators to measure that ability with traditional underwriting tools. The proposed QRM rule, in contrast, takes most underwriting decisions away from originators in favor of rigid loan-to-value and other targets.

For example, for the loan to qualify for QRM status, borrowers must make at least a 20 percent down payment—and at least 25 percent if the mortgage is a refinancing (and 30 percent if it is a cash-out refinance). Certainly, loans with lower loan-to-value (LTV) ratios are likely to have lower losses if in default, and we agree that this is *one* of a number of characteristics to be considered. However, the LTV should not be the only characteristic for eligibility as a "Qualified Residential Mortgage," and it should not be considered in isolation. *Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit.* To illustrate the severity of the proposal, even with private mortgage insurance, loans with less than 20 percent down will not qualify for the QRM.

ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

B. Risk Retention Requirements Should Be Conformed to GSE Underwriting Standards

The proposal presented by the regulators will make it vastly more difficult to end the conservatorship of Fannie and Freddie and to shrink FHA back to a more rational portion of the mortgage market. As noted above, under the proposed rule, loans with a Federal guarantee are exempt from risk retention—which includes loans sold to Fannie Mae and Freddie Mac while they are in conservatorship and backed by the Federal Government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans today being sold are bought by Fannie and Freddie or insured by FHA—and as long as these GSEs can buy loans without risk retention—it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, *this proposal does not foster the growth of private label securitizations that would reduce the role of Government in backing loans.*

Equally important is the fact that the conservatorship situation is unsustainable over the long term. Eventually, these narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. After the conservatorships end, even fewer borrowers will qualify for QRM mortgage loans, and the risk retention rules make it less likely that community banks will underwrite non-QRM—but prudent and safe—loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. *Driving community banks from the mortgage marketplace would be counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well.*

Instead of exempting the GSEs from risk retention, the QRM should instead encompass most if not all of the low risk loans being underwritten today and purchased by the GSEs. If a loan meets those requirements (which we anticipate will evolve to conform with any new QM definition) and is thus eligible for purchase by the GSEs, it should also be exempt from risk retention requirements. Conforming the QM, QRM, and GSE standards will set the foundation for a coherent and sustainable secondary mortgage market.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. ABA urges Congress to exercise its oversight authority to assure that rules adopted are consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability. Setting logical, consistent, and workable underwriting standards is the foundation upon which GSE reform must be built.

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 imperative that reform be *cautious,* in order to avoid inflicting further harm on an already fragile housing economy, *but deliberate,* in order to move away from the current situation of full Federal support for the long-term. We must not wait, but start the process now. I hope that these recommendations and the eleven Principles for Reform which are appended to this statement are helpful to you in this process. The American Bankers Association stands ready to assist in any way possible.

Appendix

Principles for Mortgage Finance Reform

The eleven principles developed by the ABA GSE Policy Committee and endorsed by the ABA's Government Relations Council are:

1. The primary goal of any government sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to the primary mortgage market for low- and moderate-income families.
2. In return for the GSE status and any benefits conveyed by that status, these entities must agree to support all segments of the primary market, as needed, in all economic environments.
3. Strong regulation, examination and authority for immediate corrective action of any future GSE must be a key element of reform.
4. Any GSE involved in the mortgage markets must be strictly confined to a well defined and regulated secondary market role and should not be allowed to compete with the private, primary market.
5. Any reform of the secondary mortgage market must consider the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks or access to advances by their members.
6. GSEs must both be allowed to pursue reasonable risks, but the risk/reward equation must be transparent and more rigorously defined and regulated.
7. GSEs must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.
8. A better alternative to "skin in the game" is the establishment of strong minimum regulatory standards to assure sound underwriting for all mortgages, regardless of whether they are sold or held. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.
9. Accounting and regulatory changes should be developed to more appropriately reflect and align securitizations with underlying risks. True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures.
10. Affordable housing goals or efforts undertaken by the GSEs should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects.
11. GSEs must provide for fair and equitable access to all primary market lenders selling into the secondary market through the GSEs.

PREPARED STATEMENT OF PETER SKILLERN

EXECUTIVE DIRECTOR, COMMUNITY REINVESTMENT ASSOCIATION OF NORTH CAROLINA

JUNE 28, 2011

Greetings, I am Peter Skillern, Executive Director of the Community Reinvestment Association of North Carolina, a nonprofit advocacy and community development agency working at the local, regional, and national levels. Thank you for the opportunity to speak on reforms in the secondary mortgage market.

