

**A FAILURE TO ACT: HOW A DECADE  
WITHOUT GSE REFORM HAS ONCE  
AGAIN PUT TAXPAYERS AT RISK**

---

**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**  
ONE HUNDRED FIFTEENTH CONGRESS  
SECOND SESSION

\_\_\_\_\_  
SEPTEMBER 6, 2018  
\_\_\_\_\_

Printed for the use of the Committee on Financial Services

**Serial No. 115–115**



\_\_\_\_\_  
U.S. GOVERNMENT PUBLISHING OFFICE  
WASHINGTON : 2018

31–575 PDF

## HOUSE COMMITTEE ON FINANCIAL SERVICES

JEB HENSARLING, Texas, *Chairman*

PATRICK T. MCHENRY, North Carolina,  
*Vice Chairman*

PETER T. KING, New York  
EDWARD R. ROYCE, California  
FRANK D. LUCAS, Oklahoma  
STEVAN PEARCE, New Mexico  
BILL POSEY, Florida  
BLAINE LUETKEMEYER, Missouri  
BILL HUIZENGA, Michigan  
SEAN P. DUFFY, Wisconsin  
STEVE STIVERS, Ohio  
RANDY HULTGREN, Illinois  
DENNIS A. ROSS, Florida  
ROBERT PITTENGER, North Carolina  
ANN WAGNER, Missouri  
ANDY BARR, Kentucky  
KEITH J. ROTHFUS, Pennsylvania  
LUKE MESSER, Indiana  
SCOTT TIPTON, Colorado  
ROGER WILLIAMS, Texas  
BRUCE POLIQUIN, Maine  
MIA LOVE, Utah  
FRENCH HILL, Arkansas  
TOM EMMER, Minnesota  
LEE M. ZELDIN, New York  
DAVID A. TROTT, Michigan  
BARRY LOUDERMILK, Georgia  
ALEXANDER X. MOONEY, West Virginia  
THOMAS MACARTHUR, New Jersey  
WARREN DAVIDSON, Ohio  
TED BUDD, North Carolina  
DAVID KUSTOFF, Tennessee  
CLAUDIA TENNEY, New York  
TREY HOLLINGSWORTH, Indiana

MAXINE WATERS, California, *Ranking  
Member*

CAROLYN B. MALONEY, New York  
NYDIA M. VELÁZQUEZ, New York  
BRAD SHERMAN, California  
GREGORY W. MEEKS, New York  
MICHAEL E. CAPUANO, Massachusetts  
WM. LACY CLAY, Missouri  
STEPHEN F. LYNCH, Massachusetts  
DAVID SCOTT, Georgia  
AL GREEN, Texas  
EMANUEL CLEAVER, Missouri  
GWEN MOORE, Wisconsin  
KEITH ELLISON, Minnesota  
ED PERLMUTTER, Colorado  
JAMES A. HIMES, Connecticut  
BILL FOSTER, Illinois  
DANIEL T. KILDEE, Michigan  
JOHN K. DELANEY, Maryland  
KYRSTEN SINEMA, Arizona  
JOYCE BEATTY, Ohio  
DENNY HECK, Washington  
JUAN VARGAS, California  
JOSH GOTTHEIMER, New Jersey  
VICENTE GONZALEZ, Texas  
CHARLIE CRIST, Florida  
RUBEN KIHUEN, Nevada

SHANNON MCGAHN, *Staff Director*

# CONTENTS

	Page
Hearing held on:	
September 6, 2018 .....	1
Appendix:	
September 6, 2018 .....	43

## WITNESSES

THURSDAY, SEPTEMBER 6, 2018

Bailey, Nikitra, Executive Vice President, Center for Responsible Lending .....	8
DeMarco, Edward J., President, Housing Policy Council .....	5
Pinto, Edward J., Co-Director, Center on Housing Markets and Finance; Resident Fellow, American Enterprise Institute .....	9
Swagel, Phillip L., Professor, University of Maryland School of Public Policy ..	6

## APPENDIX

Prepared statements:	
Bailey, Nikitra .....	44
DeMarco, Edward J. ....	75
Pinto, Edward J. ....	94
Swagel, Phillip L. ....	118

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Duffy, Hon. Sean:	
Government-sponsored Enterprise Reform Coalition letter .....	126



## **A FAILURE TO ACT: HOW A DECADE WITHOUT GSE REFORM HAS ONCE AGAIN PUT TAXPAYERS AT RISK**

---

**Thursday, September 6, 2018**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The committee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Present: Representatives Hensarling, Lucas, Posey, Luetkemeyer, Huizenga, Duffy, Stivers, Hultgren, Ross, Pittenger, Barr, Rothfus, Tipton, Williams, Poliquin, Hill, Emmer, Zeldin, Trott, Loudermilk, MacArthur, Davidson, Budd, Kustoff, Tenney, Waters, Maloney, Sherman, Clay, Lynch, Scott, Green, Cleaver, Perlmutter, Himes, Foster, Kildee, Delaney, Sinema, Beatty, Vargas, Gottheimer, Crist, and Kihuen.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time, and all Members will have 5 legislative days within which to submit extraneous materials to the Chair for inclusion in the record. This hearing is entitled, “A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk.” I now recognize myself for 4 minutes to give an opening statement.

September 6, 2008 is a day that will live on in economic infamy, for today marks the not-so-happy anniversary of one of the most frustrating and costly moments in recent financial history, namely the 10-year anniversary of the Federal takeover of the failed housing government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac. The GSE’s anticompetitive government charters and ever-increasing affordable housing mandates created a toxic mess of systemic risk. Their collapse directly led to the second worst financial crisis in our history, causing more than \$190 billion of taxpayer bailouts and forcing them into a government-run conservatorship.

Embarrassingly, 10 years later, the GSEs remain in conservatorship very much alive and very much unreformed, as they quietly return to their pre-crisis market dominance. That is bad news for competition, innovation, and, most of all, taxpayers, since the Congressional Budget Office has said their \$5.1 trillion of mortgage obligations are, quote, “effectively guaranteed by the Federal Government,” unquote.

Meanwhile, as several of our witnesses will testify, systemic risk is building yet again. The cost and risk of continuing to do nothing is rising, and rising at an alarming rate.

Reform, while critical, has proven elusive. For almost 20 years, I, along with other handful of reformers like Congressman Ed Royce, have labored in vain to replace the GSE's government-sanctioned monopoly with a new system based on competitive private capital, innovation and consumer choice, and market discipline.

We passed the PATH (Protecting Americans from Tax Hikes) Act in the 113th Congress to do just that. I am reintroducing the PATH Act this week if, for no other reason, it is the right thing to do, and it will let me sleep better at night. Regrettably, its chances for passage remain slim.

So as an alternative, I have decided to partner with Mr. Delaney on the other side of the aisle to propose a bipartisan compromise housing reform plan that preserves the government guarantee in the secondary mortgage market. In the time I have remaining in Congress, this is the plan I will pursue.

Our discussion draft, which we will unveil later today, will repeal the GSE's charters permanently ending their monopoly, and transition to a system that allows qualified mortgages backed by an approved private credit enhancer, with regulated diversified capital resources to access the explicit full government securitization guaranty provided by Ginnie Mae. I believe the plan will preserve much of what is demanded in the current system, liquidity, the TBA market, and the 30-year prepayable fixed mortgage. And it will do so while dispersing risk and leveling the playing field for all entrants into mortgage finance. Additional details of our proposal will be released later today.

While by no means perfect, we offer this proposal as a grand bargain on how to move past an increasingly dangerous status quo. Codify and explicit government MBS guarantee into law, coupled with an accountable and effective affordability program, in exchange for placing the taxpayer in a catastrophic loss position only, diffusing the credit risk beyond two GSEs, and creating market competition. If the political will to enact such reform stalls in this Congress or the next, the Administration can and should effectuate change.

The President will appoint a new Federal Housing Finance Agency (FHFA) director in January. The director has broad, unilateral powers as conservator of Fannie and Freddie to dramatically reduce their size, scope, and functions. If Congress fails to act by early next year, I call upon the new director to institute these reforms administratively.

The grand bargain I have described does not necessarily represent my preferred policy, or optimal policy, but I believe it represents an achievable policy in a good faith effort at bipartisan compromise. A decade without GSE reform has once again put homeowners, taxpayers, and the economy at risk. The time to act is now.

With apologies to the Rolling Stones, "You can't always get what you want, but if you try sometimes, you just might find you get what you need" to avert the next housing crisis.

I now call upon the Ranking Member. I yield her 3 minutes for an opening statement.

Ms. WATERS. Thank you, Mr. Chairman. Mr. Chairman, this hearing will focus on the failure to reform the housing finance system. I would point out that Republicans control the House, the Senate, and the White House, and there have been no apparent steps to advance comprehensive housing finance reform since they gained that control.

It was over 5 years ago that committee Republicans pushed the PATH Act through this committee. That bill was not seen as credible. It failed to gain unanimous Republican support in committee, and the Republican leadership of the House declined to bring the bill to the House floor for a vote. I am in support of responsible efforts to reform our housing finance system. I believe we must evaluate what Fannie Mae and Freddie Mac have done well, as well as areas where the system still needs improvement and reform.

Contrary to the claims of the majority, Fannie and Freddie did not cause the crisis. The Financial Crisis Inquiry Commission and others have made that clear. As we all know, the crisis was driven by predatory lending, the private market packaging those toxic, risky loans into securities, and then selling those securities to unsuspecting investors. Fannie and Freddie did not drive those actions, but the events that transpired during the crisis made clear the need for their reform.

While the Republican-controlled Congress has yet to act, the Federal Housing Finance Agency has taken significant, administrative steps to improve the safety and soundness of the enterprises and reduce risk to taxpayers. As we consider housing finance reform and work to address the structure of our housing finance system, it is a priority for me to ensure that underserved borrowers and communities are not overlooked. This means that at the heart of any reform proposal, we need a comprehensive strategy around access to affordable mortgage credit, as well as access to affordable rental housing. And with that, I yield the balance of my time Mr. Chairman.

Chairman HENSARLING. The gentlelady yields back. I now recognize the gentleman from Wisconsin, Mr. Duffy, Chairman of our Housing and Insurance Subcommittee, for 1 minute.

Mr. DUFFY. Thank you, Mr. Chairman. Ten years, 10 years on since the financial crisis that was caused by a mortgage crisis that put the U.S. economy and the global economy into a tailspin, and at the center of that crisis was Fannie Mae and Freddie Mac that was allowed, by way of a government guarantee, to create a risky book of business they should have never been able to make.

And so what did the Congress do? We passed Dodd-Frank, and I don't want to get into a spitting match because Dodd-Frank didn't do the reform that was necessary in the housing space, and the Ranking Member will say, Well, you guys have controlled Congress and now you have the White House. What have you done? And that is fair enough.

The point is that we have to come together as a Congress in a bipartisan fashion, to figure out a way to address our housing finance system and make sure it works. But now to look 10 years

on that Fannie and Freddie are in conservatorship, and they have become bigger beasts than they were even before is troubling. This is—one second, Mr. Chairman. Housing is important to America. Housing is important to families. You can't have a partisan bill, and that is why I am proud of Mr. Delaney and Mr. Hensarling for working together. Whether this is the package we move forward with or a different package, we have to come together as a Congress representing American families to make housing work in a more sustainable way. I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Michigan, Mr. Kildee, Vice Ranking Member of the committee, for 1 minute.

Mr. KILDEE. Thank you. Thank you, Mr. Chairman and Ranking Member. We have talked about GSE reform for a long time in this committee. Several bipartisan proposals have been offered, yet we have not been able to move any of those bipartisan bills to the floor. I hope that changes. I have some reason for optimism, but I hope it does happen. It is also important not just that we talk about this and raise it in this meeting, but we do so with facts and data rather than bias and misdirection.

We have to be wary of those who try to blame the 2008 crisis on expanded homeownership opportunities for low- and moderate-income people. We need an honest assessment of the larger role that other factors played, including the market for mortgage-backed securities, deregulation, the availability of risky nontraditional lending products. Home ownership opportunities have to be available for low- and moderate-income families, something that bipartisan GSE reform can encourage. So it is up to this committee to ensure that reform doesn't pit investors and lenders against one another to the detriment of homeowners.

Finally, GSE reform must include a government backstop for the secondary market. Without that, we can't see the end of the 30-year fixed-rate mortgage, which is the product around which our markets are calibrated. I look forward to working on this issue, and I am encouraged by what I heard in the last few days. I hope we can move something this year. We shouldn't give up on that possibility. This is really important. I thank the Chair and the Ranking Member for holding this hearing. I yield back.

Chairman HENSARLING. The gentleman yields back. Today we welcome the testimony of Mr. Ed DeMarco, President of the Housing Policy Council. Mr. DeMarco earned a BA in economics from the University of Notre Dame and a PhD in economics from the University of Maryland. Prior to joining the Housing Policy Council, Mr. DeMarco was a Senior Fellow at the Milken Institute, and was the Acting Director, as I think we all know, of the FHFA for 4-1/2 years.

Dr. Phillip Swagel is a Professor at the University of Maryland School of Public Policy. Dr. Swagel earned his BS from Princeton University and a PhD in economics from Harvard University. Prior to joining the University of Maryland, Dr. Swagel was a Visiting Professor at Georgetown University and the Assistant Secretary for Economic Policy at the Treasury Department.

Next, Ms. Nikitra Bailey is the Executive Vice President at the Center for Responsible Lending. She earned a BA from the Penn-



sylvania State University and a JD from the University of Pittsburgh School of Law. Prior to joining the Center for Responsible Lending, Ms. Bailey was a Communications Fellow for the Opportunity Agenda.

Last but not least, Mr. Ed Pinto is the Co-director at the Center on Housing Markets and Finance and Resident Fellow at the American Enterprise Institute. Mr. Pinto earned a BA from the University of Illinois and a JD from the Indiana University School of Law. Prior to joining AEI, Mr. Pinto was Vice President and Chief Credit Officer for Fannie Mae.

I think most of you have testified before so each one of you, I believe, knows you will be recognized for 5 minutes to give an oral presentation of your testimony. When the yellow light comes on you have a minute remaining. Without objection, each of your written statements will be made part of the record.

Mr. DeMarco, you are now recognized for your testimony.

#### **STATEMENT OF EDWARD J. DEMARCO**

Mr. DEMARCO. Thank you, Mr. Chairman. Mr. Chairman, Ranking Member Waters, Members of the committee, thank you for having me here today. It is an honor to be back before you at this time in my capacity as the President of the Housing Policy Council.

My prepared statement makes the following key points: Fannie Mae and Freddie Mac failed 10 years ago and were placed into government conservatorship backed by billions of taxpayer dollars. The reason for this conservatorship and for this massive amount of taxpayer support is that if their failure had led to shutting them down, the systemic ramifications of that would have been devastating. It was said at the time, and I detail this in my statement, that the final resolution of these conservatorships requires congressional action. Why is that?

Simply put, it was the Congress of the United States that created these companies, chartered them, gave them their mission, gave them their special privileges, gave them their names, and reserved for itself, reserved for Congress alone the authority to change the charters, eliminate the charters, create new charters, merge the charters, and so on. So that is why with these companies in conservatorship, we are awaiting congressional action.

Now in the 10 years since, a lot of positive developments have taken place, including developments that give the Congress something to build on. This includes the development of a credit risk transfer market and a common securitization platform. In those ways, things have gotten better, but in some ways, things have not. Indeed, the systemic reliance we are placing on Fannie Mae and Freddie Mac, if anything, has grown in these 10 years.

So 10 years ago we saw all around us the manifestations of systemic risk in our financial system and since then, the Congress and regulators and, indeed, private financial firms have taken many steps to address these systemic issues, but the ones embedded in our housing finance system are still unchecked. So on behalf of the Housing Policy Council, I am here to say we need Congress to make the policy decisions only elected officials can make. The good news for all of you is that there is a foundation to build upon. I

already mentioned the work being done by the conservator, but there is more than that.

Just in this committee, there have been three comprehensive proposals: One by the Chairman, one by the Ranking Member, one by Congressmen Delaney and Himes. And just now, we have learned of a bipartisan approach that creates a fourth basis upon which to work. And that is not all the good news. There is also this: As I review in my written statement, there is broad agreement on many of the basic principles and desired outcomes we are trying to achieve.

So the Housing Policy Council welcomes the Chairman's latest proposal with Mr. Delaney and looks forward to reviewing it and working with this committee, not just for the remainder of this year, but until the job gets done. In the meantime, we hope the FHFA and the Treasury continue to support Congress by carefully examining the common elements across reform proposals, and taking the administrative steps consistent with these proposals that will make legislating easier and the transition easier.

I would like to make a final comment. It is easy to focus this discussion on what to do with Fannie Mae and Freddie Mac, especially today as we mark this 10-year anniversary, but we should not let the discussion get wrapped up in focusing just on Fannie and Freddie. Our goal is to strengthen and modernize a credit market, a market essential to one of our fundamental needs—the need for housing. Our focus should be on the market. In this case, the secondary mortgage market and how it connects the ultimate borrower, a person or a family looking to buy a home, with the ultimate provider of those resources—the investor.

So let's start by remembering the key principles of a sound market system: Competition, transparency, consistency, data, equitable rules, and so on. And let's remember that with financial markets, systemic risk is a real threat. We ought to disperse risk through the system, not concentrate it. And we ought to avoid deep concentration of market power in the hands of one or two firms. And finally let's remember sometimes social goals can only be met with the help and support of government.

In housing finance, one key element of that support comes from the FHA (Federal Housing Administration) program and other government insurance programs. They also need to be part of our conversation if we want to envision a complete safe and sound housing system that assures the opportunity of sustainable homeownership.

So, Mr. Chairman, thank you for inviting me to this hearing, and I look forward to participating in the discussion.

[The prepared statement of Mr. DeMarco can be found on page 75 of the Appendix.]

Chairman HENSARLING. Dr. Swagel, you are now recognized for your testimony.

#### **STATEMENT OF DR. PHILLIP L. SWAGEL**

Dr. SWAGEL. Thank you, Chairman Hensarling, Ranking Member Waters, Members of the committee, thank you for the opportunity to testify on the subject of GSE reform. I was at the Treasury Department 10 years ago when Fannie Mae and Freddie Mac were taken into conservatorship. In fact, I testified in this room before

this committee 10 years ago next week on housing policy, the same day that AIG was rescued, bailed out.

I think no one envisioned that 10 years later, the two firms would remain in government control and that taxpayers would still be on the hook for so much credit risk. Reform is still needed. Too many families still find it difficult to get a mortgage while the dominant government role means that taxpayers are taking on too much risk. Today's housing finance system should be unsatisfactory to all sides.

With the two firms at the time, and still today, the linchpins of the U.S. mortgage system, allowing them to fail 10 years ago would have risked systemic consequences. Ten years later, however, the two firms are still undercapitalized and still too important to be allowed to fail. That is the key problem. Housing finance reform should clarify the roles of the private sector and the government. If the two firms or any other firms competing in housing finance are still too important to fail, simply stating that there will not be another bailout is not credible. A return to a duopoly of private firms such as with the recap and release idea would reconstitute the implicit guarantee that was the most problematic aspect of the pre-crisis system.

At the same time, considerable progress has been made in conservatorship, and I think it is important to recognize that FHFA under the leadership first of Ed DeMarco, and then most recently under Director Mel Watt deserves credit for this progress, as do the two firms themselves. Most importantly, there is now private capital taking on housing credit risk ahead of taxpayers. This is important progress. Reform, though, should go further to improve incentives and better protect taxpayers.

As policymakers, you should look skeptically at the suggestion that requiring adequate capital will price people out of mortgages. If a certain amount of private capital is enough to protect taxpayers against all but catastrophic risk, then additional capital should not be at risk. It cannot be the case that taxpayers are safe, and yet, more capital has a large impact on interest rates. If capital is expensive, well, then, taxpayers are not safe. It can't be one or the other.

Administrative measures, while legislation is still being discussed, should focus the GSE activities, especially on improving their effectiveness. My written testimony discusses several suggestions. I want to briefly focus here on ways to improve the effectiveness with which the housing finance system supports affordable housing. The current system provides about \$3.8 billion every year in cross subsidies within the pricing structure of the insurance premiums charged by Fannie and Freddie. Essentially, lower risk borrowers pay more so that higher risk borrowers get a subsidy. But the problem is that nearly one in four of the borrowers who receive a subsidy in the current system are not low-income and not moderate-income. The subsidies are not allocated based on need.

The impact is that a lower income family that has prudently accumulated a downpayment and has lived within their means, ends up paying more to subsidize a wealthier family with a small downpayment and lots of debt. We can focus the affordable housing as-

sistance, even the amount that is there today, and provide much better and more effective assistance for the families who need help.

Housing finance reform remains necessary 10 years after Fannie and Freddie were taken into conservatorship. Not moving forward leaves too many families still facing difficulty obtaining mortgages and taxpayers taking on too much risk. Reform can improve the safety of the housing finance system and better protect taxpayers and also provide for more access for mortgage financing and better support for affordable housing. Thank you very much.

[The prepared statement of Dr. Swagel can be found on page 118 of the Appendix.]

Chairman HENSARLING. Ms. Bailey, you are now recognized for your testimony.

#### **STATEMENT OF NIKITRA BAILEY**

Ms. BAILEY. Good morning, Chairman Hensarling, Ranking Member Waters, and committee Members. I thank you for the opportunity to testify on this critical issue of GSE reform. Ten years after the housing crash of 2008, millions of hardworking families most harmed by unnecessary foreclosure continue to be locked outside of the Nation's steady recovery and housing finance system. However, their hopes to participate in the American dream of homeownership remains strong.

I am Executive Vice President of the Center for Responsible Lending, a nonpartisan research and policy organization dedicated to protecting family wealth and ending predatory lending. We are affiliated with one of the Nation's largest community economic development credit unions Self-Help, which is based in Durham, North Carolina, and has provided over \$7 billion of safe and responsible credit in communities all across the country.

The bipartisan Housing and Economic Recovery Act of 2008, enacted by Congress, represented substantial reforms to the Nation's housing finance system. This act put in place a new and empowered regulator. Moreover, Dodd-Frank's ability to repay standard and qualified mortgage (QM) rules together provided baseline mortgage protections to have enabled the steady though uneven recovery we experience today.

The sum of these reforms return profitability to the Nation's financial institutions, and is well-documented in regulatory reports. Earlier this month, the Federal Deposit Insurance Corporation reported that the U.S. banking sector reported a record \$60 billion in profits in the second quarter.

With these gains, now it is time for the GSEs to be restructured. It is a needed action that can be taken administratively. Among housing stakeholders, there is broad consensus that the housing finance system needs an explicit and fully paid-for government guarantee with private capital in the first loss position. However, we equally acknowledge and need to resolve this fundamental disagreement with any proposal that calls on the elimination of the enterprise's chartered Duty to Serve obligations. The Duty to Serve provisions that begin in the charters and remain in HERA (Housing and Economic Recovery Act) require that credit is available in all markets at all times. This directive creates liquidity in every

community, including rural ones, and for community banks and for credit unions.

These requirements ensure that lower wealth borrowers get an opportunity to succeed in homeownership. They also provide mechanisms to keep smaller banks on equal footing with private banks. Any reform that the system builds that moves us toward excessive risk-based pricing has to be opposed. Average pricing actually makes mortgage loans more affordable.

Our Nation's fair lending laws, along with HERA and Dodd-Frank, underscore a longstanding Federal commitment for safe and responsible mortgage credit on affordable terms. These principles also evidence the belief that the system should not only serve borrowers with the most pristine credit profiles.

Congress has exercised extreme caution thus far. You must also reject untested models that introduce anxiety that come with higher cost projections and provide less access and affordability for working families.

Today, we mark the 50th anniversary of the Federal Fair Housing Act, so as we think about GSE reform and all that it offers, we have to deal with the fact that 50 years later, black Americans still have the same rates of homeownership that they had in 1968 when this Congress passed that significant legislation.

We also have to look right at the Federal Government's role in fostering historic discrimination that has put us in the racial wealth gap that we are dealing with today. Today, African Americans have 13 times less the wealth of whites. Latinos have 10 times less the wealth of whites. That is the result of Federal housing policy that said we will only insure mortgage loans to white families for a significant portion of those programs starting. They have given whites a heads up and have denied African Americans and Latinos an opportunity for equal parity.

Discriminatory redlining, along with predatory mortgage lending targeted at families of color, place them at higher risk of foreclosure. Many families were steered into loans with dangerous features and higher costs, even when they qualified for loans on separate terms that were cheaper. CRO's research shows that for people who did not even experience foreclosure, they lost \$1 trillion of wealth in communities of color. So they didn't have a foreclosure themselves, but they lived in a community where there was a propensity toward it.

So the Federal Government role needs to be addressed, and now is the time to do it. Thank you for this opportunity. I appreciate it, and I look forward to answering your questions.

[The prepared statement of Ms. Bailey can be found on page 44 of the Appendix.]

Chairman HENSARLING. OK. Mr. Pinto, you are now recognized for your testimony.

#### **STATEMENT OF EDWARD J. PINTO**

Mr. PINTO. Thank you, Chairman Hensarling and Ranking Member Waters, for the opportunity to testify today. In all the work that I do, my prime interest is in the big picture—policy implications informed by data about housing finance. I am also interested in pointing out the various ways that the housing lobby distorts na-

tional policy discussions for their own benefit, and the detriment of first-time buyers and taxpayers.

In my written testimony, you will see a lot of detail but my remarks are going to focus on big picture policy implications. I will be referring to some of the numbered charts in my written testimony. My testimony is based on risk grading of 60 million individual mortgage loans dating back to 1990, and price appreciation trends for the most recent 9 million. I will cover four points that are informed by our research: House price boom 1.0, from the '90s and the outyears, the current house price boom 2.0, both driven by government policy. The same policy decisions are promoting leverage and leave entry-level buyers and taxpayers more exposed. The long-running conservatorship and how that has been used to strengthen the GSE's taxpayer-backed duopsony, and prompt administrative action is advisable now.

Figure 1 shows that the risk buildup that took place starting in the early '90s and ending the first time in 2007, at the GSEs coincided with real house price increases over the same period. This buildup is starting up again since 2012, and as are house prices, which are in a boom 2.0. The FHA is a big part of this process.

For many decades, U.S. housing policy has relied almost exclusively on increasing borrower leverage, and a failed attempt to make housing more affordable. This is because credit easing in a seller's market makes homes less affordable as the easing gets capitalized into higher prices.

Figure 2 shows that the history of GSE debt-to-income (DTI) ratios over the past 30 years confirms this. Seller's markets coincided, in both times, with the rapid rises in DTIs and the real house prices that occurred during booms 1.0 and 2.0.

Turning now to some of the deleterious actions of Fannie Mae, Freddie Mac, and the Federal Home Housing Finance Agency since the beginning of the conservatorship. The DTI patch was announced by the Bureau of Consumer Financial Protection in 2013, and is still in effect and bears special mention. Since 2013, 85 percent of all primary home purchase financing has been guaranteed by agencies eligible under the patch.

Figure 3 shows that rather undertaking an orderly transition period to the qualified mortgages, 43 percent DTI limitation, this was what was envisioned by the Bureau, the FHFA, the GSEs, FHA, and the VA, all took advantage of the patch to promote higher DTI loans. Private portfolio lenders and RHS showed much less use of DTIs greater than 43 percent.

As a result, 36 percent of agency-guaranteed loans that originated in March 2018, had a DTI in excess of 43 percent, the QM limit. Double the level the month before the patch was announced. It may shock you to learn that 26 percent of FHA's purchase loans have a DTI greater than 50 percent.

I will now turn to the core of the problem. In my view, not enough attention has been paid to the policy arena—in the policy arena to changes in leverage, or to the distinction between buyer's and seller's markets. We are introducing four new price indices to help highlight these changes.

One of the innovations is that we divided the price, the house price into four bins because the market behaves differently for each

bin. Our broad conclusion is there is a strong correlation between increasing census tract home price appreciation, and increasing census tract mortgage risk index.

As you can see from Figure 7, most first-time buyers are in the bottom two bins, and their mortgage loans are much riskier. Prices in the low bins have increased much faster, 41 percent, than medium high and high bins at 28 percent. This aggressive financing has been a key driver of excessive house price appreciation. In the low bin, 80 percent of the loans are guaranteed by the GSEs and FHA. There is no doubt where this impetus for higher prices is coming from. Consider if low prices had increased at the same rate as the medium- and high-tier—medium-high and high tier price bins. Entry-level buyers today would be able to buy the exact same home for an average of \$17,000 less and with a lower risk of default. This is a badly designed housing policy that is in place.

In my written testimony, I list a number of areas where the long-running conservatorship has been used to strengthen the GSEs. I will leave that to your review.

What about solutions? Let me start off by saying measured step now should moderate the current pace of unsustainable home pricing increases. In terms of legislation, I believe the PATH Act is the only viable solution. In terms of administrative steps, prompt acts should be taken by four agencies: HUD, Bureau of Consumer Financial Protection, FHFA, and Treasury. These are all laid out in my written testimony. Thank you.

[The prepared statement of Mr. Pinto can be found on page 94 of the Appendix.]

Chairman HENSARLING. I thank the witnesses for their testimony. I yield myself 5 minutes for questions.

Mr. DeMarco, I was struck by your written testimony. On page 3, you subtitle that portion of your testimony, "Yet Systemic Risk is Growing Not Fading." You mentioned that there are signs that underwriting standards are weakening, that pricing by the GSEs is less than that backed by private capital. You talk about the government's involvement growing substantially in the 10 years since the conservatorship. And then I am really struck by your quote, "The level of systemic risk posed by the GSEs has grown over these 10 years," unquote. As one of the four—as somebody who spent 4-1/2 years of their life as the GSEs' regulators and probably one of the three or four most knowledgeable people in the galaxy about the GSEs, this is a profound statement. Can you elaborate?

Mr. DEMARCO. Thank you, Mr. Chairman, yes. What I am trying to indicate here is that during this time of conservatorship, while we provide a taxpayer support to the conservatorships to keep Fannie Mae and Freddie Mac functioning so that the country could have a functioning secondary mortgage market, given the duration of these conservatorships and the path that we have since followed, what we have effectively done is concentrated more and more of the actual decisioning and credit risk management and risk assessment and pricing in these two companies, two companies operating in a government conservatorship.

So end to end, Fannie Mae and Freddie Mac are responsible for virtually all the risk—for a great deal, if not virtually all, of the risk analysis, pricing, and risk bearing in our housing finance sys-

tem, particularly and certainly for the \$5 trillion of it that they are directly involved. They determine which counterparties can participate in the system and in what manner. They have broad reach to all stakeholders whose functions are actually intended to manage and mitigate risk, whether that be a mortgage insurer or a title insurer, an appraiser, or a lender. So they set the rules of the business for the entire market, including the underwriting box, and as I said, the pricing and so forth.

So this tremendous concentration of being responsible for the decisioning, the decisions and the practices governing credit risk in our mortgage market is, to me, building systemic risk.

Chairman HENSARLING. Thank you. Mr. Pinto, you say something similar in your testimony where you speak of we are in the midst—quote, “We are in the midst of another potentially dangerous buildup of housing risk.” You have, I guess, a proprietary system mortgage-risk index. You say it is on the rise again. How is this comparable to the buildup of risk that you saw before the 2007–2008 real estate bust?

Mr. PINTO. Thank you, Mr. Chairman. We are seeing risk increasing. We risk rate every loan that the agencies guarantee each and every month. We have been tracking this for 5 years. It is a little difficult, and we haven’t completed our research to compare it completely back to what it was last time, particularly for FHA, which is a big part of the risk. What we focus on is how the risk is going up generally, and then how that ties into house price increase. And the research that I presented today shows very clearly that the higher the risk in a census tract, and the percentage of loans that are high risk in a census tract, the faster the house prices go up. And this is because these policies that the Federal Government has, have done nothing to add any supply. It only promotes demand, and demand in a pernicious way.

You can afford to buy a more expensive house, even though it is the same house that sold for 10 percent less a year ago, and that is what we are seeing; house prices going up year after year, for the same houses in entry-level markets, and the government is providing the leverage that allows that to be purchased.

Chairman HENSARLING. You also said in your testimony almost half of the GSE’s 2017 volume wasn’t even related to buying a primary residence, another 41 percent went to help well-to-do buyers. And only 3.7 percent of GSE dollars went to repeat buyers of more modest homes. So can you elaborate again how the GSEs are making entry-level homes less affordable?

Mr. PINTO. So again, a very little amount of the GSEs’ business goes to entry-level, but because the GSEs are so huge, they are 50 percent of all the mortgages, so even if, say, 10 percent of their business is going to entry-level but at very risky terms, then that is cascading through these markets along with FHA loans in these low entry-level price points, and that is what is driving up the price. What we find is that today, the GSEs, particularly Fannie Mae, are increasing their risk most rapidly in the entry-level, and that is because they are in competition with FHA.

Chairman HENSARLING. Thank you, Mr. Pinto. My time has expired. I now recognize the Ranking Member for 5 minutes.



Ms. WATERS. Thank you very much. Before I get to a question about this discussion about systemic risk, I would like to ask Mr. DeMarco what good has happened since conservatorship, and how has it been managed and what good can you say about it?

Mr. DEMARCO. I can say a number of good things, as I went through in my prepared statement. First of all, conservatorship actually did ensure stability of our secondary mortgage market during the financial crisis.

Second, while we had challenges in getting this right, trying different things and seeing what worked and didn't, the conservatorships did a lot to help prevent foreclosures and to help people stay in their homes. A lot of effort was poured into efforts to bring stability to existing homeowners.

Third, we have built a number of foundational, or we are in the process, the FHFA continues to build foundational cornerstones for reform, including credit risk transfer work that has been done, the common securitization platform, loan level data disclosures that have begun, and so on.

Ms. WATERS. Very good. Now what evidence do you have of this systemic risk that you are trying to describe to us today that you blame the conservatorship for?

Mr. DEMARCO. So in conservatorship, these companies continue to operate with the tremendous advantages that they had before conservatorship now with the added benefit of the government backing. These companies are the ones that are responsible for determining everything about credit—

Ms. WATERS. I understand that. If I may interrupt you, I understand what you have described. What is the evidence? Where do we see the risk? Where does it actually manifest? Where is it demonstrated?

Mr. DEMARCO. Well, I think a couple of my fellow panelists have provided a good bit of data on that point, but I would point to a few things: The decisions to relax underwriting standards in certain places is in the province just of Fannie and Freddie; so, for example, they get to determine who gets an appraisal waiver when they buy a home.

In terms of rules that this Congress or the Congress established through Dodd-Frank on a qualified mortgage really trying to get the Consumer Financial Protection Bureau to set standards of what constituted a qualified mortgage, we have written in this huge loophole for Fannie and Freddie that says, Well, while this rule, this QM rule, is really important, it doesn't apply for Fannie and Freddie.

Ms. WATERS. OK. I appreciate that, and if the rule does not apply on qualified mortgages, then you are saying great risk is being created. You think it can be, but you have no demonstration that it has created risk.

I am going to move on to Ms. Bailey. What do we need to expand housing opportunities for the average citizen and for low income?

Ms. BAILEY. Yes, thank you so much. Fannie and Freddie, along with FHA actually did what they were designed to do. They actually sustained the market when private credit withdrew. Risky private credit led us to the crisis and that is evidenced in the Finan-

cial Crisis Inquiry Commission on pages 26 and 27. So they did exactly what they were intended to do.

FHA actually increased lending at that time when Fannie and Freddie were in trouble and actually has now returned to more stable base levels. So Mr. DeMarco, while I appreciate the wonderful perspective he is offering today, he instituted policies in his tenureship of loan-level price adjustments when he was the director of the Federal House and Finance Agency. That agency's decision actually made it more expensive for people of color and lower wealth families to afford loans guaranteed by the GSEs.

So I would like to get a better understanding about that decision and knowing how that was going to have the outcome that we are talking about today where we are saying that the GSEs aren't serving the broader-based market. That decision happened during then.

Today we need to make access and affordability central in this debate, and we need to get at pricing segmentation. The whole system today is moving toward segmenting borrowers by credit buckets, and by doing that, we are getting rid of something that sustained the system for a long time, which is average pricing, which allows us to make sure we have affordable mortgages across the Nation.

Ms. WATERS. What would you advise us to do to ensure that we could include more low-income and more minorities in these housing opportunities?

Ms. BAILEY. Continue the system back toward pooling of loan risk, because when you segment by the credit buckets, pricing actually determines who can actually afford a mortgage, and that is where most of the proposals are off track.

Ms. WATERS. Thank you very much, and I yield back.

Chairman HENSARLING. The gentlelady yields back. The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, Chairman of our Housing and Insurance Subcommittee, 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman. Ms. Bailey, I just want to clarify, I think, something that you said in your opening statement. Are you saying that we should get rid of risk-based pricing in the mortgage market?

Ms. BAILEY. No, sir. I am saying we should get rid of excessive risk-based pricing.

Mr. DUFFY. What does that mean?

Ms. BAILEY. The mortgage market already has risk-based pricing built in, but what we have done now is to say we are going to go in and put the burden of risk on borrowers that the Financial Crisis Inquiry Commission said did not actually cause the crisis, lower wealth families. So what we are saying to those families who also have a history of racial discrimination that resulted in them having lower credit scores and smaller downpayments, that they actually have to pay more now in this current system when they were not responsible for the housing crash.

So what I am saying is, continue to do what the system does well. For many, many years, the system has provided broad liquidity in every community across the Nation. Both GSEs, Fannie Mae and Freddie Mac, have made sure that we could expand credit across the Nation, so continue to do what they actually do really well, and don't get rid of such a foundational aspect of the system

so that we can bring in the very borrowers that the future system depends. Seven out of 10 future borrowers are going to be people of color, so we talk about affordability, but we have to think about it in—

Mr. DUFFY. I want to be clear here. So as long as our system is blind to race and religion and sex or sexual preference, blind to those things, you are OK with us looking at someone's risk profile in regard to pricing of a mortgage?

Ms. BAILEY. I appreciate you thinking that the system is blind to race and sexual orientation, but it is not, sir. The housing finance system is really rooted in the history and the legacy of intentional—

Mr. DUFFY. So I guess I am saying—I should say are we going to base prices then on race and sex and sexual preference?

Ms. BAILEY. Say that again, sir.

Mr. DUFFY. Are we going to base our prices on race or sex or sexual preference or religion, is that what we should do?

Ms. BAILEY. Part of what we are doing is we are saying that we know that the impact of these practices impact people of color, women, and lower wealth families differently, and we are still orchestrating policies toward those—

Mr. DUFFY. I am going to reclaim my time.

Mr. DeMarco, what happens in a system where we don't base pricing on risk. Obviously we all want to make sure that the system is blind to race and sex and religion, and based on credit, but that is the way the market should work, right?

Mr. DEMARCO. Right. Certainly when one is talking about insurance, if you don't price based upon risk you get more risk.

Mr. DUFFY. Mr. Pinto?

Mr. PINTO. I agree. If you don't price on risk, you get more risk. FHA is a perfect example of that. It does not price on risk, and it gets a tremendous amount of risk, and it is at the foundation along with the GSEs of this house price boom.

Mr. DUFFY. And when you have more risk, that can lead to crises which help the poorest among us, fair enough?

Mr. PINTO. Fair enough.

Mr. DUFFY. OK. Mr. DeMarco, you talked about what might not appear to be obvious to the average eye, but the bills that you have looked at that have come out from both sides, there are a lot of common themes. I don't have a whole lot of time, but I want to touch on a few common themes that you see everyone in the Congress talking about where we can wrap our hands around a pathway forward that everyone could buy into.

Mr. DEMARCO. Right. I will do, too, to be brief. The first is that Fannie Mae and Freddie Mac do not continue forward as government-sponsored enterprises. That doesn't mean that they get liquidated. It means that their specialness and their privileges and protections go away, and whatever they are transformed into, they have to compete in the marketplace on the same footing as everyone else. So we can keep the functions that they have been providing the market, but make those functions available to be provided by others.

The second thing is that they are now, with the Chairman's announcement today, there certainly seems to be broad consensus

about establishing a single, mortgage-backed security that has a catastrophic guarantee from the taxpayer, but is backed by a substantial private capital in a first loss position, and that is true from the Chairman's proposal to Ms. Waters' proposal and all the others.

Mr. DUFFY. I think one of the great debates we will have to have is where does that catastrophic guarantee kick in. We don't want it too low where the market would assess that. Obviously if it is too low, and the Congress is going to step in and say the market before the legislation would kick in, fair enough?

Mr. DEMARCO. That is correct.

Mr. DUFFY. OK. I just want to quickly ask the panel about any concerns about FHFA and transparency today. Mr. Pinto, any concern there?

Mr. PINTO. Which?

Mr. DUFFY. Transparency, encourage more transparency in the markets today.

Mr. PINTO. I think there should be more information released about the mortgages that are being made. There should be complete transparency, and it should come from all the agencies, and it should go back in time in terms of those loans, so those can be looked at and researched.

Mr. DUFFY. Mr. DeMarco?

Mr. DEMARCO. Yes, one of the things that could be done is to further make available to the public the loan level details of the loan portfolios of Fannie and Freddie.

Mr. DUFFY. Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired. The Chair will recognize the gentleman from Missouri, Mr. Cleaver, Ranking Member of our Housing and Insurance Subcommittee.

Mr. CLEAVER. Thank you, Mr. Chairman. Thank you Mr. DeMarco, for sitting down with me some time back and discussing some of these issues. Mr. Duffy and I have had a number of conversations, and he just talked about one of the things that I lift up as someone that must be involved in any kind of reform of the GSEs from my standpoint, and they are, as I have said before, a 30-year fixed-mortgage rate as well as the explicit government backstop. I would like for the entire panel to tell me something that you believe to be inextricable to a reform package of the GSEs, other than the two that I have just laid out. Anyone?

Ms. BAILEY. I would say the system's current affordability provisions, its Duty to Serve, the ability to provide by broad liquidity in every credit market across the Nation, and the housing goals that are really important to ensuring that we have an inclusive and broadly serving mortgage market, so those would be additional ones, along with ensuring that smaller lenders remain on equal footing with their larger bank competitors.

Mr. CLEAVER. But what specifically can we do to increase affordable financing or financing of affordable housing? What can we build into the infrastructure of a reform package for the GSEs that would assure increased funding for affordable housing, which is one of the biggest needs in the country right now?

Ms. BAILEY. Yes, sir. I totally agree with you, and I would say that the move toward excessive risk-based pricing is really making it really challenging. So underwriting standards help determine

who should qualify for a mortgage. Pricing actually determines who can actually afford to pay, and when we move toward these excessive standards, we make it too expensive for working families to afford these mortgages. So what we often see is that FHA is now overconcentrated with a segment of borrowers—upper-income people of color, Latinos, and African Americans—that the conventional market should be serving, but because of the historic discrimination and lower downpayments and lower credit scoring, that is the result of the historic discrimination they are not able to get conventional markets from the conventional space.

Mr. CLEAVER. Mr. DeMarco?