On September 6, 2000, I testified in the House of Representatives Subcommittee on Government Sponsored Enterprises to warn against Fannie Mae and Freddie Mac purchasing high cost subprime loans. I said "For the record . . . these high-cost loans will become a significant problem in the coming years. In the future, this Committee will return to the issue of how the financial markets played a role in spurring high default rates and the decline of our neighborhoods."

That proved to be true. Subprime lending was bad for neighborhoods and the economy. The GSEs purchase of subprime securities was a primary cause of their failure.

Today I am concerned that reform proposals that eliminate the GSEs and convert to a solely private capital market will also be harmful for communities and our housing market as a whole. Reforms are needed to increase the private market role with adequate oversight and to reduce risk to tax payers. However the GSEs are needed as public purpose agencies for the stability of our Nation's housing and finance markets.

GSEs Role in the Mortgage Markets

Megabanks have accelerated their market dominance and size since the financial crisis. Nationally, in 2008, 56 percent of mortgage originations were made by the top five banks; today 70 percent of originations are made by the top four banks. In the rural areas of Alabama, North Carolina, Oregon, Ohio, and South Dakota, megabanks originated 75 percent of the loans and 88 percent of FHA loans. By comparison small institutions under $10 billion originated 16 percent of conventional loans (Federal Financial Institutions Examination Council, 2009). Concentration of capital and mortgage origination market share of big banks will continue.

Megabanks do not have dominance in the secondary market. There are three primary sectors that loans are sold to: (1) Private commercial entities like commercial banks, insurance companies, and their affiliates (2) Fannie Mae and Freddie Mac, and (3) Ginnie Mae, which deals exclusively with FHA.

Smaller financial institutions shop their loans among these secondary buyers. Loans are underwritten to a standard established by the GSEs and sold as a commodity that can to those offering the best price and services. This practice should be preserved.

If the GSEs are eliminated, the secondary capital markets may become dominated by megabanks, which will further concentrate capital in a vertical integration of the mortgage market. This will disadvantage small lenders access to capital, underwriting, and technology controlled by their competitors.

If megabanks are too big to fail now, imagine their size, power, and vulnerability, as they become guarantors and holders of the mortgage-backed security market.

Capital is scared and its volatility adds to swings during booms and busts. Private capital as the primary source of secondary markets will not act countercyclically to provide credit in a recession or to slow liquidity in a boom.

By analogy, mortgage credit is like water. We are concerned not only with the quality of water that comes that comes out of our tap, but who owns and controls the water and the plumbing from the water source of the glaciers to the spigot at home. Mortgage credit like water is critical and should not be entirely controlled by private interests.

If we should not privatize the secondary market, what should be done? We believe that the GSEs should be converted into public purpose entities that are accountable to Congress, but are not a department of the Government such as the Federal Housing Administration. The agency would provide liquidity for 30-year mortgages that are explicitly guaranteed, but priced for adequate reserves. The agency would provide liquidity for multifamily rentals. It would act as a provider of underwriting standards and technology for the benefit of the market. It would balance private-market influence by providing choice on the secondary market.

As an example, the North Carolina Housing Finance Agency is not a Government department, yet serves a public purpose of financing affordable home ownership and rental housing. While appointed by the governor and State legislature, the board is independent and operates without appropriations. It does not have a conflicting private profit motive with its public mission. Its staff is paid competitively, but not excessively. Likewise, the GSEs can serve the public purpose in the secondary market for rental and home ownership financing as an essential element to our national housing and financial policy.

Other Reforms

The *status quo* is not acceptable in the long term for a healthy secondary market and its risk to taxpayers. We support reforms that include:

- Reducing the portfolio of GSE loans and liabilities. They have grown too large and the sell of assets can help to strengthen the capital base of the institutions.
- Pricing for explicit Government guarantees on 30-year mortgages, which are placed in reserves.
- Reforming FHA to provide adequate infrastructure and oversight to its portfolio.
- The financial meltdown was caused in large part by private label mortgage backed securities. Private institutions should provide mortgage securities, but on the condition they are recognized as systemic risks to the market and have adequate oversight for safety and soundness.

Reform GSE Loan Level Pricing

The Community Reinvestment Association advocates for the reform of the GSE loan level pricing policy in order to reduce FHA volume and engage private capital in the mortgage market.

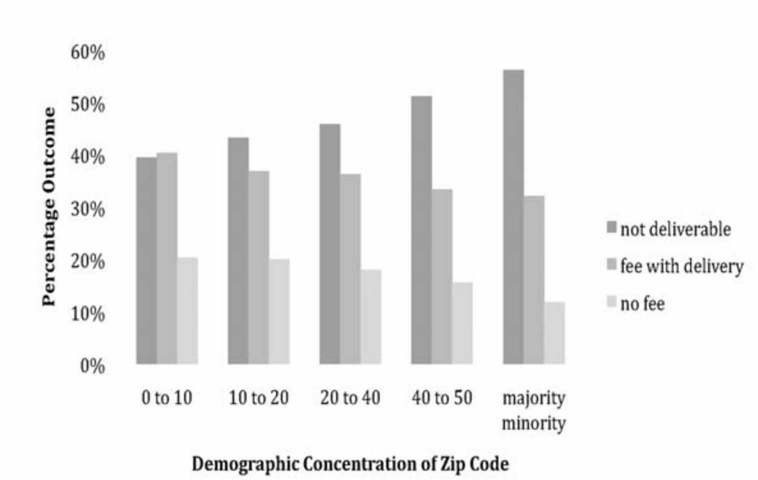
Federal Housing Administration loans are playing a significant role in the mortgage market. In 2005 FHA represented 6 percent of purchase mortgages, but grew to almost 40 percent by 2011, placing greater risk on the taxpayer (FHA, 2011). This is in part a result of the credit contraction by the private sector and the role of FHA in providing needed countercyclical liquidity.

It is also a direct result of current GSE Loan Level Pricing Adjustments LLPA. LLPA charges higher rates and fees for loans with downpayments lower than 10 percent, credit scores below 720 and homes in a declining market. The GSEs are taking the crème of the mortgage market with new GSE loans having high credit scores and low loan to value ratios.

This has not lowered risk for taxpayers. LLPA prices loans away from the GSE portfolio and into FHA. If these loans did not have higher LLPA pricing, they would be insured by the private sector with private mortgage insurance (PMI). PMI premiums layered on top of higher GSE LLPA rates are not competitive with FHA loans with low downpayments. PMI originations have dropped by two-thirds over 3 years.

The LLPA program also demonstrates the impact of requiring high downpayments as a condition of the best pricing for loans. With higher downpayments used as a proxy for underwriting, rather than ability to pay, creditworthy borrowers who can pay their mortgage are denied because of downpayment requirements that will take years to save for. The result is fewer people can buy their first home and owners have greater difficulty in selling. The people most affected are low- to moderate-income households and communities of color. For a more thorough analysis of the LLPA program please read *The New Hurdle to Homeownership* (Adam Rust, Community Reinvestment Association of North Carolina June 2011).

Chart 1: Disposition of Home Purchase Loans, by Racial and Ethnic Composition of Zip Code



We oppose the GSE loan level pricing program and recommend that it be amended to better utilize PMI. This will lower FHA volume and increase lending to creditworthy households with low downpayments.

Conclusion

The proposals being discussed in reforming the secondary market potentially throw the good out with the bad in eliminating the GSE. The catastrophic failure of the GSEs in chasing the private label subprime mortgage markets is not a justification for eliminating the successful elements of the institutions' public purpose. A conversion to a completely private market delivery system will not serve the Nation's economic or social interests.

Let me state for the record, if the proposal to eliminate the GSEs succeeds, this Committee will meet in the future to address new problems. We will have more volatile capital markets; greater inequality in the access to mortgage credit; and disinvestment and decline of low- and moderate-income communities. The real estate market will struggle as it becomes more difficult for renters to become first time homebuyers reducing household mobility. Small financial institutions will be less independent and competitive with megabanks.