Mr. DEMARCO. Mr. Cleaver, to your first question, the thing I would add that is fundamental to reform is providing real clarity about what is the role of the government in our housing finance system and where and how is that role manifested. And then what is—on the other side of that coin, what is the role we expect of the private market, and is that private market allowed to actually operate as a market and given the tools and the guard rails necessary. So that clarity would help a lot.

Mr. CLEAVER. Thank you. I thank both of you for that. Where in receivership, what is missing, what is going awry? And let's just assume we do nothing. What would be the consequences of us doing nothing right now, leaving GSEs in a conservatorship?

Mr. DEMARCO. All of the credit risk that is being run through those companies is being supported by the American taxpayer.

Ms. BAILEY. I think it is important to also add, though, that they are offloading some of that risk with the credit risk transfers, so they are—and I think all of our testimonies acknowledge that—that they are actually offloading some of that risk to the private market. The question is, are they offloaded in a way that gets rid of that segmentation of pricing that we talked about earlier. We see that some of that is happening on the front end, and it is safer when it happens on the back end. So we just need to move the system more toward that back-ending when we are doing credit risk transfers. But they are offloading some of the risk on the private market.

The key is to make sure private capital comes in a safe and responsible way. The only time when private capital dominated the market, we ended up in a national housing crisis. So we want to just be careful with private capital. I think we all agree that it needs to come back in, but we have to do it in a way that is really safe for borrowers, as well.

Dr. SWAGEL. I would just add quickly, we are going to miss out on innovation if we stay with the current system, and we won't know what we are missing out. We know that too many people still can't get mortgages, and that is because the dominant government role has pushed away private innovation, and that is what we will miss with the current system.

Mr. CLEAVER. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, Chairman of our Capital Markets Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman, and I have about a half an hour's worth of questions. We are going to try and do this

real quickly, and one of the things I want to start with, and I would like to move right down the panel, and if you could quickly answer these two things. What do you think the proper loan-to-value would be for the GSEs to be involved in and engaged? And also, what is the proper debt-to-income ratio for borrowers? What should that be? So Mr. DeMarco, and I will just move right down.

Mr. DEMARCO. Mr. Huizenga, those are challenging questions because households don't—

Mr. HUIZENGA. That is why I am asking the experts.

Mr. DEMARCO. But I think it is risky to give a single answer to a question like that, because if I told you that the proper debt-to-income ratio was 38 percent, how does that work for a retiree who has retained a lot of assets but doesn't have income and wants to buy a retirement home? So that is an example of why a single answer is challenging here.

Dr. SWAGEL. Obviously—

Mr. HUIZENGA. I am sorry, but how about for the GSEs to be involved, though? I understand that debt-to-income ratio maybe for individuals, but what should that loan to value be for a GSE's involvement?

Mr. DEMARCO. Well, when I was the acting director, we had it at 95 percent was the maximum. It is currently 97.

Mr. HUIZENGA. Mr. Swagel?

Dr. SWAGEL. I will just add, obviously I agree with Ed. If we are going to have the government behind these risky loans, let's acknowledge it and make that explicit and not bury it within the details of the GSE pricing system. If we take on risk, let's account for it.

Mr. HUIZENGA. So no percentage.

Dr. SWAGEL. I apologize. I also, again, like Ed, I don't have a particular number because the circumstances of borrowers will just vary so widely.

Mr. HUIZENGA. But again, if we are looking at risk in the GSEs, what should that level of risk be?

Dr. SWAGEL. I would agree with Ed. I wouldn't want the sorts of 3-1/2 percent loans that the GSEs have been instructed to push. That, to me, seems—

Mr. HUIZENGA. Would returning to the 95 percent that Mr. DeMarco had just referenced, would that be acceptable, better?

Dr. SWAGEL. Five-percent downpayment, it just seems a very modest amount. We know housing prices can go down as well as up. I think that puts borrowers at risk.

Mr. HUIZENGA. OK. Ms. Bailey?

Ms. BAILEY. I would agree with Mr. DeMarco. I think those are decisions that need to be left with the regulator that Congress empowered to actually regulate the GSEs. We now have in place a very strong and powerful regulator that we didn't have before. The problem that we had leading up to the crisis before is that they did not have a powerful regulator. Congress has acted through hearings to actually create that, so those underwriting decisions should remain at the later level.

And I know there is some concern about moving forward the 3 percent downpayment, but I have to explain to you, the Center for Community Capital at the UNC school did research on borrowers

with smaller downpayments. And those borrowers, when they get a safe mortgage, they actually perform well. There was a study of borrowers all across the Nation, and they actually were able to amass \$38,000 in home equity even during the housing crisis. We now have the safe mortgage practices because of the strong regulation, and we now have the effective regulator.

Mr. HUIZENGA. So just make sure that you understand, I, as a former licensed realtor, I sat at those closing tables and understood, when my parents bought a home and the amount they had a downpayment was very different than when I did, and it was very different when I sat at my first closing and they slid a check across to both the seller and then the buyer. I am assuming you would agree that having zero percent down is a bad idea?

Ms. BAILEY. I am saying those decisions are best left at the regulator.

Mr. HUIZENGA. So you would say that a zero percent down would be acceptable?

Ms. BAILEY. I am saying that those decisions are underwriting and should be with the regulator.

Mr. HUIZENGA. OK. We will move on. Mr. Pinto?

Mr. PINTO. So I think we have just seen what happens when you leave it to the regulator. First of all, the Bureau said 41 percent was the proper DTI. You have pushback from the industry, went to 43. Put a rule out at 43. Got pushback from the industry, put in the patch, and then FHFA pushed Fannie and Freddie to go to 50. Regulators are not going to protect us from this.

What the issue really becomes is we had a system where we had a debt-to-income limit, generally across the country back in the early 1990's. It was 38 percent. You had compensating factors above that. I presented a chart that shows once Fannie and Freddie started moving away from that, those numbers just went to the stratosphere. They came back down. And then after the patch was put in place they have gone through the stratosphere again. You have to have some limitations that act as friction in the sellers' markets.

Mr. HUIZENGA. OK. And in the 10 remaining seconds, I wanted to talk about multifamily loans; and real quickly, can these multifamily markets function without the presence of GSEs?

Mr. PINTO. Yes.

Mr. HUIZENGA. Anybody else?

Mr. PINTO. Yes.

Mr. HUIZENGA. Ms. Bailey? Quick answer, please.

Saved by the bell.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, Ranking Member of our Capital Markets Subcommittee.

Mrs. MALONEY. Thank you, Mr. Chairman.

And thank you to all the panelists. I am a strong proponent for affordable housing. And in cities, especially large cities like New York, that I am privileged to represent, affordable housing is the absolute number one public policy goal. So I strongly believe that any reform of GSEs should not in any way diminish resources for affordable housing and should usually, or hopefully, increase resources.

So my question to Ms. Bailey and Mr. DeMarco, as we look at GSE reform, what is the most important thing that we can do to protect and even expand support for affordable housing?

Ms. Bailey?

Ms. BAILEY. Thank you. We should definitely ensure that we move the system back toward average pricing. Again, pooling of loan risks—and I know I keep harping on this point—but pooling of risk and averaging the risk actually makes it more affordable. And we have to keep those broad-based Duty to Serves. Those goals were put into the charters when the GSEs were created, and they were also carried forward in the Housing and Economic Recovery Act of 2008.

Everyone else in all the proposals that come forward, they want to give us aspirations. They don't have any strong enforcement mechanisms behind them. Without the strong enforcement mechanisms behind them for affordable housing, we won't see that produced. So, right now and in our current system, we have strong goals with clear mechanisms for enforcement. Give us a stronger enforcement; we will see a move toward that end. And get rid of this risk-based pricing.

Mrs. MALONEY. Thank you. Thank you.

Mr. DeMarco and Ms. Bailey, we are—some people on the committee are advocating using the Ginnie Mae as a model for GSE reform and essentially transferring all of the—Fannie and Freddie's responsibilities to Ginnie Mae. But this is a tiny agency, and it has less than 200 employees now, and I would say it has a very, very different business model than the—and it doesn't even focus on credit risk at all now because Ginnie Mae only securitizes loans that have already been guaranteed by the Federal Housing Administration or the Veterans Administration.

So I am really questioning and rather skeptical that Ginnie Mae is equipped to handle this type of responsibility or that the Ginnie Mae model would work for a deeper, larger mortgage market. So, in your view, Mr. DeMarco and Ms. Bailey, is this a good idea, or would using Ginnie Mae model for GSE reform raise borrowing costs for middle-class Americans looking to buy a home?

Mr. DEMARCO. So, Mrs. Maloney, as I will find out this afternoon some of the details of the Chairman's and Mr. Delaney's Ginnie Mae proposal, but I don't think it is correct to say that Ginnie Mae is going to be taking over all of the functions and responsibilities that Fannie Mae and Freddie Mac have. As I understand these proposals, having coauthored one along these lines, Ginnie Mae actually retains a more limited functionality here, which is to be the issuer of government-wrapped, mortgage-backed securities in global financial markets so that the investors globally understand the backing of the American taxpayer on these mortgage-backed securities, but they are not undertaking all these other activities. And, in fact, Fannie Mae and Freddie Mac would be transformed, and a lot of this would take place in the private sector.

As to whether this is untested, Ginnie Mae is a \$2 trillion securities operation today, and it is doing quite well.

Mrs. MALONEY. But it doesn't have the risk model. And my main question is, would it raise borrowing costs for middle-class Americans, Ms. Bailey, in your view?



Ms. BAILEY. It would. And it would also put smaller lenders on unequal footing with their larger bank competitors. Ginnie is really complex and has a lot of complexity around it that would make it difficult for smaller lenders to manage. So we would also have to take that into consideration. So I agree with your statement.

Mr. DEMARCO. I am sorry. I take some exception to that.

Mrs. MALONEY. I have one more question, and it is for you. And it is one my favorite topics.

Mr. DEMARCO. Let's have it.

Mrs. MALONEY. Multifamily housing. If the Chairman wants to give you more time after that, but I really—multifamily housing is very important to my district. Everybody lives vertically, not horizontally. And in the crisis, I think it is fair to say that multifamily housing performed relatively well. In fact, it subsidized the single-family businesses.

So my question to Mr. DeMarco is, do you think that Fannie and Freddie's multifamily businesses are currently sharing enough risk with the private sector to adequately protect taxpayers? As I understand, the first tranche is guaranteed by—

Chairman HENSARLING. The time of the gentlelady has expired. A brief answer—

Mrs. MALONEY. It is so tough, but this is such a good question.

Chairman HENSARLING. A brief answer from the witness, please.

Mr. DEMARCO. I think that the model that Fannie and Freddie each use in their different models to risk-share capital, a risk-share credit risk in multifamily is worth considering in what we are looking at with single family; it shows it can be done.

Mrs. MALONEY. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, Chairman of our Financial Institutions Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

And, Mr. DeMarco, just to follow up on that question by Mrs. Maloney, I know Mr. Huizenga asked the same question basically with multifamily housing. You made the statement in your testimony that we need to fix what is broken, preserve what works. And it seems the multifamily portfolio has done very well. And I think, as both of my colleagues indicated, is there a way to look at that as perhaps a model, or take from that the way to perhaps structure something for the single-family situation, or what is your—

Mr. DEMARCO. The basic lesson that I would suggest from the way the multifamily businesses operate at Fannie Mae and Freddie Mac is that in fact there is a meaningful amount of risk sharing that goes on in those systems. Until the conservatorships, there was virtually none in the single-family space. So effectively what has been going on with single family, we have been trying to start developing that kind of risk sharing, but it does take place in the multifamily space.

What is—what cannot be removed, however, is, as long as Fannie and Freddie are operating as government-sponsored enterprises, they are competing in this commercial market financing a multifamily dwelling; they are competing with all the advantages that

you get when you are a GSE. In this case, with—they are in conservatorship; an advantage is the backing of the American—

Mr. LUETKEMEYER. When you say “competing,” competing against the private market, right?

Mr. DEMARCO. Yes.

Mr. LUETKEMEYER. Thank you very much.

I know that yesterday we had a—under the leadership of Chairman Duffy, we had a hearing that focused on the cost of regulations with regards to the ability of consumers to be able to afford housing because we found yesterday that 32 percent of the cost to the consumers is actually Federal, State, and local rules and regulations.

We had a hearing or had a roundtable with myself and my colleagues, Mr. Budd from North Carolina and Mr. Huizenga, here on Tuesday afternoon with some regulators, all the regulators involved, as well as some banks and some other interested parties with regards to some of the CECL (current expected credit loss) rules that are coming out. Does anybody know or you have heard of CECL before and know what this is about? It is basically where the banks have to—when they make a loan, immediately upfront reserve more in their loan loss reserve for a potential loss.

And so I was wondering: This is going to be a very, very costly situation for them. They are going to have to segregate capital. It is going to be—and eventually it is going to be a cost that is passed on to the consumer. If you have heard of this and are aware of this, would you give me an opinion on whether this is going to be helpful, hurtful, to the consumers being able to afford housing, and then what effect it is going to have on FHA and Ginnie—or Freddie and Fannie, excuse me?

Mr. DEMARCO. I can't answer all of those points, but I can address a couple of them. Certainly, long duration assets like a 30-mortgage, the CECL accounting creates new challenges for portfolio lenders that they didn't have before. And so that is going to have an effect on those businesses. The question is, if you create a reserve upfront, should we be simultaneously reexamining the consideration of those reserves under capital rules?

So, if you are going to fundamentally change the accounting for reserves so that we consider reserves to be something other than what they traditionally have been, then we have to ask: Well, look, our bank capital requirements have been written in a way under an old reserving regime, we now have to reconsider those capital rules, given that we changed the nature and the requirements around reserves.

To your other point about this, if this does have an impact that makes it more costly for a bank to portfolio a mortgage loan, then it creates yet another regulatory incentive for those loans to perhaps be sold off into the secondary market to Fannie and Freddie rather than being held by the bank because the costs of carrying that loan have gone up in a relative basis.

Mr. LUETKEMEYER. We were discussing a while ago the difference between 5 percent down and 3 percent down. So we are not talking about a whole lot of money there. So, again, when you are looking at costs—32 percent of the costs of making a loan is regulation—suddenly that is a pretty significant figure. So, if that is sig-

nificant enough, we were discussing a minute ago between people getting a loan where they have 5 percent down or 3 percent down, to me this would be a barrier, would it not, those increased costs?

Mr. DEMARCO. Yes. In fact—and you are quite right. I point out in my written statement that these kinds of barriers are in fact inhibiting bringing affordable housing supply onto the market, both in terms of rental and in terms of single family. And I actually cite in an Obama Administration report pointing to some of these, especially at the State and local level, barriers and some ideas about how to mitigate some of them.

Mr. LUETKEMEYER. Thank you. My time is up. I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes another gentleman from Missouri, Mr. Clay, Ranking Member of Financial Institutions Subcommittee.

Mr. CLAY. Thank you, Mr. Chairman.

And thank the witnesses for being here. Before I get into my questions, I wanted to note that my friend and colleague Representative Duffy brought up the issue of race in consideration of risk. And it is not—it is not the risk that is involved; it is really the institutional racism that exists.

We know during the housing crisis that borrowers of color were steered into high-priced loans, and communities of color now are targeted by predators. What communities of color are looking for is fairness in the housing market, in lending, and not being charged what I call a black tax for being black, being charged more for a mortgage product. So it is not about risk; it is about the institutional racism that exists.

Just so the panel understands, and my friend from Wisconsin understands that we are asking for equal protection under the law so that we can also realize the American Dream and not the American nightmare. And I will—I intend to have that conversation with Mr. Duffy and explain it to him on what actually happens.

But this—my first question is for Mr. Pinto. Mr. Pinto, saving up for a downpayment is one of the biggest barriers to homeownership. That is why responsibly underwritten, low-downpayment mortgage products backed by Fannie Mae and Freddie Mac, the Department of Veterans Affairs, and the Federal Housing Administration serve an important role in expanding access to homeownership. In fact, the Department of Veterans Affairs has been backing zero downpayment mortgages for years with a very successful track record. You have been very critical of low-downpayment loans. Do you contend that low-downpayment loans cannot be responsibly underwritten, or do you contend that veterans should not have access to zero downpayment mortgages?

Mr. PINTO. So what I think—thank you for that question. What I contend is that credit easing, minimal downpayments, high-debt ratios, et cetera, in a seller's market with a 30-year loan ends up getting capitalized into higher prices, and that doesn't help anyone, and it particularly doesn't help low-income buyers. I presented data from 9 million loans that show that. What I have proposed—

I think I have mentioned this at this committee before is a zero downpayment loan, 100 percent LTV, with a 20-year loan term. The problem with all the subsidies that you are talking about is

they get ladled on top of the 30-year loan, and they get capitalized into higher prices.

Mr. CLAY. Got it.

Mr. PINTO. The solution is to go back to a 20-year loan and use that subsidy to increase the buying power to allow the 20-year loan, which amortizes much faster, to be gotten by this lower-income buyer. I call it LIFT Home: Low-income first-time homebuyer tax credit.

Mr. CLAY. OK. What about those who are recent graduates of college who are heavily indebted with student loans? How do we address them when you and I know that their credit scores are lower because of the student loan debt? How do we address that?

Mr. PINTO. I think Congress has to look at the student loan program, which has exploded in the last 5 or 6 years to—I have lost track—\$1.4 trillion, and fix that. Having said that, the research I have seen shows that the student loan debt—and this is going to sound counterintuitive—is not that much of an impediment, mostly because most of the buyers are in deferral or on income-based programs. Therefore, it is not creating the debt-to-income ratio problem that is commonly thought.

Mr. CLAY. How about another solution that will allow the mortgage companies to buy the student loan and roll it into the 30-year mortgage? What about that?

Mr. PINTO. Taking something that was supposed to be something paid back hopefully over 5 or 10 years and turning it into a 30-year debt doesn't make any sense to me.

Mr. CLAY. All right. I give.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr, the Chairman of our Monetary Policy and Trade Subcommittee.

Mr. BARR. Thank you, Mr. Chairman, and thank you for having this hearing on this—as you refer to it—the not-so-happy anniversary of American history involving the day that the Federal Government took over Fannie Mae and Freddie Mac. And while the GSEs admittedly provide liquidity to the housing finance system, let's face it, Fannie Mae and Freddie Mac were more than mere bystanders in the 2008 financial crisis. They were in fact at the epicenter of that crisis because they were thinly capitalized. They bought risky loans with very low downpayments. And with all respect, contrary to Ms. Bailey's revisionist narrative, the absence of risk-based pricing in loans purchased by GSEs was precisely the problem.

And the fact that GSEs fueled origination of mispriced loans that put people in homes with mortgages they couldn't afford was exactly the problem. That was what caused the financial crisis. I just think that if we ignore that basic fact, we are willfully disregarding history, and we are bound to repeat history, as Mr. Pinto was warning us here today.

I do want to compliment Mr. Delaney and our Chairman for working in a bipartisan manner. I have a lot more studying to do and looking at the proposal before us that they have worked on. I want to learn more about it. But it does seem to me that putting layers of diversified private capital in a first loss position will help

ensure more accurate pricing of risk and reduce the number of bad loans. It seems to me that that is exactly the direction we want to go in to have better pricing of risk.

Let me move to a question, and let me ask Mr. DeMarco. The QM rule that we have worked so hard—the CFPB worked on recent statutory changes where we injected a new portfolio safe harbor for the QM rule. Explain to us a little bit more your belief why we should apply a comparable QM rule to the GSEs. And I do note that the bipartisan proposal would do that.

Mr. DEMARCO. So the qualified mortgage rule was considered by many involved in developing that legislation to be a key aspect of Dodd-Frank. It statutorily ruled out certain loans or loan characteristics that were thought to be fundamental in the financial crisis. It allowed the BCFP (Bureau of Consumer Financial Protection) to then write additional rules governing what constituted a qualified mortgage, and so that rule was written, and so it applies to all mortgage lenders. It says: All right, here is the set of standards for what constitutes a qualified mortgage.

But then it said: But if the mortgage is acceptable to or financed by Fannie Mae and Freddie Mac, then that is OK. So we really created two different standards, a qualified mortgage rule, unless you have been financed through a government-sponsored enterprise.

Well, people are—the industry, borrowers, advocates, everybody seems really happy with this QM patch. Well, we can't have it both ways. Either the QM patch is the right way of articulating what constitutes a qualified mortgage, in which case we are restricting access to credit through the BCFP rule, or the BCFP rule is right, and for some reason, we are creating this huge loophole.

Mr. BARR. Mr. DeMarco, to Ms. Bailey's concern that there would be excessive pricing of risk, wouldn't the portfolio lending model provide an escape valve that would be safer than the originate-to-distribute model so that if we build upon our work in the regulatory relief package that is now law and allow for—if there is—if there is a mortgage that is out there that is outside of the QM rule, but a lender with full view of the borrower's ability to repay were willing to take that risk, retain that risk in portfolio, is that a way to address Ms. Bailey's concern that we want to provide access to affordable housing but do so in a safe and sound way?

Mr. DEMARCO. Yes, sir.

Mr. BARR. Mr. Pinto, in my remaining time, let me just ask you about credit risk transfers really quickly. Some banks are concerned that, while we like to see the credit risk transfer increasing, some banks have stressed that bank capital rules may impede credit risk transfers. Are you concerned about that?

Mr. PINTO. I am concerned that there should be a level playing field. I am also concerned that these credit risk transfers need to be upfront, transparent, and put on in place at origination. They should not be done in the murky black box that they are being done today by the GSEs.

Mr. BARR. I yield back. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch.

Mr. LYNCH. Thank you, Mr. Chairman.

I also want to thank all the panelists for your participation today. It has been very helpful. Ms. Bailey, I grew up in the south Boston housing projects, the Old Colony Housing Projects, with a lot of other families that were struggling at the time. My dad had a—so he used to say at times, we had to save up to be poor. And he was only half joking. So we had the blessings of a home in public housing.

The housing was built probably in the 1940's right after the Second World War. And now we are trying to rebuild it. We are about halfway done rebuilding some of those units. But my problem now in my district, which is a big part of Boston and Brockton and Quincy and a bunch of towns on the south shore, is that not only do I have a problem finding housing for people who are struggling, like my family was, but I am struggling to find affordable housing for firefighters, teachers, nurses, construction workers, and so there is a gap there. Now I need workforce housing. They are getting priced out. It is just insane.

I know that Chairman Hensarling sent a letter to Mel Watt back in February criticizing him for making Fannie Mae and Freddie Mac continue to contribute to the affordable housing trust fund and the Magnet Fund. What is the status right now of our public housing, and is there anything in the formula that might help my nurses, my teachers, my teamsters, and construction workers, firefighters, police?

Ms. BAILEY. Thank you for the question. Yes. Those funds need to be fully funded. And I thank you for sharing the background that you are sharing. The very pricing segmentation that I talked about earlier is hurting working people across the country. So absolutely those things should be fully funded. And I need to just, for one moment, just respond a little bit to the response about Fannie and Freddie and the revisionist history.

Most of the mortgages that Fannie got in trouble for were all A mortgage loans. They were actually financing and chasing the mortgages for upper-income borrowers; these were not working families like the ones that you were just talking about. So it is really important for us to really highlight that they were no-doc loans to A borrowers. And 10 percent of those were GSE loans. So it wasn't the subprime loans that had been raised.

Mr. LYNCH. Right.

Ms. BAILEY. And it is also really important for me to make sure that we are talking about, for the risk-based pricing, we are talking about catastrophic risk, and we need to get specifically at the GSE cost, the GSE's price for 75 percent of that, so when I am making that point that is exactly what I am going for. The housing trust fund and the Capital Magnet Fund need to be fully funded because we know increasingly more and more Americans are paying more than 50 percent of their income to cover their housing costs. The Harvard Joint Center report that just came out made that fact really clear, and clarified that working families just don't have—wages haven't kept up; they have real wage stagnation. They just don't have the resources to cover the increasing costs around housing.

So pricing segmentation really hurts them and stifles their ability to get even quality rental opportunity as well.

Mr. LYNCH. Thank you. I know that in other areas, in health insurance and in auto insurance, we spread the risk. We don't put all the risk on the sickest people and make them pay the greatest amount. We try to figure out—that is the nature of insurance; you spread the risk out so that we all absorb it, and if you are lucky enough to be healthy, you pay a little bit more, but if you do get sick, then you have some relief there. It just—and I realize that there is a blending that needs to happen here—I think Mr. DeMarco has touched upon it—where if we can shift in a balanced—if we can rebalance the risk, I guess, between the GSEs and the private market, find a way to do that because we have to shift that over, but do it in a way that maintains our ability to offer a 30-year fixed mortgage at a reasonable interest rate, that is hugely important to average Americans who are trying to get out there and buy their first home.

So, Mr. Chairman, I want to thank the witnesses again for your participation, and I yield back the balance of my time.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman, for calling this important hearing.

Thank you each of you for coming in and offering your expertise today. There are numerous options that we will consider to restructure the GSEs to—with the goal of returning them to financial health. With this, they range from simply taking them out of conservatorship to converting them to private corporations or creating a new government agency.

In your opinion, Mr. DeMarco and Mr. Pinto, which of these options would provide the most future stability for both the markets and the consumer?

Mr. DEMARCO. In my view, creating private companies backed by private capital in a competitive market has the best long-term outcome, both in terms of the stability of the market as well as innovation and provision of credit to the families.

Mr. PITTENGER. Yes, sir, Mr. Pinto, and try to—

Mr. PINTO. I would agree with that. I would just add, without a government guarantee on those companies, and I would also add that we need to have an administrative solution because, even if you put in place the proposal that the Chairman and Mr. Delaney have put forth, it would take many, many years for that to actually come to fruition. We are in a problem today where we have house price boom 2.0. What I am concerned about are the low-income buyers and the minority buyers who are in neighborhoods that have prices that are at unsustainable levels, and they are going to get hurt when that reversion to the traditional trend occurs, and it is going to be in all of your districts. And that is what I am concerned about. There is nothing in a legislative solution that is going to address that. It can only be addressed with administrative solutions—pit.

Mr. PITTENGER. Well, let me ask you this. If they are released from conservatorship, how would they be recapitalized?

Mr. PINTO. I don't believe they should be released from conservatorship. I think they should be wound down.

Mr. PITTENGER. Yes, sir. Mr. DeMarco.

Mr. DEMARCO. Yes, Congressman, I believe Congress needs to decide what the final disposition of them is, but I would not return them as GSEs.

Mr. PITTENGER. Ms. Bailey and Mr. Swagel, Dr. Swagel, concern with the GSE reorganization comes from small community banks. Small lenders fear the development of additional guarantors controlled by megabanks, which could result in volume discounts. These discounts would leave the smaller banks at a distinct disadvantage. What are your plans to ensure that small community lending groups will be able to compete?

Ms. BAILEY. Right now, as the system works, small lenders have access to the cash window on equal footing with their large bank competitors. A lot of the proposals that we have discussed could really impact the level of equal access for small lenders. So I agree with you that small lenders need to be able to operate in their own unique way without having to do pricing purchases through their large bank competitors. That puts them at an unfair advantage because they just can't get the volume discounts that the larger lenders are able to get. So I agree with that point.

Mr. PITTENGER. Dr. Swagel.

Dr. SWAGEL. I will just add. One of the worst aspects of the old system was the disadvantage of small lenders. And Chairman Hensarling's plan, the Corker-Warner, DeMarco-Bright, all of these ensure equal access for small lenders. That is important.

Mr. PITTENGER. Mr. Pinto, you have said in your testimony that current policy is creating a home boom and, therefore, making entry-level homes less affordable. In your opinion, what policies could be put in place to make housing affordable for low- to middle-income home buyers?

Mr. PINTO. Thank you for that question. As indicated earlier, the problem with all of the subsidy, cross-subsidy, Duty to Serve, all of these programs is they take the existing 30-year mortgage, which itself is a very highly leveraged instrument, add a lot of risk to it, and then somehow provide some subsidies on those loans and cross subsidies. The problem is that gets capitalized into higher house prices during seller's markets, which we are now in the 71st month of the national seller's market.

The answer is to say—if you want the 30-year mortgage over here, that is fine, but if you want to do something for low-income, let's take the 20-year term and let's figure out how we provide them an ability—and I proposed this first-time home buyer tax credit—you take the tax credit and you buy down the interest rate, and you do some other things because it is a lower risk loan to begin with, et cetera, and you then equalize the cost. So the 20-year loan now has the same monthly payment roughly as the 30-year loan, except it amortizes much more quickly. You now have a wealth-building machine for low-income buyers. They get into the house, and you would have zero downpayment, and that is the solution.

Mr. PITTENGER. Thank you. Ms. Bailey, quickly, are you encouraged that with the economic policies in the last 2 years that have been put in place, that the unemployment for African Americans is



at an all-time low, does that encourage you to believe that they will have greater access to homeownership in the future?

Ms. BAILEY. No, sir. And I have to say, when people of color have been in the marketplace, they have never been well served or fairly served, and because of the history of discrimination, they have also been targeted with more expensive—

Mr. PITTINGER. But you do acknowledge that unemployment is at an all-time low? Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Well, this has been quite a newsworthy morning. When I opened up the opinion section of The Wall Street Journal, ladies and gentlemen, this morning, I was greeted by my friend Chairman Hensarling's op-ed piece touting a bipartisan deal that he has struck on GSE reform. And I really appreciated that.

Chairman, you touted in the paper—The Wall Street Journal this morning, you said, and I quote from The Wall Street Journal, you said, reduce taxpayers' risk, codify into law an explicit government guarantee, and increase market competition.

These are all great things, and I certainly look forward to reading and learning more about it, and I certainly encourage everyone to look at this morning's Wall Street Journal. I think that the Chairman has put out some excellent points.

However, until I see the full text, I remain just a bit skeptical because it wasn't until this morning, in this surprise editorial in The Wall Street Journal, that showed the willingness of the Chairman to agree on some issues that—of course, we have had some differences—because, prior to this editorial this morning, the Republican side would not agree to the 30-year mortgage. Wouldn't agree that it would remain intact. Wouldn't agree, even more importantly, to ensure affordable housing and rental housing is supported.

Before this morning's op-ed piece, it quite honestly was only the Democratic proposals that guaranteed these proposals. Very much needed. That 30-year mortgage guarantee is the bedrock of our financial system. And I say this as one of the original cosponsors of Mr. Delaney's bill, Partnership to Strengthen Homeownership Act, H.R. 1491. But I certainly welcome this sterling example of leadership on the Chairman's part here to work in a bipartisan way in these final 3 months.

It reminds me of this past week when we went through a profound exercise in this Nation during our services for the late Senator John McCain, and we found that there was a great cry in this Nation for us to show bipartisanship, Republicans and Democrats working together. But it is also worth noting that to the American people, it was Democrats under the sterling leadership of our Ranking Member, Ms. Maxine Waters, who has been fighting and been our protector on many of these issues.

And it is so exciting and glorious, quite honestly, to see our Chairman and our Ranking Member—and I will tell you we are blessed in this committee to have the kind of knowledgeable leaders in our Ranking Member and our Chairman. And, quite hon-

estly, it is going to be a disappointment for my friend Chairman Hensarling to leave. We came together, so I have great affection for him.

And I do urge everyone to read this op-ed piece today. It is a tremendous article, and it is something that I think will provide a way for us to go forward in a bipartisan way.

Now, in my last—well, I only have 18 seconds, but let me just say, the GSEs did not cause this crisis, and the information is there to do it. It was caused by private activity in the housing market anchored in Wall Street and steering individuals that they know they couldn't pay into that.

I yield back. Thank you, sir.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Mr. Chairman, thank you.

And I thank the panel for being here. I also want to acknowledge, Mr. Chairman, your op-ed piece today, it was very refreshing to see, and it is even more refreshing to see that you and my good friend from Maryland, Mr. Delaney, are working toward a bipartisan resolution of what is a powder keg waiting to explode again, that will work to the detriment of the taxpayers of this country.

And as I look at our regulatory system and insurance and think that we have—and I know that we have better than any across the world, our State-based form of regulation, I am concerned that we should maybe take a page from our European friends', who do not have GSEs and subsidized mortgages in their housing market and seem to do very well. As I begin my questioning, I do want to lay the predicate that, of course, this issue of GSE reform has been before a majority of a Democrat Congress and a majority of Republican Congress. Eventually it will collapse if we don't make a change. And no one party has a monopoly on good ideas, and therefore, a bipartisan effort is what is necessary to get this done, and so I laud your efforts into that.

Mr. DeMarco, in your testimony, you write that, quote: The GSEs operate with a substantial advantage that guarantees that they will be able to offer better terms and lower pricing than any other market participants.

What are the dangers of not opening up the markets to other charters?

Mr. DEMARCO. You concentrate risk. You stifle competition. And even more important, perhaps, you stifle innovation.

Mr. ROSS. And without reform, do you believe that we will continue to see the GSEs entrench themselves further in the market?

Mr. DEMARCO. Yes, sir.

Mr. ROSS. There is no other alternative. And there is capacity out there, is there not in the markets?

Mr. DEMARCO. There is.

Mr. ROSS. And I would—as much of a purest I would like to be and say the government shouldn't be in the business of business, the only way we can actually address this is to have a combined effort of public-private partnerships where the government is involved in some form as a backstop—would you not agree?—unfortunately, from a political perspective.

Mr. DEMARCO. I think it actually can help perfect markets and help markets to work better with a well-defined role for the government.

Mr. ROSS. And, Mr. DeMarco, I agree, a 30-year mortgage has been the saving grace for many families. The ability to get into a mortgage affordably and be able to pay for it and move on to another mortgage later on. Now, would any way, shape, or form these reforms that we are proposing adversely impact the availability of a 30-year mortgage?

Mr. DEMARCO. No, I don't believe so.

Mr. ROSS. What about rates? The affordability of rates has been at an all-time low, somewhat suppressed, but nevertheless there. Would not—would market factors or forces allow—in a competitive environment—allow for at least a stabilization of affordable rates no different than we have today.

Mr. DEMARCO. Yes, I think so.

Mr. ROSS. Dr. Swagel.

Dr. SWAGEL. I agree. I will just add, on the risk-based pricing, the actions taken by the Fed are much more important. So, in some sense, instead of criticizing Ed on what he did with the risk-based pricing, the criticism would be of Chair Yellen and Chair Bernanke, which seems like an unfair criticism.

Mr. ROSS. I appreciate it. Anybody else? Ms. Bailey?

Ms. BAILEY. I would say, in the current system, we are likely to see rates go up, and not—

Mr. ROSS. Spike. There will probably be a spike before stabilization.

Ms. BAILEY. Not in the current system, but if we move toward these other untested systems, because what they do is they bring in a level of anxiety, and they say bring in these new market actors, market actors that won't be subject to our Nation's fair lending laws. So our ability to make sure we have the fairness and equity that the system currently has—

Mr. ROSS. I agree.

Ms. BAILEY. —a way, and then the affordability, we have a \$4 billion subsidy in the market right now. Those proposals say that they are going to bring in an extra billion dollars. However, what they fail to realize is, once you actually calculate the cost, that is not going to be the outcome, and the market at other times, when more borrowers of color and lower wealth families were actually able to get the mortgage credit they deserve, actually had a much higher subsidy. So, if we look at a better timeframe of this lending, we will see higher rates of subsidy. Right now, the market isn't doing—

Mr. ROSS. Higher rates of subsidy that are today by the GSEs?

Ms. BAILEY. Say that again.

Mr. ROSS. You are saying higher rates of subsidy than exist today by the GSEs?

Ms. BAILEY. We would see more affordability for more borrowers because right now Fannie Mae and Freddie Mac are not serving the borrower pool that they have served in the past. So we are missing out on an opportunity to really go back and do some things right. And I have to remind the committee, there was a time where we looked at loans for people of color and lower income families dif-

ferently, and we let them get perpetuated with abusive financial practices—

Mr. ROSS. I appreciate that.

Ms. BAILEY. And we have to bring them right into the center of this debate. And any reform that we do has to have them at the center. Seven out of 10 future buyers—so this is a safety and soundness concern for our market—are going to be people of color. You can't build the system without figuring out how to bring those people in. Wealthier borrowers—homeowners won't have anybody to sell their homes to.

Mr. ROSS. I appreciate that, Ms. Bailey. My time is expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Maryland, Mr. Delaney.

Mr. DELANEY. Thank you, Mr. Chairman. And I want to thank you and the Ranking Member for this hearing.

And, Mr. Chairman, in particular, I want to thank you for the opportunity to work with you on the bipartisan housing finance reform proposal that we are releasing today. I think it reflects some of—the type of great principled compromise that you typically see associated with legislation that really reflects the common good of the citizens. And I appreciate your efforts to work with me on this, and I appreciate the opportunity to work with you on this. And I think we came up with a good product. And also like most good bipartisan compromises, we were finishing it at about 11 o'clock last night. So it had all the elements of a good deal.

But, in particular, I think it does five things that are really important. First and foremost, it stabilizes the housing finance system in this country, which, let's face it, the U.S. housing market is the second largest fixed-income market in the world, and it needs to be stabilized, and it needs to be safer. And we need to put the taxpayers in a situation where they have less risk in the future, and that they will have a housing system that will have more private capital, more discipline, and it can be an enduring part of the American financial system. So I believe it does that.

Second thing it does, and this is very important, it has been a core element of the Democratic principles that the Ranking Member has led us on since I have been in the Congress, which is preserving the 30-year fixed-rate mortgage, which is important to Americans' ability to afford housing and have their housing asset be part of their long-term portfolio.

It has a meaningful increase, or at least it creates a pathway for a meaningful increase, in terms of the amount of capital allocated to affordable housing. I think we have an affordable housing crisis in this country right now, and I think it is a very, very significant problem. And it is pricing so many Americans out of the opportunity to own a home, for them to raise their family in that home, and have the stability that a home provides, and become part of a community.

And it has been my view for a long time that, as a country, we have, in general, probably over-allocated some of our resources toward housing generally at the expense of not allocating enough resources toward affordable housing in particular. And I believe this proposal we have come up with, by creating a pathway for a fee

to go on every mortgage securitized, we will start reallocating some of that capital toward the really dire need we have for more affordable housing in this country.

The fourth thing it does is protects a lot of important consumer financial—or consumer protections that were embedded in Dodd-Frank, which I think are important. And, finally, it preserves the part of the GSEs that has worked quite successfully, which is the multifamily model. So the bill is explicit about ensuring that those businesses within Fannie and Freddie will, in some shape or form or fashion, be reconstituted with the benefit of the explicit government guarantee so that they can continue to provide the financing that they do in the multifamily market.

So, again, I don't have any questions for our witnesses here. I appreciate their testimony. I just really wanted to thank you, Mr. Chairman, for the opportunity to work on this bipartisan bill, because, again, I believe it reflects the type of principled compromise that we need in this country. And I think it is a good way forward for this Congress or for future Congresses. So, with that, I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Thank you, panel, for being here today for this important discussion on this anniversary.

Mr. DeMarco, in your testimony, you talked about how moderate-income households are more susceptible to income volatility, which is more prevalent today than in the past. You continued by suggesting that housing policy and our housing finance system need to become more attuned to this challenge so better solutions may be found.

Can you give an example of some policy changes that would better accommodate income volatility among moderate-income homeowners?

Mr. DEMARCO. Certainly. So we talked earlier about QM rules and more generally various underwriting rules that are based upon fixed ratios. Well, that becomes pretty challenging if someone has an income source that is subject to this kind of volatility. So rethinking some of these standards whereby we take account of volatility so we get folks in mortgages that are actually sustainable, is I think a very important thing.

I would add one other thing, Congressman, and that is, it requires in some sense rethinking not just policies but about mortgages or how we go about constructing mortgages. If we know that there is income volatility there, what can we be doing on the front end to build in some shock absorbers for families so that they can weather those temporary disruptions and income flows?

Mr. ROTHFUS. I am wondering if you can recap, in your view, how a more streamlined and transparent housing finance system with greater private-sector participation, as you discussed in your testimony, would benefit homeowners in what way?

Mr. DEMARCO. Because you would have a much richer pool of lenders competing to provide this financing but to have alternative ways of providing that ultimate financial support—

Mr. ROTHFUS. And what happens when you have more lenders competing?

Mr. DEMARCO. You get more innovation, and you get better outcomes for consumers.

Mr. ROTHFUS. Better prices?

Mr. DEMARCO. Yes, sir.

Mr. ROTHFUS. Mr. Pinto, as you know, between the GSEs and Ginnie Mae, the Federal Government continues to dominate the secondary mortgage market. How does the current level of GSE involvement compare with historical levels?

Mr. PINTO. So, today, the GSEs are responsible for around 50 percent of all mortgages. Their percentage in history has ranged from something around 50 percent to maybe 35, 40 percent. What is somewhat different is FHA and the VA and rural housing now comprise about 35—excuse me, yes, 35 percent, and so the 85 percent being guaranteed by the Federal Government is extraordinary.

Mr. ROTHFUS. Compare that then with that historical trend, and how it relates to homeownership levels?

Mr. PINTO. So homeownership levels actually, in the United States, if you look broadly, have virtually remained unchanged since the early 1960s. I would only point out that is about the time the 30-year mortgage became commonplace. It is more commonplace in the United States. It wasn't even authorized by Congress until 1954 for existing homes for FHA. So it was in the early '60s that the 30-year loan became commonplace. We have made no progress on homeownership virtually since then.

Mr. ROTHFUS. In your testimony, you wrote: For many decades, U.S. housing policy has relied almost exclusively on increasing borrower leverage in an ineffectual attempt to make housing more affordable. Instead, the result in a seller's market—again, we have been talking about the seller's market—is to make homes less affordable for the same reason policies such as Duty to Serve, affordable housing fees, and cross subsidization have the same effect: higher prices in a seller's market.

Can you envision a scenario in which housing becomes affordable as a direct consequence of scaled-back Federal support for the housing market?

Mr. PINTO. Absolutely. And I presented in my testimony an example of the Rural Housing Service, which is part of the Department of Agriculture. They followed the Bureau of Consumer Financial Protection's admonition that the patch was to get you down to 43 percent. So what did they do in 2014? They announced that they were going to lower their debt-to-income ratios, a maximum to 41, and require compensating factors above 41.

Fannie, Freddie, FHA, VA did the exact opposite, and you have seen the data that I presented. So we then looked at, well, what happened? So the prices of FHA loans during this time period that were paid by consumers went up 25 percent in 5 years, nominal terms. Incomes did not go up 25 percent. Inflation hasn't been 25 percent, yet the prices went up 25 percent. At the lower end, they actually went up even further.

What happened with the rural housing? Prices went up 9 percent, about the same as inflation. What also happened? Debt ratios went down, and the prices were much more stable. Therefore, peo-

ple were able to buy the houses with less leverage. And, in fact, we looked at the incomes of the buyers, and the incomes of the buyers in rural housing went up about the same percentage as the income of the buyers in FHA. You get the exact result that you just described. You get a better result, not a worse.

Mr. ROTHFUS. I want to thank the panel for your insights and being with us here today, and I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman.