If we phase out the GSEs completely, we will lack financing for affordable rental housing for our workforce. If the approach is not inclusive of low- and middle-income households, we will have a system that works very well for some, but not for many others and ultimately not for the greater good. The Community Reinvestment Association affirms the vision of an inclusive and healthy housing market.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ROD STAATZ

Q.1. Mr. Staatz, Fannie and Freddie were responsible both for supporting the secondary mortgage market by guaranteeing mortgage-backed securities and for providing affordable housing by meeting Government-mandated housing goals. In your testimony, however, you state that "[t]he important role of Government support for affordable housing should be a function separate from the responsibilities of the secondary market entities."

Why do you believe that it is important for affordable housing goals to be separated from any entity that supports the secondary market?

Should affordable housing mandates be on the Government's budget?

A.1. The requirements of a program to stimulate the supply of credit to lower income borrowers are not the same as those for the more general mortgage market. Combining both goals in a single vehicle can frustrate the achievement of both goals.

In principle, it would be better for the Government's support for affordable housing to be explicitly funded rather than being subsumed in the mission of some entity such as a GSE with a broader mission, or imposed on lenders. However, it might be reasonable for the source of that funding to derive at least in part from borrowers and financial institutions that might benefit from the Government's support for the mainstream secondary mortgage market. For example, if the Government were to provide some sort of backup guarantee to the qualifying mortgage-backed securities made of up mainstream mortgages, the fee charged for that guarantee could include both a risk-premium and a small fee to fund affordable housing goals. But in any event, using the same mechanisms to support both the broader secondary market and affordable housing is likely to frustrate the achievement of both goals.

Q.2. Mr. Staatz, in your testimony you warn that Dodd-Frank will increase costs for small financial institutions. In fact, you argue that the requirements of Dodd-Frank are one factor that "will likely require small financial institutions to retain additional employees . . . stretch small financial institutional monetary resources to untenable levels, or worse, force more of these institutions, including credit unions, to cease to exist altogether."

What aspects of Dodd-Frank are most costly to small financial institutions?

A.2. It is probably too early to tell which provision of the Dodd-Frank Act will ultimately be the most costly for credit unions. However, over the last several years, there has been an accumulation of regulatory burden which has combined with the enactment of this legislation and the pending implementation of the rules it requires to create a crisis of creeping complexity. Every time a rule is changed—whether it increases regulatory burden or not—costs to credit unions are increased. So it's not any one regulation, but the cumulative effect of many, many recent regulatory changes that is adding to the cost burden. Because of the credit union ownership structure, under which each member is an owner in equal standing, every dollar that a credit union spends to comply with regulation is a dollar that is not used to the benefit of the credit union's membership.

Q.3. Mr. Hartings and Mr. Staatz, you both have advocated that the Federal Government, and by extension the American taxpayer, provide some level of guarantee to the secondary mortgage market. Secretary Geithner, however, has warned this Committee about the difficulty in having the Government guarantee mortgage-backed securities. He cautioned: "guarantees are perilous. Governments are not very good at doing them, not very good at designing them, not very good at pricing them, not very good at limiting the moral hazard risk that comes with them."

Do you agree with Secretary Geithner?

If not, on what basis do you believe that the Government can accurately price risk?

A.3. Secretary Geithner raises very valid points. It would indeed be difficult to design a system of Government support to the secondary mortgage market that does not ultimately impose undue risk to the taxpayer. But difficult is not the same as impossible. We can learn from the lessons of the recent financial crisis. We do not expect a free, no-questions-asked Government guarantee. We would expect to see significant underwriting requirements, and also a substantial guarantee fee to cover the risk. Perhaps the most difficult aspect of such a program would be maintaining discipline after a period of several years of low losses.

Q.4. There has been discussion lately about various approaches to housing finance reform. However, until we identify the most important objectives of any new entity, speculating on the structure of that entity or its products is premature.

Setting aside any characteristics of a future structure and its products, please list and describe the most important, specific priorities that community banks have in the reform of our Nation's housing finance system.

A.4. In the context of the reform of our Nation's housing finance system, the most important priorities for credit unions are: (1) access to the secondary market; (2) strong oversight and supervision of entities operating in the secondary market; and (3) that the secondary market is durable enough to continue to function during financial crisis. We also believe it is critical that there be a reasonable and orderly transition from the current system to any new system.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM ROD STAATZ

Q.1. Recently, the *Wall Street Journal* reported that the percentage of mortgage applications being rejected by the largest lenders increased last year to more than 1 in every four 4 (and increasing in every State except Delaware). Has there been a similar increase in rejections by community banks? If so, what is driving the increase? How has demand changed? (Community bank lending appears to have increased.) How have borrowers changed their behavior, if at all?