I thank the Ranking Member and the witnesses for appearing today. And if I may, with no disrespect to anyone else, I do want to thank you, Ms. Bailey, for your courage. I thank you for your courage because you have, on more than one occasion, tried to explain that race is a factor. I am a capitalist. I believe in free markets. But if you have invidious discrimination in the market, the market is not a free market.

Would you kindly explain what you have been trying to get across as it relates to invidious discrimination and race in the marketplace, especially as it relates to lending?

Ms. BAILEY. Yes, sir. And thank you for that point and for the question. The point is, when we decided to put tremendous resources in housing finance policy following the Great Depression to bring America forward and offer this idea of homeownership to more Americans, we did it in a way that excluded people of color. We did it in a way that would not allow Federal-insured mortgages to go to African Americans, Latinos, other people of color. And by doing that, we created historical wealth inequities because most Americans have built up their wealth through homeownership. The equity that they get from their mortgages is what they have passed on across generations, to pay for them to go to college, to start businesses. So that means a whole cohort of Americans did not have equal access to that outcome.

So now, today, African Americans, Latinos, and other people of color have smaller downpayments because they don't have that wealth equity to pay forward. And then because of broader societal discrimination, we know that they also have lower credit profiles. So when we take and think about price segmentation in the market today and we don't take those factors into consideration and we put in policies that reinforce that, then we just continually reinforce that legacy of discrimination, and we hurt the very borrowers that our future system depends.

Mr. GREEN. Thank you very much.

Mr. DeMarco, if I may, you are intimately familiar with what I would like to address. You know what the yield spread premium is?

Mr. DEMARCO. Yes.

Mr. GREEN. You know what the yield spread premium is?

Mr. DEMARCO. Yes, sir.

Mr. GREEN. And you know how the dastardly yield spread premium had an adverse impact on minority communities. Is this true?

Mr. DEMARCO. I would be even more general, Congressman. I would say that there were a number of lending practices that were

very abusive of minority communities and other borrowers as well. Yes, sir.

Mr. GREEN. Absolutely. I agree with you. And for edification purposes, the yield spread premium allowed a broker, an originator, to qualify a person for a loan at 5 percent and then walk out and shake that person's hand and smile in his face and say: Good news, we got you a loan for 9 percent.

It wasn't right. It wasn't fair. But it did encroach upon the free market. And many people from minority communities who qualified for lower loans, who would have been able to keep their homes, were into foreclosure because they were pushed, if you will, into these high-cost loans, notwithstanding a good credit history. That actually happened to people, and you are aware of this, Mr. DeMarco.

And, by the way, I am not condemning you, but you are the person who knows most about this of the people on the panel, in my opinion, because of your years of service with the Federal Government. Do you concur with what I have said, Mr. DeMarco?

Mr. DEMARCO. I believe instances like this did happen, Congressman, and I would again take you a step further, and say that private markets require and depend upon ethical behavior by those involved.

Mr. GREEN. So the point that Ms. Bailey is making is salient. It is something that has to be considered. But here is my closing point, since I have but 20 seconds or less: Whenever we have the opportunity to do something about invidious discrimination, we find clever ways to work around it and just go on with life as it is. I refuse to ignore what is obvious. And at some point, we have to take what Ms. Bailey has said seriously.

Thank you, Mr. Chairman. I yield back.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you, Chairman. Thank you all. I appreciate you being here. The Federal Home Loan Bank of Chicago serves my district and works to provide liquidity to member institutions to support the housing finance system. During your tenure at the FHFA, Mr. DeMarco, you began the rulemaking process to reevaluate FHLB membership requirements. When Director Watt finished the rulemaking in 2016, it resulted in a new definition of insurance, which excluded captive insurers. FHL Bank of Chicago has three captives that will eventually lose their membership in the bank because of this change.

In a cooperative like the Federal Home Loan Bank, the loss of these members and their significant borrowing would reduce the scale that the Federal Home Loan Bank of Chicago and limit its ability to serve its members in their communities. I wonder, there has been a lot of discussion today about the need to increase the role of private capital in our housing finance system, and so I hope you might speak to the role that you see the Federal Home Loan Bank already play in funding banks, insurers, and other mortgage lenders that choose to hold mortgage loans on their balance sheet instead of selling those loans to Fannie or Freddie. And would you agree that we could increase the role of private capital in our hous-



ing finance system by shifting more mortgage lending to balance sheet lending and away from securitization through the enterprises? And I wondered, do the Federal home loan bank's advances to their members tend to support balance sheet lending?

Mr. PINTO. Yes. Basically, Congressman, yes to all of that, but I suppose you want slight elaboration. First of all, the home loan bank system and Home Loan Bank of Chicago, in particular, have shown some real leadership in demonstrating the capacity to credit share, that is, to syndicate credit risk through what they do, through providing an alternative avenue for aggregating the loans of lenders, particularly of small lenders. They have been especially good at providing financing support for small lenders and for large lenders in terms of being able to manage mortgages on their balance sheet by getting the funding flexibility that home loan banks provide.

Mr. HULTGREN. Thanks. I wonder if you—see what other things I want to cover here real quick. While I understand the concerns associated that many have, I do understand it potentially expanding the footprint of Federal home loan banks by allowing captive insurers to maintain membership. I wondered is it fair to say, perhaps, that with some other regulatory changes, captive insurers could provide a way to actually attract private capital into the market while shifting mortgages away from Freddie and Fannie?

Mr. PINTO. I believe that that is possible, and I would, since the subject of this hearing is housing finance reform, I would take it a step further in a general direction you are headed, which is, I think it is important for the Congress to consider liquidity sources for our financial system and housing finance reform and what the proper role of the Federal home loan banks and being a source of liquidity is, and I think that this question about captive insurers is really one best addressed by the Congress, because when the Congress created the home loan banks, just like with Fannie and Freddie, and wrote their mission and gave them these privileges but then set some limits, the limit was really about who is eligible for a membership and how that membership is structured, because Congress knew it was providing a set of benefits to this system. It wanted a closed system to benefit mortgage finance.

Life insurance companies—insurance companies were part of the original membership of the home loan bank system because in 1932, when the system was created, life insurance companies were a big source of capital that financed mortgages. Our system is much different today. The risk with captive insurance is there is a tradeoff. Certainly, captive insurance companies can be structured in way in which they are an important source of capital to support housing finance, but if this isn't done properly, and you just simply allow captives then you can have all sorts of companies, nonfinancial companies, companies with no interest in housing, being able to gain access, and I believe that that is part of what motivated the FHFA's final rulemaking.

Mr. HULTGREN. Just one last question on that, and I think maybe getting into more specifics of how do we find that right balance? How would you view an expansion of membership that came with higher collateral requirements, or perhaps even restrictions on types of eligible collateral and a way to ensure that those that do

gain membership do so in a way that doesn't significantly increase the risk of the entire Federal home loan bank system?

Mr. PINTO. All right. I think it is quite important if one is to consider changes in the membership construct of the home loan bank system that for the existing members, most of which are insured depository institutions, and we pay careful attention about how that alters the risk profile and whether we are putting insured depositories at risk through how we do that. So some of the ideas you suggested are ways of mitigating the risk, but let me simply say it is a very important question, one that needs to be carefully thought through.

Mr. HULTGREN. I appreciate that, and I definitely agree with you that I think it is something Congress ought to address and ought to talk about, and I certainly would look forward to suggestions or advice from the entire panel of how to do that well. My time has gone by too fast. I yield back.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Arkansas, Mr. Hill.

Mr. HILL. I thank the Chairman. I thank the Ranking Member for doing this hearing. I agree with the Ranking Member. It is a long time in coming in my 3-1/2 years in Congress that we have a comprehensive hearing on this topic. So I thank the Chairman. I thank he and Mr. Delaney for working on a comprehensive proposal.

But abdication about responsibility in the secondary mortgage market is a bipartisan opportunity. There is no one contrary to the Ranking Member's emphasis on this Administration and this Congress. This is a problem that started 35 years ago. It has been dealing with it, it has been abdicated by numerous administrations, both Democratic and Republican, and I don't remember sitting here for 3-1/2 years hearing any comprehensive proposal to change the secondary mortgage market by Jack Lew during the Obama years.

My shelves are littered with studies about what is wrong with Fannie Mae and Freddie Mac and the secondary mortgage market. We have this historic one, 1980, Ronald Reagan. We have the one I had to work on as a staffer of the Treasury 1990, and it had a supplement smaller, 1991, and the list goes on and on. And we ought to all be embarrassed, I think, by passing Dodd-Frank and having the Financial Crisis Commission and not pursuing active change in the series. So I thank all four of you for being here today and sharing your views.

A few quick questions for the four of you. Do you support a recap and release of the two secondary mortgage market entities? Just give me a yes or no. We will talk some more. It is not a trick question.

Mr. PINTO. No.

Dr. SWAGEL. No.

Ms. BAILEY. Fundamental reforms have to happen first.

Mr. DEMARCO. No.

Mr. HILL. Thank you. I think that is important, because I think that is an important statement on your part. It reflects across policy thinking apparatus, and that is something I think is very important is that we don't just simply turn the page and go on. And I agree, Ms. Bailey, that the new regulator has a lot of power, and

so I look forward to a new appointee at that agency and hear their considerations.

One of my concerns is, and I was looking back at Congressman Frank's work on Dodd-Frank. He said the profligate availability of credit is a major reason for the current problem, the housing crisis. Too many loans were made to people that shouldn't have gotten them, and we need to reduce the pattern of people getting loans who shouldn't have gotten them because they couldn't repay them. That is what we think we have achieved in this bill, and he is referring to Dodd-Frank, and, he is talking about the ability to repay and the QM process.

So, Mr. Pinto, I think you have done a great job with your research about how this patch issue allowing the GSEs to get out and around the debt-to-income ratio that you talked to the Ranking Member about; she also challenged you that those aren't necessarily bad loans, and so, when you see FHA and the VA going up over 50 percent debt-to-income ratio, that also comes with a higher risk index that you outline in your testimony. You didn't really talk much about that, but the GSEs have a 12 percent high-risk mortgage in their portfolios. Back in 2012, it was 10 percent. Now your data shows that it is 29 percent. So it is three times higher, they have made three times higher risk loans in their portfolio since the patch. So the systemic risk is growing in these unreformed GSEs.

The issue of mission creep. I have read a lot recently that your successor, Mr. DeMarco, Mr. Watt is allowing a series of expansions of power of Freddie Mac and Fannie Mae, and this is an oligopoly, this is government power that is incurring now on the private mortgage insurance business, on the commercial lending business for purchase mortgage service rights. Can you talk to us in the minutes we have remaining about your views on expanding more pricing and market power by these two entities?

Mr. DEMARCO. I think it contributes to the sort of systemic risk that was at the heart of the financial crisis 10 years ago. And the one—just to point out one example what you said, providing advances to nonbank lenders for their mortgage servicing is competing directly with a traditional function that happens in our financial system without the benefit of government backing, and by using Fannie and Freddie to fund that we are using essentially the ability to raise money at taxpayer cost of funds to provide that subsidy.

Mr. HILL. Well, it takes a lot to figure that rent on a \$700 million building, so that is important. Mr. Pinto, quickly.

Mr. PINTO. We had a conference on this a couple months ago and this was the poster for it. Insatiable, out of control, nothing can stop it, the blob, Fannie Mae, Freddie Mac, and we showed how the exact same thing happened at the end of the '90s, and it is happening again today.

Mr. HILL. Well, I was there for the first movie so the sequel is no better.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from North Carolina, Mr. Budd.

Mr. BUDD. Thank you, Mr. Chairman, and also, again, thank you to our witnesses, each of you, for being here today for what I think is a very important hearing. I think the time is right for Congress to make a push toward housing finance reform, and if we don't act in a timely manner, the same risks that were at the root of the 2008 financial crisis are going to continue building up in the system, and we all know how that story ends. Taxpayers and my constituents and people I serve back home in North Carolina, they are on the hook. Taxpayers are on the hook.

So, Mr. DeMarco, my line of questions are for you this morning, or afternoon, whatever it is. It is afternoon now. In your testimony you write that, quote, "The uncertainty about the future of GSEs and about the government's next steps stymie innovation and long-term strategic investment by private lenders and services and other stakeholders in the system," end quote.

So this is an important point that will not be solved by continuing the status quo like we have now and thinking that what we have today is just good enough. Markets need the long-term certainty that can only come from real legislative reform. So my question: What insights do you have today about the advantages of legislative reform over administrative reform in providing certainty in the market?

Mr. PINTO. Just what you said, Congressman. Even if legislative reform has a multiyear transition cycle to it, financial companies, mortgage lenders, servicers, everyone else who participates in this ecosystem can know, with some certainty, what the role of the government is, what the long-term framework looks like and can make strategic business decisions and capital investment in housing finance with some certainty about what their role and opportunity is going to look like. As long as we keep this cloud of uncertainty, they don't know whether those long-term investment decisions are going to be sound or not, because the government is creating this uncertainty.

Mr. BUDD. So just to further clarify, so you would agree that it puts taxpayers at risk by avoiding long-term legislative solutions to fixing housing finance reform?

Mr. PINTO. Yes, sir.

Mr. BUDD. Do you believe that we will ever reach a level of private capital necessary for a functioning mortgage market without legislative action? Without legislative action?

Mr. PINTO. Not without legislative action.

Mr. BUDD. OK. And finally, what areas in mortgage finance would benefit the most from ending the GSE duopoly and opening up to competition and innovation?

Mr. PINTO. Actually, I believe that we can do a lot more in the affordable housing space and in the innovation of helping borrowers where their actual needs are. We don't have innovation in that space. It is only what Fannie and Freddie allow through.

Mr. BUDD. Thank you, Mr. DeMarco, that is the end of my questions. I yield back to the Chairman the remaining time. I thank you.

Chairman HENSARLING. The gentleman yields back. There are no other Members in the cue who have requested time, so I would like to thank the witnesses for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

[Whereupon, at 12:18 p.m., the committee was adjourned.]



# **A P P E N D I X**

September 6, 2018

**Testimony of Ms. Nikitra Bailey**

Executive Vice President, Center for Responsible Lending

Before the United States House of Representatives

Committee on Financial Services

A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk

September 6, 2018



# I. Introduction

Good morning Chairman Hensarling, Ranking Member Waters, and Members of the House Committee on Financial Services. Thank you for the opportunity to testify regarding our nation's housing finance system during the 50<sup>th</sup> year commemoration of the federal Fair Housing Act, which promises all Americans an opportunity to live in thriving communities free of housing discrimination including in the sale, financing, and securitization of mortgage loans. Housing is an issue that profoundly impacts American families as all Americans deserve a safe and decent place to live. Housing accounts for nearly 20 percent of the national economy as homeownership is the engine that drives the economy by creating jobs that stabilize communities across the nation. Homeownership is also one of the most important tools for building and passing on wealth for most middle-class families in America.

I am Executive Vice President of the Center for Responsible Lending (CRL), a nonprofit, nonpartisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL is an affiliate of Self-Help, a community economic development lender headquartered in Durham, NC. Since 1980, Self-Help has provided more than \$7 billion in financing to 131,000 families, individuals, and businesses under-served by traditional financial institutions. It helps drive economic development and strengthen communities by financing hundreds of homebuyers each year, as well as nonprofits, child care centers, community health facilities, public charter schools and residential and commercial real estate projects. Through its credit union network, Self-Help's two credit unions serve more than 130,000 people in North Carolina, California, Illinois, Florida and Wisconsin and offers a full range of financial products and services. Learn more at [www.self-help.org](http://www.self-help.org) and [www.self-helpfcu.org](http://www.self-helpfcu.org).

This important hearing provides an opportunity to look back over the last decade where significant reform occurred in the secondary market and offer a pathway for continued improvement by moving to a utility model that regulates rates of return, and that can be achieved through administrative action. Such action will lead us toward creating a more equitable housing finance system rooted in access to safe and responsible mortgage credit for all credit-worthy consumers on affordable terms. The prior approach of extreme caution must continue as we build on initial repairs so as not to disrupt the delicate recovery that the system is experiencing. The foundations offered by the Housing and Economic Recovery Act of 2008 (HERA) and the new rules created by the Dodd-Frank Act and the Consumer Financial Protection Bureau (CFPB) deliver important safety and soundness regulation that the prior system lacked. Our end goal must be to better protect taxpayers from systemic catastrophic risk and incorporate important market segments—people of color, low-to-moderate income families, and rural residents – that a well-functioning future system depends. Successful reform produces a system that serves the full universe of credit worthy borrowers, and provides equal treatment for small lenders, including community banks and credit unions, which often are the only sources of mortgage credit in underserved communities across the nation.

Today's testimony draws extensively from our October 25, 2017 remarks delivered before the House Financial Services Committee Subcommittee on Housing and Insurance.<sup>1</sup>

## II. The GSEs and Ginnie Mae Provide Important Access to Mortgage Credit in Underserved Communities

Both the GSEs and Ginnie Mae continue to provide critical mortgage capital to underserved communities. The GSEs purchased more than two million homes and refinance mortgage loans in 2015, including almost half a million loans to low- and moderate-income borrowers, nearly 400,000 loans to borrowers of color and over 300,000 loans to borrowers living in rural areas. At the same time, smaller financial institutions (those with assets less than \$10 billion) originated and sold loans to the GSEs in order to meet the credit needs of nearly 400,000 borrowers seeking mortgage credit in rural communities, relying on the GSEs for critical capital. Loans backed by Ginnie Mae also continue to play a significant role in serving borrowers whose credit may warrant additional enhancement or who have limited resources for a down payment. However, government-backed lending cannot and should not be the sole source of mortgage lending in these communities.

To better understand the GSE market share among low- and moderate-income borrowers, borrowers of color, rural borrowers and among community banks and credit unions, CRL analyzed over six million home purchase and refinance mortgages for first-lien, owner-occupied, 1-4 family homes (including manufactured homes) reported under the Home Mortgage Disclosure Act in 2015 (referred to as purchase lending and refinance lending going forward). Of these loans, 34.2 percent were sold to Fannie Mae, Freddie Mac or Farmer Mac (collectively, the GSEs) and 16.2 percent were loans guaranteed through Ginnie Mae (see Figure 1).

**Figure 1. 2015 purchase and refinance loans by purchaser**

	All loans		Loans to LMI borrowers		Loans to borrowers of color	
	#	%	#	%	#	%
<b>GSEs</b>	2,065,978	34.2%	457,450	31.3%	374,133	30.0%
<b>Ginnie Mae</b>	976,119	16.2%	235,514	16.1%	262,773	21.1%
<b>Not sold in 2015</b>	1,245,698	20.6%	275,054	18.8%	225,453	18.1%
<b>Other</b>	1,752,868	29.0%	493,318	33.8%	382,781	30.7%
<b>Total</b>	<b>6,040,663</b>		<b>1,461,336</b>		<b>1,245,140</b>	

<sup>1</sup> Sustainable Housing Finance: Private Sector Perspectives on Housing Finance Reform, Hearing before the Subcommittee on Housing and Insurance of the House Financial Services Subcommittee, 115<sup>th</sup> Congress. 1-26 (2017) (Testimony of Nikitra Bailey), available at <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba04-wstate-nbailey-20171025.pdf>.

Source: CRL analysis of 2015 Home Mortgage Disclosure Act data, home purchase and refinance mortgages for first-lien, owner-occupied, 1-4 family homes, including manufactured homes. GSEs refers to all loans sold to Fannie Mae, Freddie Mac or Farmer Mac in 2015 calendar year. Other category includes loans acquired by an affiliate institution, commercial bank, savings bank, savings association, life insurance company, credit union, mortgage bank, finance company or private securitization.

#### **A. The GSEs and Ginnie Mae Provide Important Credit Access for Low- and Moderate-Income Borrowers and Borrowers of Color**

In 2015, GSEs purchased 457,450 purchase and refinance loans made to low- and moderate-income (LMI) borrowers, making up 31.3 percent of purchase and refinance mortgage lending to LMI borrowers, or borrowers with incomes less than 80 percent of the area median income. Likewise, Ginnie Mae guaranteed 235,514 purchase and refinance loans to LMI borrowers, making up 16.1 percent of all purchase and refinance lending to low- and moderate-income borrowers (Figure 1).

During the same year, the GSEs purchased 374,133 loans to borrowers of color, or 30.0 percent of all loans to these borrowers and Ginnie Mae guaranteed 262,773 FHA loans to borrowers of color—a 21.1 percent market share.

#### **B. GSE Market Share Exceeds Ginnie Mae Market Share in Rural Communities**

While conventional financing and the GSEs remain a critical component of the mortgage market in low- and moderate-income communities of color, the GSEs also provide an important source of mortgage capital in rural communities.<sup>2</sup> According to research by CRL and released by Brookings Institution, the GSEs purchased nearly one out of every three new mortgages in rural communities in 2016. In 2016, lenders made over 1.2 million purchase and refinance loans in rural areas.<sup>3</sup> The GSEs also purchased 80,680 purchase and refinance loans to LMI borrowers in rural areas and 24,132 loans to rural borrowers of color, a 26.7 percent and 21.9 percent market share, respectively (Figure 2).

In comparison, Ginnie Mae guaranteed 244,573 FHA loans in rural areas, including 59,455 (19.7 percent) to rural LMI borrowers and 30,308 loans (27.6 percent) to rural borrowers of color.

<sup>2</sup> Calhoun, Michael, Tom Feltner, and Peter Smith. Supporting Mortgage Lending in Rural Communities. Brookings Institution, (January 2018). [https://www.brookings.edu/wp-content/uploads/2018/01/es\\_2018\\_01\\_10\\_rural\\_housing\\_report.pdf](https://www.brookings.edu/wp-content/uploads/2018/01/es_2018_01_10_rural_housing_report.pdf).

<sup>3</sup> Census tracts, which were classified as either urban or rural areas based on the 2017 definition of rural area at 12 CFR 1282.1, and available at <https://www.fhfa.gov/DataTools/Downloads/Pages/Duty-to-Serve-Data.aspx>.

Figure 2. 2016 purchase and refinance loans by purchaser in rural areas

	All loans		All rural loans		Loans to rural LMI borrowers		Loans to rural borrowers of color	
	#	%	#	%	#	%	#	%
<b>GSEs</b>	<b>2,427,505</b>	<b>35.2</b>	<b>364,719</b>	<b>30.3</b>	<b>80,680</b>	<b>26.7</b>	<b>24,132</b>	<b>21.9</b>
<b>Ginnie Mae</b>	1,191,979	17.3	244,573	20.3	59,455	19.7	30,308	27.6
<b>Not sold in 2016 CY</b>	1,346,756	19.5	283,722	23.5	74,531	24.7	24,926	22.7
<b>Other</b>	1,932,929	28.0	311,900	25.9	87,058	28.8	30,643	27.9
<b>Total</b>	<b>6,899,169</b>		<b>1,204,914</b>		<b>301,724</b>		<b>110,009</b>	

Source: Center for Responsible Lending analysis of 2016 HMDA data

The GSEs also provide a critical source of mortgage capital for smaller lenders, those with assets of less than \$10 billion in 2016. The GSEs purchased 100,151 purchase and refinance loans from smaller lenders lending in rural areas, or 26.8 percent of the market. Ginnie Mae guaranteed just 9,119 purchase and refinance loans made by small lenders in rural areas that same year—a 2.4 percent market share (Figure 3).

Figure 3. 2016 purchase and refinance loans originated by small lenders by purchaser in rural areas

	Purchase		Refinance		Total	
	#	%	#	%	#	%
<b>GSEs</b>	50,334	24.6%	49,817	29.6%	100,151	26.8%
Ginnie Mae	7,450	3.6%	1,669	1.0%	9,119	2.4%
Not sold in 2016 CY	78,691	38.4%	79,975	47.4%	158,666	42.5%
Other	68,252	33.3%	37,123	22.0%	105,375	28.2%
<b>Total</b>	<b>204,727</b>		<b>168,584</b>		<b>373,311</b>	

Source: CRL analysis of 2016 Home Mortgage Disclosure Act data

In addition to support for homeownership, the GSEs also play a vital role in supporting affordable rental housing, which is essential for many working families. These programs have performed well, even through the recent financial crisis, and should be continued going forward.

**III. FHA is a Critical Component of the Housing Finance System and Along with the GSEs Saved the Market from Total Collapse. To Remain Effective and Achieve its Goal of Promoting Homeownership, it Must be Reformed and Modernized.**

**A. When Considering Reform Changes to the Housing Finance System, it is Crucial to Start by Recognizing the Central Role that the GSEs and FHA Play in the Nation's Housing Market Recovery**

The GSEs and FHA ensured that stable and affordable mortgage credit was available across the country throughout the economic downturn and are still essential to the market today. Currently, they hold mortgages worth \$6.17 trillion with Fannie Mae at 44.2 percent, Freddie Mac at 27.5 percent, and Ginnie Mae at 28.3 percent.<sup>4</sup> The GSEs were created by Congress in the 1930s to provide stability to the capital markets and to increase the availability of mortgage credit throughout the United States following periods of significant economic instability. The GSEs have a mandate to serve all credit markets at all times, which guarantees broad credit availability in all regions of the nation. The charters of the GSEs state that they must “promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”<sup>5</sup> By

<sup>4</sup> Laurie Goodman et.al., Housing Finance at a Glance: A Monthly Chartbook, at 6-7 (May 2017), available at [http://edit.urban.org/sites/default/files/publication/90451/may\\_chartbook.pdf](http://edit.urban.org/sites/default/files/publication/90451/may_chartbook.pdf).

<sup>5</sup> Fannie Mae's charter is in Title III of the National Housing Act, 12 U.S. Code § 1716 et. seq. Freddie Mac's charter is in 12 U.S.C. §1451 et. seq.

pooling and securitizing mortgages, backed by an implied federal government guarantee, the GSEs have ensured the flow of credit to all parts of the nation. We now have a national mortgage market, investor confidence, increased loan volume, and widespread use of the 30-year fixed rate mortgage.

**B. Following the Financial Crash, GSE and FHA Lending Saved the Market from Complete Shutdown**

Private capital withdrew from the market during the housing crash. The countercyclical nature of the GSEs and FHA insured mortgage credit sustained the market during this time. Private label lending peaked in 2006 with approximately 40 percent of all mortgage originations.<sup>6</sup> It began to decline in 2007 and virtually stopped by 2008.<sup>7</sup> With record levels of defaults and foreclosures occurring alongside sharp declining prices nationwide, overall mortgage lending quickly dried up.

Credit would not have been available for most mortgagees if not for government support during the financial crisis. Backed by government guarantees, the GSEs, under Federal Housing Finance Administration conservatorship beginning in September 2008, and FHA continued to ensure the availability of credit. GSE lending jumped to over 65 percent of all mortgage originations in 2008.<sup>8</sup> FHA lending also played a key role as its involvement increasing rapidly.<sup>9</sup> Since then, FHA purchase loans have dropped steadily and returned closer to the normal levels of the early 2000s (Figure 9).<sup>10</sup> Moody's estimated that FHA's contribution prevented a second collapse in the housing market, which could have sent the U.S. economy into a double-dip recession and caused the economy to shed another three million jobs and the unemployment rate to rise an additional 1.6 percent.<sup>11</sup>

<sup>6</sup> Laurie Goodman et al., *Housing Finance at a Glance: A Monthly Chartbook*, at 8 (May 2017), available at [http://edit.urban.org/sites/default/files/publication/90451/may\\_chartbook.pdf](http://edit.urban.org/sites/default/files/publication/90451/may_chartbook.pdf).

<sup>7</sup> *Id.*

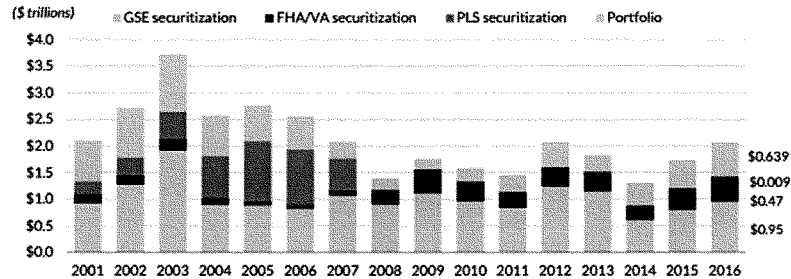
<sup>8</sup> *Id.*

<sup>9</sup> John Griffith, "The Federal Housing Administration Saved the Housing Market" (Washington: Center for American Progress, 2012), available at <https://www.americanprogress.org/issues/housing/report/2012/10/11/40824/the-federalhousing-administration-saved-the-housing-market/>. This report cites data estimates from Moody's Analytics in October 2010.

<sup>10</sup> US Department of Housing and Urban Development, *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010*, at 2 (November 2010), available at [https://portal.hud.gov/hudportal/documents/huddoc?id=report\\_to\\_congress.pdf](https://portal.hud.gov/hudportal/documents/huddoc?id=report_to_congress.pdf); See also US Department of Housing and Urban Development, *Federal Housing Administration Annual Report to Congress, The Financial Status Of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2016*, at 8 (November 2016), available at <https://portal.hud.gov/hudportal/documents/huddoc?id=2016fhaannualreport1.pdf>.

<sup>11</sup> John Griffith, "The Federal Housing Administration Saved the Housing Market" (Washington: Center for American Progress, 2012), available at <https://www.americanprogress.org/issues/housing/report/2012/10/11/40824/the-federalhousing-administration-saved-the-housing-market/>. This report cites data estimates from Moody's Analytics in October 2010.

Figure 9. First lien origination volume



Source: Inside Mortgage Finance and Urban Institute, last updated February 2017

### C. Modernizing the FHA is Critical to Ensure It Carries Out its Mission to Promote Homeownership and Ensure Access to Credit

The FHA is one of the main pillars of the nation's housing finance system. The program creates an entry point for millions of first-time home buyers. As noted above, FHA was central to the nation's economic recovery after the financial crash by continuing to insure mortgage loans when private capital dried up. However, the program would benefit tremendously from both funding and statutory reform.

#### i. The False Claims Act

Lender liability under the False Claims Act has been the subject of a variety of proposed reforms. There is a recognized need to clarify what types of errors can trigger liability under the Act. The statute imposes treble damages against anyone who submits a false claim to the government, including FHA insurance payments. Because these treble penalties can cost a far greater amount than the loan itself, this has the potential to decrease the appetite for making FHA insured loans that have only a modest risk of defaulting.<sup>12</sup> This has potential negative effects on access to mortgage credit, especially for those borrowers that rely on FHA to secure mortgage loans. The False Claims Act can be a strong tool to curb fraud in the mortgage lending space and should be reformed to clarify the liability provisions so it can bolster access to credit.

#### ii. Program Funding

FHA loan volume plummeted during the subprime mortgage lending boom. In 2015, FHA lending slightly recovered, but while the increase in lending volume has bolstered FHAs capital levels it has

<sup>12</sup> See, *The Federal Housing Administration Can Do More With More*, April 2017, available at <https://www.brookings.edu/research/the-federal-housing-administration-can-do-more-with-more/>.

counterintuitively negatively impacted FHA's operations.<sup>13</sup> Under statute the entirety of FHA's revenue is sent to the Mutual Mortgage Insurance Fund (MMIF) and cannot be used for FHA's operations, regardless if that funding could significantly improve operational or program efficiency. For example, FHA attempted to address the False Claims Act ambiguity by establishing which errors would and would not trigger liability, but this effort was abandoned due to lack of funding.<sup>14</sup> Additionally, FHA loan servicing for modifications for troubled loans is expensive and risky, so servicers will be constrained in their ability to provide payment relief for borrowers without programmatic changes.

FHA has made attempts to secure additional funding to address these (and more) complications but has been met with resistance. One of these proposals was legislation authorizing a 4 basis point ongoing fee on FHA loans. Additionally, HERA authorized \$25 million a year for five years out of a "negative credit subsidy", proceeds from the MMIF, to target system upgrades and quality control.<sup>15</sup> These upgrades would advance FHA's role in the housing market, protect taxpayers, and support the overall economy.

### **III. Access to Safe and Responsible Credit on Affordable Terms Must Be Central in the Future of the Housing Finance System**

Despite historical inequities in access to mortgage credit, the future of the market depends on often-excluded borrowers including people of color and LMI families, the fastest growing segment of potential future homebuyers. These borrowers have less wealth, which has translated into lower credit profiles and an inability to make large down payments on mortgage loans.<sup>16</sup> Therefore, a future well-functioning system that serves all credit-worthy borrowers would not only fulfill the GSE's mission, but enable the mortgage market to thrive—for example, making it easier for families to sell their homes to new buyers.

#### **A. Serve All Credit-Worthy Borrowers**

Rural borrowers, new emerging households, LMI borrowers and borrowers of color all face obstacles to receiving competitive and affordable mortgage loans. Current statutory provisions governing the

<sup>13</sup> See, *The Federal Housing Administration Can Do More With More*, April 2017, available at <https://www.brookings.edu/research/the-federal-housing-administration-can-do-more-with-more/>.

<sup>14</sup> See *The Federal Housing Administration Can Do More With More*, April 2017, available at <https://www.brookings.edu/research/the-federal-housing-administration-can-do-more-with-more/>.

<sup>15</sup> 12 U.S.C. § 4501 et. seq.; Section 2126 authorized \$25m negative subsidy (This funding was dependent on FHA's meeting its statutory capital ratio, and FHA has been below this standard for several years before present day, so this provision was never implemented.)

<sup>16</sup> See *The State of the Nation's Housing*, Joint Center for Housing Studies, at 3 (2013) (stating that "[m]inorities—and particularly younger adults—will also contribute significantly to household growth in 2013–23, accounting for seven out of ten net new households. An important implication of this trend is that minorities will make up an ever-larger share of potential first-time homebuyers. But these households have relatively few resources to draw on to make down payments. For example, among renters aged 25–34 in 2010, the median net wealth was only \$1,400 for blacks and \$4,400 for Hispanics, compared with \$6,500 for whites. Even higher-income minority renters have relatively little net wealth, with both blacks and Hispanics in the top income quartile having less than half the average net wealth of whites. Proposed limits on low-down payment mortgages would thus pose a substantial obstacle for many of tomorrow's potential homebuyers.")



GSEs include important measures to further service of these markets: the mandate to serve the broad market, even at a lower rate of return; affordable housing goals; the duty to serve under-reached markets; and the affordable housing funds. These were all included in or reaffirmed by HERA, which passed with strong bipartisan support. These bipartisan compromises, worked out over nearly a decade, must be preserved and expanded in order to meet needs of the current and future mortgage market, which will include large proportions of these borrowers. Equally important, credit risk transfers must continue to be done by the GSEs through mechanisms that do not price these borrowers or small lenders out of the market. This means credit risk transfers must be executed through reinsurance structures that permit pooling of loans and risk, and not through deeper upfront risk transfers.

#### **B. Pricing Practices Should Expand Mortgage Access**

The GSEs and FHA today have an affirmative duty to serve all markets which incentivizes them to set prices in a way that balances risk and access.<sup>17</sup> These participants in today's housing finance system are incentivized to pool risk and price credit risk on a pooled basis. Unfortunately, recent proposals for legislative housing finance reform share a common feature that undermines this pricing approach. Deep upfront credit risk transferred to private capital would incentivize actors to segment, rather than pool, credit risk and prices. Segmented pricing puts mortgage credit out of reach for too many credit-worthy borrowers by making mortgage debt more expensive.

The total amount borrowers pay to cover credit risk is a function of modeled losses, capital standards and the required rate of return on capital.<sup>18</sup> Modeled losses are largely independent of system structures.<sup>19</sup> Capital requirements and required rates of return on capital are dependent on the structure of a future system, and function to increase or decrease the overall total amount to be held to guard against losses.

It is the policies of participants in the housing finance system that translate predicted credit losses into borrower prices and distribute prices for borrowers with different characteristics. Importantly, the degree to which costs are pooled or distributed is determined by the structure of the housing finance system. For example, FHA charges the same insurance premium to borrowers regardless of credit score,<sup>20</sup> whereas private mortgage insurers charge widely different fees to borrowers with different credit scores and/or levels of down payment (Figure 4).

<sup>17</sup> CRL continues to work with FHFA to encourage changes which could further open up access to credit. For example, eliminating the loan level price adjustments (LLPAs) that were put in place after the crisis.

<sup>18</sup> For a more detailed discussion of the levers that affect pricing and the distribution of pricing for credit risk see Calhoun, M. and Wolff, S. Who Will Receive Home Loans, and How Much Will They Pay?, 2016, *available at* <http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/mike-calhoun-and-sarah-wolff-who-will-receive-home-loans-and-how-much-will-they-pay>.

<sup>19</sup> System structure could introduce new risks. For example, if a future system made it very difficult or costly for first-time homebuyers to purchase a home, then existing homeowners would have a difficult time selling their homes. This could depress housing prices or limit liquidity in the housing system overall, which could result in a downturn and create losses in the system above what would be predicted by current models.

<sup>20</sup> FHA premium rates *available at* <https://portal.hud.gov/hudportal/documents/huddoc?id=17-07ml.pdf>.

Figure 4. Private mortgage insurance pricing, 2017

	97-95.01% LTV 35% Coverage	95-90.01% LTV 30% Coverage	90-85.01% LTV 25% Coverage	85% LTV and under 12% Coverage
>=760	55	41	30	19
740-759	75	59	41	20
720-739	95	73	50	23
700-719	115	87	60	27
680-699	140	108	73	32
660-679	190	142	100	41
640-659	205	150	105	43
620-639	225	161	110	45

From online published rate sheets for Borrower Paid Mortgage Insurance from private mortgage insurers Genworth ([https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly\\_Natl.FIXED.0616.pdf](https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly_Natl.FIXED.0616.pdf)) and Radian (<http://www.radian.biz/sfc/servlet.shepherd/version/download/068C0000002osy9IAA>)

Underwriting structures determine if borrowers are credit-worthy, but pricing structures have a significant impact on whether a credit-worthy borrower can afford a mortgage. Differential pricing creates an additional barrier to mortgage credit by increasing the price, sometimes significantly, for some borrowers relative to others. There is evidence of price acting as a barrier even in today's mortgage market. For example, although Fannie Mae's guidelines allow the GSEs to purchase loans with credit scores down to 620 and loan-to-value (LTV) ratios of up to 97 percent, very few loans purchased by the GSEs have these characteristics.<sup>21</sup> One reason is that risk-based pricing by both the GSEs and private mortgage insurers add significantly to the cost of loans for borrowers with lower scores and less wealth for a down payment. For example, the combination of loan-level price adjustments (LLPAs) and mortgage insurance (MI) premiums adds over 300 basis points to the cost of a mortgage for a borrower with a credit score of 620 and an LTV of 97 percent.<sup>22</sup>

The GSEs, though, currently set prices based on a more consolidated set of borrower characteristics than private actors like private mortgage insurers. They lay off credit risk largely through back-end credit risk transfer mechanisms which allows for pooling of loans and risk. Ultimately, these policies limit the degree to which loan pricing is highly segmented.<sup>23</sup>

<sup>21</sup> See p. 6 of *2017 First Quarter Credit Supplement*, Fannie Mae, May 5, 2017, available at [http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2017/q12017\\_credit\\_summary.pdf](http://www.fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2017/q12017_credit_summary.pdf).

<sup>22</sup>  $350/4 + 225 = 312.5$  basis points. Fannie's Mae's LLPA for this combination of credit score and LTV is a one-time fee of 350 basis points (see page 2: <https://www.fanniemae.com/content/pricing/llpa-matrix.pdf>), we assumed a LLPA multiple of 4 to convert this upfront fee to an ongoing cost comparable to the MI premium. Borrower paid MI from Genworth for this combination of credit score and LTV is a continuing fee of 225 basis points (see: [https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly\\_Natl.FIXED.0616.pdf](https://mortgageinsurance.genworth.com/pdfs/Rates/11370775.Monthly_Natl.FIXED.0616.pdf)).

<sup>23</sup> Through the LLPAs the GSEs also have differential pricing, which limits their reach to underserved borrowers.

Comparing the GSE guarantee fee structure to the MI pricing structure reveals the private market's tendency to create finely defined bands. GSE guarantee fee pricing<sup>24</sup> breaks up credit scores into three bands:  $\geq 740$ , 700-739, and 620-699. From December 2013 to April 2016, MI companies broke up this same range into four bands:  $\geq 760$ , 720-759, 680-719, and 620-679. Recent MI pricing, released in April 2016, breaks this same range of credit scores into eight different bands:  $\geq 760$ , 740-759, 720-739, 700-719, 680-699, 660-679, 640-659, and 620-639 (Figure 5).

Finely defined pricing frameworks produce more extreme pricing. Figure 5 below shows the change in basis points borrowers with a given credit score experienced when PMI pricing changes were implemented in April 2016. Some borrowers, those with credit scores above 740, enjoyed a reduction in fees whereas others, almost all borrowers with scores below 680, experienced increases. The cells highlighted in dark green saw a decrease of more than 30 basis points. The cells highlighted in dark orange saw an increase of more than 30 basis points (Figure 5).

**Figure 5. Change in MI pricing by credit score and LTV December 2013 to April 2016**

	97-95.01% LTV 35% Coverage	95-90.01% LTV 30% Coverage	90-85.01% LTV 25% Coverage	85% LTV and under 12% Coverage
$\geq 760$	-50	-13	-9	-4
740-759	-35	-3	-3	-7
720-739	-15	11	6	-4
700-719	-16	-2	3	-6
680-699	9	19	16	-1
660-679	42	27	29	2
640-659	57	35	34	4
620-639	77	46	39	6

From online published rate sheets for Borrower Paid Mortgage Insurance from private mortgage insurers Genworth and Radian for December 2013 and April 2016.

Proposed housing finance systems that rely on deep, upfront private capital to cover credit risk do not provide a countervailing pressure to market incentives to finely and differentially price credit risk. Even in the current system, in which the GSEs have incentives for risk and price pooling, troubling pricing differences prevent credit worthy borrowers from getting mortgages. Unfortunately, the legislative proposals further erode incentives for pooling and are likely to result in even greater differential pricing. This will make it even harder and costlier for credit-worthy borrowers of modest means to afford a mortgage.

<sup>24</sup> As described in *Fannie Mae and Freddie Mac Guarantee Fees: Request for Input*, FHFA, 2015, available at <https://www.fhfa.gov/policyprogramsresearch/policy/documents/gfeerfi060514f.pdf>

**IV. Build on the Extensive Changes Already Made with the HERA, Dodd Frank Act's Ability-to-Repay and QM Rules with a Utility Model**

Congress has already substantially reformed the housing finance system. It can now allow for continued changes through the administrative process because the FHFA is a more effective, stronger regulator for the GSEs that enjoys key enforcement tools to help rein in the abuses of the past. Moving the system to a utility model will build on the substantial reforms of the HERA and the reasonable protections provided through the Dodd-Frank Act's Ability-to-Repay Standard and QM rules.

**A. A Utility Model Will Rein in Risky Profit Seeking Activity**

The structure of the GSEs created a conflict that has been noted by many. While they had public purposes and goals, their structures made them accountable to shareholders who expected maximum returns. This created an incentive for the GSEs to take on more risks to increase returns. It also encouraged the GSEs to focus on the most lucrative segments of the market, underserving small lenders, rural communities, and LMI borrowers. To counteract this conflict, the GSEs should be restructured to operate as a utility that have a regulated rate of return and require the approval of new products and services. The Duty to Serve and Affordable Housing Goals would be maintained as well.