A.1. We do not yet have recent data on rejection rates on credit union mortgages, although they have historically been much lower than rejections at other lenders across all types of borrowers. We do know however that the credit union share or first mortgage originations has risen dramatically since the beginning of the financial crisis. Before the crisis, credit unions would typically originate less than 2 percent of total first mortgage loans. Last year, that proportion had doubled to about 3.5 percent. This suggests that credit unions are still willing and able to grant first mortgage loans to their members. Also, prior to the recession, credit unions were primarily portfolio lenders, selling only a quarter to a third of their new loans. Last year credit unions sold over half of new production because of the risks inherent in holding long-term, fixed-rate loans during a period of very, very low interest rates.

Q.2. One significant point in the housing finance reform debate has centered on the use of "guarantee fees." How much of the housing reforms could be accomplished just through proper establishment and use of guarantee fees? How should they be established? What would be the increase to the cost of the average mortgage?

A.2. This is of course the crux of establishing a responsible program. In general, a guarantee fee would need to be sufficient to cover the risks to the Government. Following are some likely useful features of a guarantee fees:

- Fees should be sufficient to build a substantial minimum reserve fund for losses. Fees should err on the side of more than fully funding possible losses rather than the other way around.
- A series of reserve levels could be established, with the guarantee fee reduced each time a higher reserve level is reached.
- Guarantee fees should reflect loan-specific risks factors, but under no circumstances should they be zero.
- Guarantee fees should be set by a single entity within the Government, rather than by competing GSEs.

Q.3. What would be the price of private guarantee fees? Should there be consideration given to a gradient of guarantee? For example, a guarantee of 60 percent or 75 percent or lower, similar to current private mortgage insurance?

A.3. We do not have the expertise and information to opine on the actual level of Government guarantee fees, but believe they would likely be higher than historical fees charged by the GSEs. Gradients of guarantee fees are unlikely to be very attractive to investors, and might be an unnecessary complication.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER R. DUNN

Q.1. Mr. Dunn, in your testimony you state that creating multiple sources of liquidity, including covered bonds, may be the best way forward for housing finance reform.

What benefits would covered bonds provide for community banks?

A.1. Covered bonds may be a potential additional source of liquidity for community banks, but there likely would be impediments to such use. In comparison, large banks are much more likely to use covered bonds, because they have the scale and investment ratings to enter capital markets readily. I do not expect community banks to change their pattern of use of collateralized borrowing from Federal Home Loan Banks (FHLBs) to finance mortgage loans, even if covered bonds become available. FHLB advances operate in a manner similar to covered bonds, where advances to banks are backed by collateral which generally is in the form of mortgage loans held in a bank's portfolio. The FHLBs have the scale and investment rating to issue debt directly in capital markets, which in turn funds FHLB advances to banks and other lenders.

Q.2. Mr. Dunn, you advocate two methods for reducing Fannie and Freddie's role in the mortgage market: raising the guarantee fee and lowering the conforming loan limits.

Please explain how these two actions would help revive the private market.

A.2. Simply stated, a private label mortgage securitization market cannot develop if Fannie Mae and Freddie Mac are managed in conservatorship in a manner which significantly underprices the valuable Government guarantee that is being offered. Only when investors face the full cost of the Government guarantee will they actively consider and begin to chose alternative MBS that can offer an enhanced yield equal to or greater than the cost of the fully priced guarantee. No rational investor will buy private label MBS as long as the Government guarantee is being given away on the cheap.

Lowering the high cost area exceptions from loan limits created at the start of the financial crisis will shrink the pool of loans on which the full guarantee is available, opening the door further for the private market to address needs in the higher loan value categories. This has already been occurring, because the high cost area exceptions were defined to be 125 percent of median area home prices, up to a maximum of $729,000. As median home prices have declined over the past 3 years, the permissible high cost area exceptions have also declined in frequency. It is time to reduce the maximum high cost limit from $729,000 to keep pace, as is scheduled to commence in October, 2011.