A new utility structure preserves the efficiencies and the key countercyclical role that the GSEs play while protecting private entities from unfair competition. Under this structure, investors are provided a lower, but less volatile, rate of return. Additional advantages include closer oversight of the entities, including regulation of fees, as has been done in conservatorship of the GSEs. This change in structure would prevent the present conflict of interest created by the GSEs' structures.

**1. Additional Reforms Must Include Prohibitions on Political Activities and Lobbying, Vertical Integration, and Portfolio Arbitrage**

Other reforms that would also better align the GSEs with their important public goals include making permanent the ban on their political and lobby activities and continuing the prohibition on any vertical integration of their activities into the retail mortgage market.

It is accurate to say that the GSEs had exploited their implicit government backstop to borrow at advantaged interest rates and used this funding to arbitrage the purchase and holding of an outsized mortgage portfolio. Doing so produced much higher rates of return than just guaranteeing loans that they securitized. However, this action placed additional risk on the books of the GSEs. Such arbitrage should be prohibited, and the GSEs have dramatically reduced the size of their portfolios in recent years under pressure from the FHFA and Congress. However, some portfolio is necessary for the aggregation of TBA loans, the modification of distressed loans and the holding of specialized loans. Borrowing for these limited purposes should continue to be permitted and should be protected in times of stress. Otherwise, when the need for these services is greatest for the benefit of the overall economy, funding will be unavailable or unaffordable.

**2. FHFA Requires the GSEs to be Well Capitalized and Participate in Credit Risk Transfer Programs**

The FHFA has decreased taxpayer risk by requiring that the GSEs enter into credit risk transfers on most of their loans. This action decreases the amount of risk that the GSEs hold and has already increased

private capital in the housing finance system. However, as stated above in the pricing section, front end credit risk transfers promote pricing segmentation and make mortgages less affordable. FHFA should direct the GSEs more towards back end credit risk transfers that will continue to allow them to pool risk.

### **3. The Boards of the GSEs Should Have Designated Public Positions**

To ensure more accountability to the public mission of the GSEs, the boards should have designated public positions. This action will protect the public interest and could include seats for taxpayers, borrowers, and lenders, including community banks and credit unions.

## **V. Current Legislative Proposals to Reform the GSEs will Produce Less Access to Safe and Responsible Credit and Drive Up Cost**

Since the Housing Crash of 2008, there have been various proposals to reform the GSEs. There is broad consensus that any future reforms must make the government backstop explicit and fully paid for, and that access to safe and responsible credit for all credit-worthy borrowers must be a central purpose of a future system. However, how to achieve those goals remains a point of major contention. Existing proposals fall far short of advancing the types of reforms needed to produce a more inclusive housing finance system and as drafted will increase cost for all borrowers by scrapping the system's current affordability mechanisms.

### **A. Preserve Duty-to-Serve and Affordability for All Market Participants**

The statutorily defined duty-to-serve requirements ensure broad availability of mortgage credit throughout the business cycle, which ensures that no region of the nation is left out of the housing finance system. Congress created the obligation within the actual charters of the government sponsored enterprises (GSEs), and they state that the GSEs must "promote access to mortgage credit throughout the nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing".<sup>25</sup> These obligations continue through the Fair Housing Act of 1968, which Congress passed immediately following the death of Dr. Martin Luther King, Jr. who spent a crucial portion of his life working to address housing discrimination.<sup>26</sup> They are carried forward in the Equal Credit Opportunity Act of 1974 (ECOA), and are implemented through the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA) and Housing and Economic Recovery Act of 2008 (HERA).<sup>27</sup> They represent Congress' long-term view that all secondary mortgage market participants have an affirmative duty to further fair lending.

Congress also created the Affordable Housing Goals in 1992 with FHEFSSA and carried them forward in 2008 with HERA to help expand credit access for underserved groups, ensure liquidity in the financial markets, and further fair lending goals.<sup>28</sup> Originally, the goals advanced lending opportunities to low-income families in underserved areas, which resulted in mortgage originators making more affordable

<sup>25</sup> 12 U.S.C. § 1716; 12 U.S.C. § 1451 note.

<sup>26</sup> 42 U.S.C. § 3601 et seq.

<sup>27</sup> 15 U.S.C. § 1691 et seq; 12 U.S.C. 4501 et seq; Pub. L. 110-289 (July 30, 2008).

<sup>28</sup> 12 U.S.C. § 4562 (single-family housing goals)

loans. The affordable housing goals made a tremendous impact on helping credit-worthy borrowers purchase homes. From 2003 through 2012, the National Community Reinvestment Coalition reported that more than 25 million hard-working families nationwide were able to become homeowners due to the goals.<sup>29</sup> Now, they are a metric for accountability by the GSEs' conservator, the Federal Housing Finance Agency, to address underservice to important, and often excluded, market segments such as LMI families, rural communities, and people of color.

Thus, the goals must be strengthened and fully enforced to ensure that their true purpose is realized. They can be a tool for helping to strengthen household wealth in a safe and sound manner while also shoring up economic growth. Further, Congress should continue to require that all participants within the secondary mortgage market be subject to the duty-to-serve mandate and affordable housing goals.

**B. Proposals that Abandon the Public Interest Mandate Will Increase Cost Harming Lower Wealth Families and Smaller Lenders**

Most proposals to reform the GSEs seek an explicit and fully paid for government guarantee for systemic catastrophic loss. Such a public risk requires the granting of an equal public benefit. Yet, most proposals offer untested alternatives to the current system's longstanding affordability provisions that are the result of the incentives that the GSEs must pool risk and price credit risk on a pooled basis. Unfortunately, recent proposals for legislative housing finance reform share a common feature that undermines this pricing approach. Deep upfront credit risk transferred to private capital would incentivize actors to segment, rather than pool, credit risk and prices. Segmented pricing puts mortgage credit out of reach for too many credit-worthy borrowers. Further, the proposals ignore the reality that the broad liquidity provided by the GSEs create the ability for the current system to offer lower costs to all borrowers through the existence of the 30-year fixed rate mortgage which allows for predictable monthly borrower payments.

**1. Corker-Warner Is A Blow to Affordable Housing and Harmful to the Overall Economy**

The most recent draft of the Corker-Warner proposal would jettison the very foundation blocks of the obligations of companies using government backing to promote the public interest, including serving a national market, including rural and urban areas; serving all lenders equitably; including community banks and credit unions.<sup>30</sup> It also undermines fair housing and the ability to increase access to affordable mortgage credit for underserved borrowers.<sup>31</sup> Finally, it repeals and replaces the current system's affordable housing goals and enforcement provisions with unenforceable aspirations and an

<sup>29</sup> National Community Reinvestment Coalition, *Nationwide Benefits from the Affordable Housing Goals*, available at <http://www.ncrc.org/images/PDFs/ahg/nationwide%20ahg.pdf>.

<sup>30</sup> CRL's President Mike Calhoun provides a more in depth analysis on the weaknesses with the Corker-Warner proposal along with the President & CEO of the National Urban League Marc Morial, and mortgage default risk and insurance regulation expert Mike Molesky in *Senate GSE Reform Proposal: A Blow to Affordable Housing and Harmful to the Overall Market*, available at [https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-nul-senate-gse-reform-proposal\\_march2018.pdf](https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-nul-senate-gse-reform-proposal_march2018.pdf).

<sup>31</sup> *Id.*

even explicit prohibition on interfering with the “business judgment” of those receiving and profiting from government backing.<sup>32</sup>

Moreover, the assumptions used in its affordability provisions use narrow scenarios and unreasonable assumptions that tilt the numbers erroneously towards the proposal, while a more neutral analysis shows that those promises are unattainable.<sup>33</sup> When one looks behind the promises, it is clear that this proposal would be a historic setback for affordable housing and harm the overall market.<sup>34</sup>

Central to the Corker-Warner proposal is the notion that the proposed affordability mechanism will result in an additional \$1 billion cross subsidy towards affordable housing through the implementation of the Market Access Fund. To achieve this goal, the fund would collect fees each month from payments of all borrowers, who would, in turn, use them to pay a portion of targeted mortgage payments.<sup>35</sup> This action introduces unnecessary complexity and is unlikely to receive broad bi-partisan support. Further, once the calculations are closely examined it is clear that this formula when applied to current 2016 loan distribution would produce a much smaller outcome.<sup>36</sup> It should be noted that the 2016 distribution has low levels of targeted loans.<sup>37</sup>

The GSEs currently provide \$4 billion of cross subsidy. Moreover, in a more typical and inclusive mortgage market it would be greater.<sup>38</sup> The current system provides nearly twice the amount of subsidy for underserved borrowers than the proposed system.<sup>39</sup>

## 2. Proposed Ginnie Models are Untested and Will Lead to Higher Costs

While proposals for Ginnie Mae models for reform try to strike a public-private hybrid balance, they fail to consider the substantial cost increases of this move. Ginnie Mae is the third GSE. It guarantees the servicing performance of the issuer and not the underlying collateral. It has a full government wrap on the loans that it insures. Extending this wrap is likely to drive up fees as the market will respond to the increased number of participants in the Ginnie program with anxiety.

Further, smaller lenders are disadvantaged with this model as Ginnie has inherent operational complexities that could deter smaller lenders from becoming issuers.

The servicing within the Ginnie program is also far more complex than the existing system and puts enormous financial pressure on servicers, especially in times of economic distress. Ginnie servicers are required to advance missed payments to investors for an unlimited amount of time until the loan is resolved or buy it out of the pool using the servicer’s resources. This buyback scenario requires servicer financing in times of economic distress when loan defaults are heightened. Ginnie already faces difficulty suitably overseeing its large roster of issuers and servicers, which are mostly nonbanks.

---

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 4-5.

<sup>36</sup> *Id.* at 5.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at 5-9.

A recent HUD Inspector General report details these concerns and found that Ginnie was not prepared for the rise in nonbank lending and did not respond to the changes in its lender base. Further, Ginnie does not currently evaluate credit risk. Currently, Ginnie relies on FHA, VA, and Rural Housing to determine that that program underwriting standards are met. With the new model, it would take on the role of determining underwriting and risk on privately guaranteed mortgages along with having to determine and manage the counterpart's risk of the many issuers (it has a limited amount of risk today on VA loans, which do not have 100% insurance, but the counterparty risk is small).

In the Ginnie proposals the goal is to absorb Fannie and Freddie to utilize their expertise to fulfill this requirement. However, the Bright-DeMarco proposal would require that this function continue to be performed under the regulatory authority of the FHFA. This action creates uncertainty.

Finally, a Ginnie model will isolate all affordable mortgage lending to the FHA, VA, and other government insured programs. This action places a higher burden of risk in those programs as they struggle with needed technology and staffing updates. It will also potentially raise cost for nearly all borrowers with the brunt of the weight felt by borrowers with lower credit scores and down payments.

### **C. Ensure Equal Access for Smaller Lenders Including Community Banks in the Housing Finance Reform**

Community banks, credit unions and other small lenders play a critical role in providing mortgages and other financial services on a local basis to American families, and they must be supported by the housing finance system. The current system has many provisions to do this, and these should be continued and expanded. Some proposals for changes in housing finance, though, would strongly tilt the system against these institutions.

Community banks, credit unions, and other small financial institutions deliver mortgages to their customers, along with other essential financial services, in the communities where they are located. As has been noted by many, these institutions have a different business model than larger institutions, often serving local markets and having close relationships with their customers. In rural areas, these institutions play a particularly important role. In many rural communities, community banks and credit unions are the only financial institutions providing retail branches and services in the community. These institutions also focus on traditional banking services and do not engage in many of the complex lines of business that larger institutions do, such as securities issuance, credit default swaps, or proprietary trading.<sup>40</sup> Disruptions to the traditional banking services, such as mortgages, cannot be offset with other products and lines of service. As a result, stress on community banks and their mortgage lending would be felt elsewhere. For example, community banks provide almost half of small business lending, and that is dependent on the overall sustainability of the institutions.

The GSEs provide a number of features that are essential for community banks. First is the GSEs' cash window, which provides lenders the option of selling individual loans. This means that smaller institutions do not have to trade their loans for securities or sell their loans to other large banks. Although many larger lenders trade their loans for GSE securities, this is difficult for small lenders. The

---

<sup>40</sup> These distinctions have been recognized by the CFPB, which created a number of special provisions for these lenders in the mortgage regulations, exempting smaller lenders from many requirements and providing additional flexibility for underwriting and servicing of loans.



securities carry the interest rate risk of the underlying loans and, as a result, can change in value if market interest rates change. An increase in market interest rates would significantly reduce the value of the securities and create a loss for the bank holding the security. Larger institutions can purchase interest rate swaps to hedge this risk, but this is much harder for small lenders to do.

Another advantage of the current cash window is that the GSEs purchase these loans without requiring the transfer of the servicing of the loans to a third party. This enables the community banks and credit unions to continue the relationship with the customer during the life of the loan rather than having the loan serviced by a third party or even a competitor. Private loan purchasers and aggregators often require the seller to transfer the loan servicing to the purchaser. Keeping loan servicing in the hands of the community based financial institutions usually results in better consumer outcomes in terms of customer service and loan performance.

The current cash window also provides comparable pricing to trading for securities. This is critical, as options such as the cash window are viable only if the pricing is at a level that permits community banks to be competitive in the mortgage market. Overall, the mortgage market favors larger lenders and larger transactions, particularly for securities. Sales of large pools of loans are more attractive to buyers of the loans and buyers of the securities backed by the loans. Absent safeguards, large lenders can leverage the government support to use these structural advantages to squeeze community banks and other small lenders out of the market. These important features of the cash window option, which are not available for FHA loans, are a reason that the FHA program, while vitally important, is not a substitute for community banks having access to conventional lending for their full spectrum of customers.

Given the importance of these provisions in the current housing finance system, they should be continued and expanded. However, some of the proposals for housing reform have provisions that would tilt the government supported mortgage market heavily against community banks. While most options preserve some form of a cash window, they do not have the supporting protections that make it workable. Most important is pricing parity with the securities option. If securities trade at a better price, it greatly diminishes the value of the cash window. This is true even if there is a provision that prohibits volume pricing or discounts. If all cash transactions are disfavored to securities, the lack of discounts in either market are of little consolation to community banks who are disproportionately dependent on the cash window transactions. To provide this pricing parity, the guarantor/issuer must have the ability to pool costs across the market. This makes it essential that guarantor/issuers serve a national market and have a duty to equitably serve all lenders. Otherwise, if some guarantors/issuers can choose to cream the market, serving only the large lenders and the most lucrative markets, the remaining guarantors will not have sufficient loans from the full market to be able to provide pricing parity to small lenders and still compete in the overall market. In order to provide this parity, the guarantor/issuers also must be able to pool the credit risk that they hold and reinsure. If all but the catastrophic credit risk is transferred before the loans are purchased by the guarantor/issuers, there is insufficient revenue remaining for the guarantors/issuers to pool the costs and provide viable pricing to small lenders. If substantially all of the credit risk is sold and priced before the loans are acquired by the guarantor/issuer, then these other parties control the access and pricing and they will favor the larger lender transactions, which will be more profitable.

Provisions for a small lender security or issuer are offered in some plans to address this problem, but they are inadequate. Securities resulting from small groups of loans from many lenders will be

measurably more expensive to assemble. They would also still lack the size to create enough loans to provide the large volume of securities for the economies of scale and liquidity that investors in securities desire, and would also reduce the price community banks received for the mortgages.

Other aspects of the mortgage market already have headwinds for community lenders. Many components of the production of mortgages favor large lenders due to their market size. These larger lenders can demand lower prices for many of the third-party services provided to lenders, and overall, they have the advantage of economies of scale over smaller lenders. These conditions make it all the more important that the government elements of the mortgage provide a level playing field and not contribute to the squeezing out of community bank mortgage lending.

#### **VI. Today's Housing Finance System is Rooted in a Legacy of Discrimination and Exclusion**

In an address to Howard University titled "To Fulfill These Rights," President Lyndon B. Johnson offered the following remarks on June 4, 1965:

You do not wipe away the scars of centuries by saying: Now you are free to go where you want, and do as you desire, and choose the leaders as you please.

You do not take a person who, for years, has been hobbled by chains and liberate him, bring him up to the starting line of a race and then say, "you are free to compete with others," and still justly believe that you have been completely fair.

Thus is it not enough just to open the gates of opportunity. All our citizens must have the ability to walk through those gates.<sup>41</sup>

Regrettably, President Johnson's recommendation did not occur within the nation's housing finance system. Race matters in mortgage lending. Federal housing policies created in the twentieth century in response to the Great Depression explicitly discriminated against families of color and denied them access to federally insured mortgage programs. These federal programs helped white families, mostly former immigrant families with European backgrounds, enter homeownership and build a solid foundation to help establish the American middle class. These federal policies granted whites the ability to build wealth through homeownership while denying equal opportunities for families of color to build similar home equity over the same period. As a result, whites built an economic advantage over families of color that has been passed on to future generations through intergenerational wealth transfers. According to a report by Demos, if homeownership rates were the same for whites and people of color we would see a decrease in the racial wealth gap by 31 percent for African-Americans and 28 percent for Latinos.<sup>42</sup> The current mortgage market was built on discriminatory federal housing policies and has yet to offer an equitable solution forward.

#### **A. Homeownership is Critical to Reducing the Persistent and Growing Racial Wealth Gap**

<sup>41</sup> Lyndon B. Johnson: Commencement Address at Howard University: 'To Fulfill These Rights.' Accessed October 23, 2017. <http://www.presidency.ucsb.edu/ws/?pid=27021>.

<sup>42</sup> Tanvi Misra, Why America's Racial Wealth Gap is Really a Homeownership Gap, Demos, March 12, 2015, available at <http://www.demos.org/news/why-americas-racial-wealth-gap-really-homeownership-gap>.

Homeownership is the foundation of the American Dream and is still the primary way that most middle-class families build wealth and achieve economic stability. Wide access to credit is critical for building family wealth, closing the racial wealth gap, and for sustaining the housing market overall—which in turn, contributes significantly to our overall economy. Today, the opportunity to purchase, maintain and refinance a home has not reached significant portions of low-to-moderate income families and people of color. As a result, these families lag far behind wealthier and white communities that received a head start due to historic lending discrimination supported by our federal government’s mortgage policies. These well-documented policies began in 1933 with the underwriting guidelines of the Home Owners Loan Corporation (HOLC) and allowed redlining of African-American and other communities of color, denying them access to mainstream banking services.<sup>43</sup> Examples of the impact of this inequity include the reality that only 2% of FHA insured mortgage loans went to homebuyers of color during the first 35 years of the program due to redlining.<sup>44</sup> Further, the administration of the GI Bill loan programs enacted by Congress in 1944 continued this discrimination.<sup>45</sup> In the state of Mississippi alone, just 2 out of 3,229 VA insured mortgages went to African-Americans servicemembers seeking to finance a home or business in the first three years of the program.<sup>46</sup>

Likewise, the lasting impacts of the Great Recession have eroded the modest increase in homeownership rates that African-American and Latino families enjoyed since the passage of the Fair Housing Act in 1968. Evidence from data provided by the Home Mortgage Disclosure Act suggest that communities of color continue to be underserved by the conventional mortgage market and are more likely than white borrowers to receive FHA loans.<sup>47</sup> At the same time, while FHA remains an important part of the mortgage market, lending backed by Fannie Mae and Freddie Mac is also a critical part of the housing finance system in low-wealth communities, rural communities and communities of color.

The Great Recession exacerbated inequality in wealth distributions. According to the Pew Research Center, in 2012 whites had 13 times the wealth of African-Americans and 10 times the wealth of

---

<sup>43</sup> For a more robust discussion of how federal housing policies benefitted whites while disadvantaging African-Americans and other people of color, see Ta-Nehisi Coates, *The Case for Reparations*, *The Atlantic*, June 2014, *available at* <http://www.theatlantic.com/features/archive/2014/05/the-case-for-reparations/361631/>; Bob Herbert, *Against All Odds: The Fight for the Black Middle Class*, Bob Herbert and Public Square Media, Inc (2016), *available at* <http://www.pbs.org/wnet/chasing-the-dream/films/against-all-odds/>; James Carr and Nandinee Kutty, *Segregation: The Rise Costs for America*, Routledge (2008); Ira Katznelson, *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America*, W. W. Norton & Company (2005); Thomas M. Shapiro, *The Hidden Cost of Being African American: How Wealth Perpetuates Inequality*, Oxford University Press (2004); Melvin L. Oliver and Thomas M. Shapiro, *Black Wealth/White Wealth: A New Perspective on Racial Inequality*, Routledge (1997).

<sup>44</sup> Dedrick Asante-Muhammad, et. al, *The Road to Zero Wealth: How the Racial Wealth Divide is Hollowing Out America's Middle Class*; p. 15, September 2017, *available at* [https://prosperitynow.org/files/PDFs/road\\_to\\_zero\\_wealth.pdf](https://prosperitynow.org/files/PDFs/road_to_zero_wealth.pdf).

<sup>45</sup> *Id.* at. 16.