Q.3. Mr. Dunn, a key issue in housing finance reform is what should be done with the portfolios of Fannie Mae and Freddie Mac. Currently, these portfolios are scheduled to be dramatically reduced. However, some have argued that Congress should preserve the portfolios when it undertakes housing finance reform.

Do you believe that it is appropriate to continue reducing the GSEs' portfolios?

Do you believe that portfolio lending by a public sector entity is necessary for there to be a healthy secondary market?

A.3. The American Bankers Association strongly believes that the GSE's portfolios should be reduced and eventually eliminated but for a small portfolio which may be necessary to facilitate balance sheet and liquidity management.

We do not believe that a GSE must retain a significant portfolio. While a small portfolio may be necessary for balance sheet and liquidity management, anything further is unnecessary and counterproductive to an efficient private mortgage market. Some flexibility may be desirable to allow for temporary and contained growth of portfolios during times of market disruption to ensure that a GSE is able to step in during a market failure, but such flexibility should be limited and tightly controlled.

Q.4. Mr. Dunn, many have argued for continuing, or even expanding, certain housing goals within the future secondary mortgage market.

Based upon your experience, is imposing arbitrary social goals upon mortgage market participants the appropriate method for the Government to implement social policy?

A.4. We do not believe that social goals should be imposed as a part of secondary market facilitation by the Federal Government. The goal of Federal involvement in the mortgage markets should be to ensure liquidity and stability in the mortgage markets for lending to qualified borrowers. Affordability and other social goals may be important, but should be addressed through other, more direct means such as Federal programs through the Department of Housing and Urban Development.

Q.5. There has been discussion lately about various approaches to housing finance reform. However, until we identify the most important objectives of any new entity, speculating on the structure of that entity or its products is premature.

Setting aside any characteristics of a future structure and its products, please list and describe the most important, specific priorities that community banks have in the reform of our Nation's housing finance system.

A.5. First, the paramount priority for community banks is equitable access to the capital markets, and preserving the function of Federal Home Loan Banks is a key priority. It is imperative that the accessibility and services provided by FHLBs to their members/owners not be disrupted. Community banks do not have the capability to access the capital markets directly, and the cooperative FHLB system has proven to be a safe and reliable means for community banks to fund loans, particularly during the recent crisis.

Second, community banks support a much smaller Government footprint in mortgage markets. We believe that a predominantly private secondary market will best serve borrowers and lenders alike. At the same time, we believe that a secondary mortgage market GSE(s) based on a guarantee business model only should be maintained in an important, if residual, role. We believe that some form of "controlled" secondary market GSE should be maintained to ensure that community lenders have equitable market access regardless of the size of the institution. Such a GSE structure also would offer an operating fail-safe in the event of future mortgage market disruptions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM CHRISTOPHER R. DUNN

Q.1. Recently, the *Wall Street Journal* reported that the percentage of mortgage applications being rejected by the largest lenders increased last year to more than 1 in every 4 (and increasing in every

State except Delaware). Has there been a similar increase in rejections by community banks? If so, what is driving the increase? How has demand changed? (Community bank lending appears to have increased.) How have borrowers changed their behavior, if at all?

A.1. It is difficult to answer this without great speculation; however, there is no doubt that lower appraisals and tighter underwriting standards contributed to an increase in declines throughout the industry. Nevertheless, borrower demand is clearly down, most likely due to uncertainty about housing prices and a fear by some borrowers of buying now when prices may still fall further. Additionally, many potential borrowers are in the process of paying down other debts before considering new borrowing.

It should be noted that the article referenced covers a period in time where many customers were focused on refinancing. Many of these existing borrowers shortened their loan term to pay off their loans sooner.

Q.2. One significant point in the housing finance reform debate has centered on the use of "guarantee fees." How much of the housing reforms could be accomplished just through proper establishment and use of guarantee fees? How should they be established? What would be the increase to the cost of the average mortgage?

A.2. The American Bankers Association believes that adjusting guarantee fees (G-fees) charged by the GSEs is a critical first step in bringing about reform. The full guarantee being provided by the Federal Government to Fannie and Freddie is significantly underpriced at the moment. G-fees should be carefully, but deliberately ratcheted up to a level more appropriately reflecting the true value of the guarantee. Eventually, as these fees increase, the private market will likely return and offer products without a guarantee at a lower price which will then be considered competitive.

Q.3. What would be the price of private guarantee fees? Should there be consideration given to a gradient of guarantee? For example, a guarantee of 60 percent or 75 percent or lower, similar to current private mortgage insurance?

A.3. The price of the guarantee fee, as well as the usefulness of a gradient is more accurately determined by the investor channel, so we would defer to those market participants for input on this question.

Q.4. In your written remarks, you note that "[w]ith a high enough [guarantee fee], the private market will be able to price for risk" What is the differential in that rate? How should it be set? What would be the impact on the rate of an average loan?

A.4. Again, this is likely a question better addressed to the investor community. It will be up to investors to determine how much risk is offset by the guarantee (and how much they will pay for that offset) and how willing they are to invest in products that could potentially be offered without such a guarantee.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

NAFCU
National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
703-522-4770 • 800-336-4644 • 703-522-0594

B. Dan Berger
Executive Vice President
Government Affairs

June 27, 2011

The Honorable Tim Johnson
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington DC 20510

The Honorable Richard Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington DC 20510

Dear Chairman Johnson and Ranking Member Shelby:

I write today on behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, with respect to tomorrow's hearing "Housing Finance Reform: Access to the Secondary Market for Small Financial Institutions." NAFCU member credit unions appreciate the committee prioritizing this issue and carefully reviewing all aspects housing finance reform before moving forward.

Tomorrow's hearing focusing on small lenders is a first step in ensuring that any reforms made to our country's housing finance system will result in equal and uninterrupted access to the secondary mortgage market for credit unions and other community-based financial institutions. Nearly 93 million Americans are members of their local credit union, and each deserves to be on an even playing field should they desire to purchase a home. Credit unions didn't contribute to the financial crisis and pride themselves in solid underwriting that creates high quality loans. Moving forward, the past performance of credit unions should be taken into consideration by ensuring that they can still effectively meet the needs of their members.

NAFCU would like to reiterate to the Committee on Banking, Housing, and Urban Affairs a core set of principles that must be taken into account for credit unions to be treated fairly during any housing finance 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

E-mail: dberger@nafcu.org • **Web site:** www.nafcu.org

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) as each of these functions serve 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 need 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.

- While a central role for the U.S. government in the secondary mortgage market is pivotal, 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. <u>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.</u>

- 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.

As you know from previous correspondence, NAFCU has concerns about the Administration's report on the future of housing finance and the proposals contained therein. We applaud the Administration for their efforts in crafting this report; however, as the report recognizes, the cost of mortgage credit "would likely increase" under each of the options for unwinding the GSEs. We agree and believe this outcome would restrict otherwise qualified borrowers from achieving homeownership.

Equally as troubling about the approach outlined in the Administration's report, and other proposals that have been put forward in the House of Representatives, is opening the door for a handful of large banking institutions to dominate the secondary market. Clearly, this would create a situation that would limit options for smaller community financial institutions, such as credit unions, or even drive some out of the mortgage business entirely. Further consolidation of the mortgage market among the same mega-banks who contributed to the worst financial crisis since the Great Depression defies commonsense and is not good public policy. NAFCU urges the Senate to reject all proposals that would create such a scenario.

Housing finance reform involves consideration of many highly complex issues, thus requiring careful treading, and should not be done quickly. Fannie Mae and Freddie Mac own or guarantee a significant amount of mortgages in the United States, and any piecemeal Congressional action could have serious unintended consequences for current and perspective homeowners. For example, implementing changes too quickly could lead to traditional mortgage products like the 30-year fixed rate being priced out of the market, only further disintegrating the American dream of owning a home. In addition, as you know, disruptions could trigger a "double-dip" recession wreaking havoc on our country's economy and the broader global finance system. In short, NAFCU urges Congress to move in a comprehensive and deliberative manner.

Lastly, we believe it is critical that the essential functions of Fannie Mae and Freddie Mac are retained until taxpayer capital that the federal government injected into the GSEs is recovered. The essential functions include, but are not limited to, purchasing and guaranteeing mortgages originated by credit unions.

We thank you for holding this important hearing and shining a spotlight on the role of small financial institutions in the secondary mortgage market. NAFCU welcomes 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 Committee on Banking, Housing and Urban Affairs