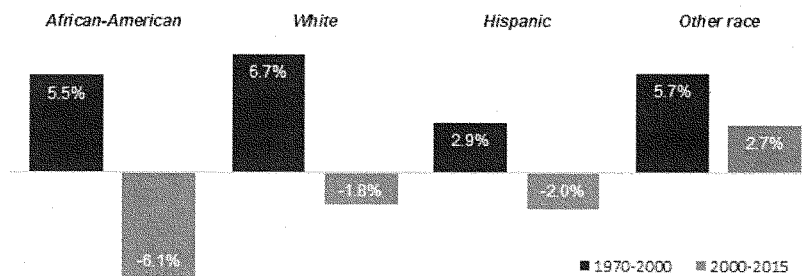
<sup>46</sup> *Id.*

<sup>47</sup> Center for Responsible Lending, *New HMDA Data Show Despite Growing Market, African-Americans and Latinos Remain Underserved* (September 2017) *available at* <http://www.responsiblelending.org/research-publication/new-hmda-data-show-despite-growing-market-african-americans-and-latinos-remain>.

Hispanics.<sup>48</sup> Specifically, whites had a median wealth of \$141,900 compared to \$13,700 and \$11,000 for non-Hispanic whites and African-Americans respectively.<sup>49</sup> Also, the St. Louis Federal Reserve reports that one in nine whites have less than \$1,000 in wealth compared to one in four for Latinos and one in three for African-Americans.<sup>50</sup> Home equity plays a great role in determining a families' wealth and is the furthestmost contributor to the racial wealth gap between whites and people of color.<sup>51</sup>

Unfortunately, the decline in homeownership that followed the Great Recession wiped out thirty years of homeownership gains among African-Americans and substantially reduced the homeownership rate among Hispanics (Figure 6). Between 1970 and 2000, African-American homeownership rate increased 5.5% and the Hispanic homeownership rate increased 2.9%. Since 2000, the homeownership rate decreased 6.1% among African-Americans and 1.8% among Hispanics.<sup>52</sup>

**Figure 6. All gains in African-American homeownership since the Fair Housing Act have been erased since 2000**



Source: Urban Institute. Other race includes Asian Americans, Pacific Islanders, American Indians and Alaska Natives, people who identify as "other," and (starting 2000) people who chose more than one racial identity. Hispanics can be of any race; all other categories are non-Hispanic.

<sup>48</sup> Rakesh Kochhar and Richard Fry, Wealth inequality has widened along racial, ethnic lines since end of Great Recession, Pew Research Center, December 12, 2014, available at <http://www.pewresearch.org/fact-tank/2014/12/12/racial-wealth-gaps-great-recession/>.

<sup>49</sup> *Id.*

<sup>50</sup> Ray Boshara and William Emmons, Stark Disparities in Wealth Are Key in Discussions on Race in the United States, Washington Post, December 30, 2014, available at [https://www.washingtonpost.com/opinions/policies-that-can-bootstrap-the-poor-out-of-the-wealth-gap/2014/12/30/3bf972a6-8f87-11e4-a412-4b735edc7175\\_story.html?utm\\_term=.bfc010a14313](https://www.washingtonpost.com/opinions/policies-that-can-bootstrap-the-poor-out-of-the-wealth-gap/2014/12/30/3bf972a6-8f87-11e4-a412-4b735edc7175_story.html?utm_term=.bfc010a14313).

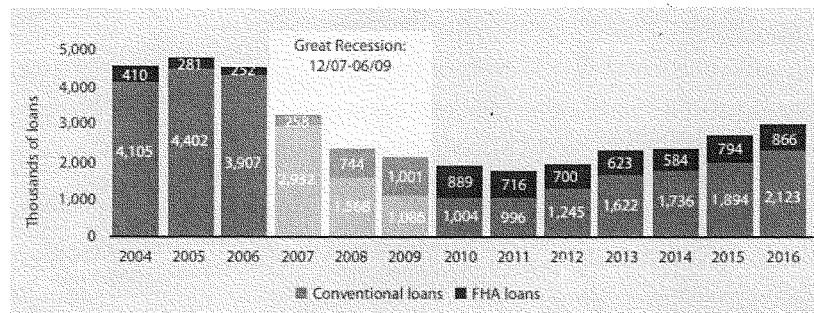
<sup>51</sup> See Shapiro et al., The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide, Institute on Assets and Social Policy, (February 2013).

<sup>52</sup> Goodman, Laurie, Jun Zhu, and Rolf Pendall, Are Gains in Black Homeownership History? Urban Institute, February 14, 2017. <https://www.urban.org/urban-wire/are-gains-black-homeownership-history>.

**B. Evidence From 2016 HMDA Data Suggests that the Current Housing Finance System is Underserving Important Market Segments**

As the housing bubble burst between 2008 and 2012, access to conventional loans decreased dramatically for low- and moderate-income borrowers and borrowers of color. At the same time, FHA stepped in to maintain access to mortgage credit for many underserved homebuyers, as well as ensure toxic subprime loans could be refinanced into more sustainable FHA loans (Figure 7).<sup>53</sup> FHA's loan volume grew quickly following the financial crisis, and this growth helped prevent more foreclosures and even steeper declines in home prices.<sup>54</sup> According to estimates from Moody's Analytics, home prices would have fallen another 25% nationally if FHA had not stepped in.<sup>55</sup> While FHA played a crucial countercyclical role following the crisis and preserved access to credit for underserved borrowers, the conventional market has tightened credit standards and shut out over 6 million creditworthy borrowers between 2009 and 2015.<sup>56</sup>

**Figure 7: Conventional and FHA purchase loans by year, 2004–2016**



Source: CRL calculations of 2004–2016 HMDA purchase loan data

During the recession, as credit standards tightened in the conventional market, the FHA took on a much broader role than it had previously. This was a necessary countercyclical influence in the fallout from the era of subprime mortgages, but it marked changes within both markets. While FHA has historically provided access to credit to lower-income borrowers and first-time homebuyers, it has emerged and remained the mortgage credit source for over 40% of the low-income home purchase market (Figure 8).

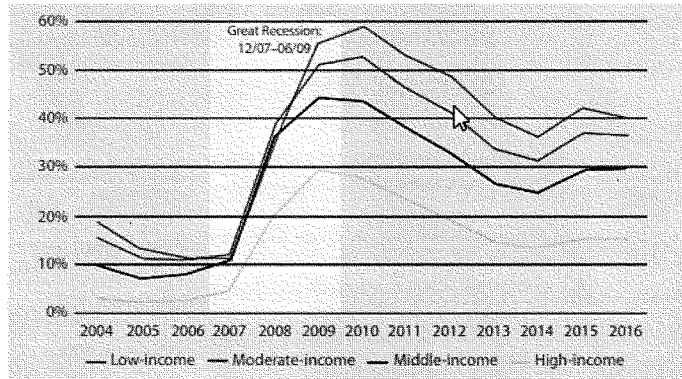
<sup>53</sup> Jared Bernstein, The FHA's Countercyclical Contribution, N.Y. Times, Dec. 16, 2013, <https://economix.blogs.nytimes.com/2013/12/16/the-f-h-a-s-countercyclical-contribution/>.

<sup>54</sup> John Griffith, The Federal Housing Administration Saved the Housing Market, Center for American Progress (Oct. 11, 2012), available at <https://www.americanprogress.org/issues/economy/reports/2012/10/11/40824/the-federal-housing-administration-saved-the-housing-market/>.

<sup>55</sup> Mark Zandi and Cris deRitis, What If There Were No FHA, Moody's Analytics (Oct. 2010), available at <https://www.economy.com/mark-zandi/documents/2010-10-01-What-If-There-Were-No-FHA.pdf>.

<sup>56</sup> Laurie Goodman, Jun Zhu, and Bing Bai, Overly Tight Credit Killed 1.1 Million Mortgages in 2015, Urban Institute (Nov. 21, 2016), available at <https://www.urban.org/urban-wire/overly-tight-credit-killed-11-million-mortgages-2015> (stating that lenders would have issued 6.3 million additional mortgages between 2009 and 2015 if lending standards had been more reasonable).

Figure 8: FHA share of all purchase loans made by income category, by year, 2004–2016

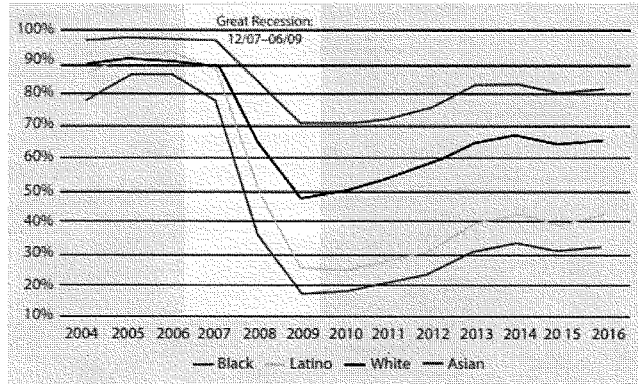


Source: CRL calculations of 2004–2016 HMDA purchase loan data

Since the Great Recession, the share of conventional loans made to borrowers of color has declined precipitously and failed to recover at the same rate it has for white borrowers. In 2006, Black, Asian, Latino, and white borrowers each received more than 85% of their purchase loans from the conventional market. By 2009, conventional lending market share among Black borrowers had declined dramatically, with Black borrowers receiving just 18.2% of their loans from the conventional market—less than half the rate of conventional lending to white borrowers. While the 2006 conventional market included some of the most problematic subprime loans,<sup>57</sup> this cannot explain the post-recession difference in conventional lending between white borrowers and borrowers of color (Figure 9).

<sup>57</sup> Marshall Lux and Robert Greene, What's Behind the Non-Bank Mortgage Boom?, Harvard Kennedy School Mossavar Rahmani Center for Business and Government (June 2015), at 2, *available at* [https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/42\\_Nonbank\\_Boom\\_Lux\\_Greene.pdf](https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/42_Nonbank_Boom_Lux_Greene.pdf).

Figure 9: Conventional share of all purchase loans by race/ethnicity category, by year, 2004–2016

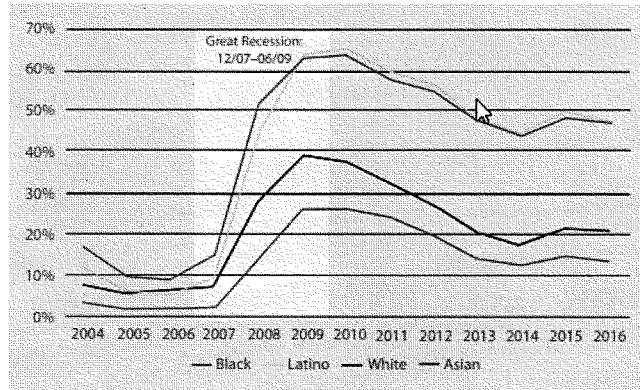


Source: CRL calculations of 2004–2016 HMDA purchase loan data

As conventional lending to borrowers of color steeply declined between 2006 and 2009, the FHA share of lending to borrowers of color increased and remains high. While the share of FHA purchase lending made to Black and Latino borrowers has exceeded the share of FHA purchase lending to white borrowers since 2004, the FHA share to borrowers of color also grew at a faster rate during the recession and has remained persistently high.<sup>58</sup> In 2016, Black and Latino borrowers received nearly half their purchase mortgage loans from FHA, while white borrowers received less than a quarter of theirs and Asian borrowers received under 14% (Figure 10).

<sup>58</sup> The only exception was the 2005–06 FHA, which made a higher percentage of white borrowers' loans than those of Latino borrowers.

Figure 10: FHA share of all purchase loans by race/ethnicity category, by year, 2004–2016



Source: CRL calculations of 2004–2016 HMDA purchase loan data

As historically FHA-reliant low- and moderate-income borrowers continue to rely on FHA lending for access to purchase mortgage credit, there are similar FHA lending patterns among borrowers of color. In 2006, Black, Asian, Latino, and white borrowers each received more than 85% of their purchase loans from the conventional market. By 2009, conventional lending market share among Black borrowers had declined dramatically, with Black borrowers receiving just 18.2% of their loans from the conventional market—less than half the rate of conventional lending to white borrowers.

While the overall market share for these programs continues to decline as the market improves, the rate at which people of color rely on these programs has not diminished. Government-insured loans, such as FHA, have clearly been an important source of credit post-crisis. FHA mortgages are a primary source of credit for African-Americans and Latino home purchasers. However, compared to conventional loans these loans can be costlier over the life of the loan. Further, increasingly, lenders have also been less willing to make these loans.

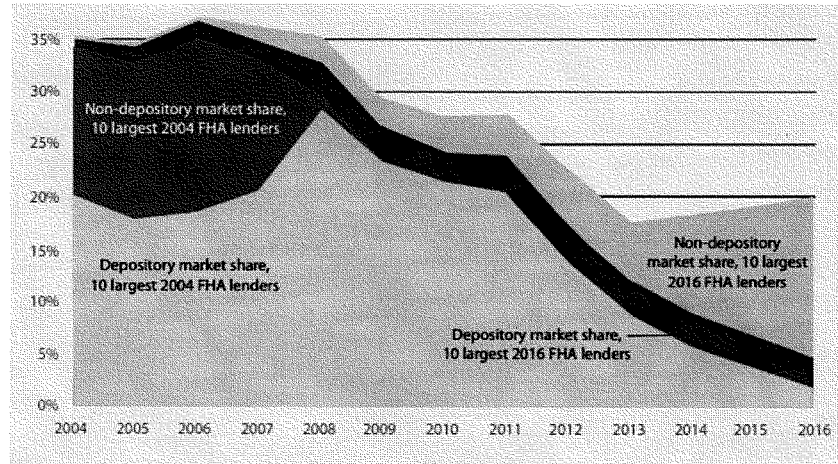
As banks have exited the FHA market or reduced their FHA lending, the market share of the 10 largest lenders has declined, and nonbank lenders have become the dominant market segment.<sup>59</sup> In 2004, the top 10 FHA lenders held a 34% share of the total FHA home purchase market, and by 2016 the market share of the largest lenders declined to just over 18%. Of the 10 largest FHA home purchase lenders in

<sup>59</sup> Michele Lerner, The Mortgage Market is Now Dominated by Non-Bank Lenders, Washington Post, Feb. 23, 2017, [https://www.washingtonpost.com/realestate/the-mortgage-market-is-now-dominated-by-nonbanklenders/2017/02/22/9c6bf5fc-d1f5-11e6-a783-cd3fa950f2fd\\_story.html?utm\\_term=.577814ac35f5](https://www.washingtonpost.com/realestate/the-mortgage-market-is-now-dominated-by-nonbanklenders/2017/02/22/9c6bf5fc-d1f5-11e6-a783-cd3fa950f2fd_story.html?utm_term=.577814ac35f5).



2004, no lender remained in the top 10 by 2016 (Figure 11). At the same time, the share of non-depositories increased dramatically.<sup>60</sup>

**Figure 11. FHA purchase lending of the top 10 largest FHA purchase lenders in 2004 and 2016, before and after the financial crisis**



Source: CRL calculations of 2004–2016 HMDA purchase loan data

While FHA cannot be the major source of mortgage credit for borrowers of color, these programs are critical and deserve ongoing federal support. The FHA program must be adequately funded and modernized to ensure its viability. However, these data also underscore the urgent need for federal regulators to better enforce fair lending requirements to ensure a more robust conventional mortgage market that serves borrowers of color.

Market indicators highlight how tight lending standards have become, especially for conventional mortgages. These trends help explain the remarkably low levels of conventional loans that made to African-American and Latino borrowers in 2016. As noted, last year only 3.1% of conventional loans were made to African-American borrowers, and only 5.8% were made to Hispanic white borrowers. By contrast, non-Hispanic white borrowers received 70.2% of the conventional loans.

<sup>60</sup> For a further discussion of the market participants in the FHA market, see Stegman, Melissa, and Peter Smith. Repairing a Two-Tiered System: The Crucial but Complex Role of FHA. Center for Responsible Lending (May 2018). <https://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-repairing-two-tiered-system-fha-may2018.pdf>.

In 2016 the average credit score for all new loan originations fell from its high of 750 in 2013 to stand at 732 in December of 2016. However, the average score remained about 33 pts above the average score a decade before.<sup>61</sup> At the same time, market-level credit availability indices continue to show that lenders have a very low tolerance for taking reasonable risk for new loans.<sup>62</sup> Recent vintages of new mortgages (loans originated from 2011-2015) have had near zero rates of default.<sup>63</sup>

These tight credit standards are preventing homeownership opportunity for credit-worthy borrowers of color and low- to moderate-income borrowers. Recent data released by Fannie Mae show that loans to low-income borrowers originated from 2010-2015 had a default rate of just 0.3 percent, approximately equal to that of loans to high-income borrowers originated from 2002-2004.<sup>64</sup> There is ample opportunity in the mortgage market to expand lending to borrowers while still offering responsible loans that borrowers can successfully repay.

## **VII. Housing Finance Reform Must Address Prior Discrimination in the System**

Discrimination within the nation's housing finance system is well documented and a significant contributor to the current racial wealth gap that plagues our nation today. This discrimination harms the market by curtailing credit-worthy borrowers from accessing loans in a marketplace that is safer; has historically low interest rates; and relatively lower housing costs than the times leading up to the Great Recession. Action is needed now to reduce unnecessary restrictions on mortgage credit access such as excessive risk-based pricing. Thus, the FHFA's loan level price adjustments (LLPAs) must be eliminated.

### **A. The Future of the Market Depends on Mortgage Providers Meeting Their Duty-to-Serve Obligations**

Existing homeowners, especially older Americans, will need buyers when they want to sell, and new families need access to affordable mortgage credit to buy their homes. In the future, homebuyers will be more racially and ethnically diverse than they have been in the past. Harvard's Joint Center for Housing Studies found that non-whites accounted for 60 percent of household growth from 1995-2015 and predicted that half of millennial households by 2035 will be non-white.<sup>65</sup> The mortgage market will need

<sup>61</sup> Laurie Goodman et.al., *Housing Finance at a Glance: A Monthly Chartbook* (March 2017), *available at* <https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-march-2017/view/full-report>.

<sup>62</sup> *Id.*; Mortgage Bankers Association, *Mortgage Credit Availability Index* (2017), *available at* <https://www.mba.org/newsresearch-and-resources/research-and-economics/single-family-research/mortgage-credit-availability-index>.

<sup>63</sup> Laurie Goodman, *Squeaky Clean Loans Lead to Near-Zero Borrower Defaults – And That is Not a Good Thing*, Urban Institute (Aug. 31, 2016), *available at* <http://www.urban.org/urban-wire/squeaky-clean-loans-lead-near-zero-borrower-defaults-and-not-good-thing>.

<sup>64</sup> Fannie Mae 2016 Annual Housing Activities Report and Annual Mortgage Report, chart at page 19, *available at* <https://www.fhfa.gov/PolicyProgramsResearch/Programs/AffordableHousing/Documents/Fannie-Mae-2016-AHAR-AMR-FINAL.pdf>.

<sup>65</sup> Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 2017*, June 2017, *available at* <http://www.jchs.harvard.edu/research/state-nations-housing>.

to find ways to serve borrowers of color and lower-wealth borrowers to sustain a robust market in the coming years.

Responsible and affordable refinance loans are also crucial to allowing borrowers to preserve homeownership. Recent history shows this to be the case, as toxic refinance loans helped spur the housing crisis. In fact, 90 percent of borrowers who took out subprime loans from 1998 to 2006 were already homeowners.<sup>66</sup> Yet, discrepancies persist in access to refinance mortgages as well as purchase mortgages. In fact, while very modest gains were made in 2016 in the access of borrowers of color to purchase mortgages, these gains did not carry over for African-American and Hispanic white borrowers, relative to the growing refinance market. In addition to making loans broadly available for home purchase, responsible and affordable refinance mortgages need to be broadly available to support sustained homeownership.

#### **B. The Federal Housing Finance Agency Must Eliminate Loan Level Price Adjustments**

Following the mortgage crisis of 2008, which was found to be caused by Wall Street's appetite for excessive profits, market overcorrections emerged that led to excessive pricing of risk in the system. FHFA instituted LLPAs to offset risk from borrowers with lower credit profiles and smaller down payments, despite compelling evidence that when provided with safe and affordable mortgage loans, these borrowers perform well. Further, these increased fees disproportionately impact potential homebuyers of color and low-to-moderate income families whose ability to save for down payments and credit profiles have been negatively impacted by discrimination and lack of opportunity in the mortgage market that has been previously been discussed.<sup>67</sup>

Moreover, families of color and LMI communities have been deeply harmed by irresponsible lending in the last decade. Predatory mortgage lending dominated formerly redlined communities and, the brunt of the impact was experienced in communities of color across the nation. The Center for Responsible Lending's research on the effects of subprime lending found that a disproportionate number of foreclosures occurred in communities of color — even when these borrowers qualified for less expensive and sustainable mortgage loans.<sup>68</sup> Core Logic reports that 7.8 million foreclosures have been completed.<sup>69</sup> The post foreclosure spillover costs within communities of color totaled \$1 trillion

---

<sup>66</sup> Maura Reynolds, Refinancing spurred subprime crisis, Los-Angeles Times (July 5, 2008), available at <http://articles.latimes.com/2008/jul/05/business/fi-refi5>; Amir Khandani, Andrew Lo, and Robert Merton, Systemic Risk and the Refinancing Ratchet Effect, National Bureau of Economic Research Working Paper No. 15362 (Sept. 2009), available at <http://www.nber.org/papers/w15362>

<sup>67</sup> For a more detail discussion of how discrimination contributes to lower credit scores for borrowers of color see, Racial Justice Project of the National Consumer Law Center, Past Imperfect: How Credit Scores and Other Analytics "Bake In" and Perpetuate Past Discrimination, May 2016 available at [https://www.nclc.org/images/pdf/credit\\_discrimination/Past\\_Imperfect050616.pdf](https://www.nclc.org/images/pdf/credit_discrimination/Past_Imperfect050616.pdf).

<sup>68</sup> Debbie Gruenstein Bocian, Wei Li, and Keith S. Ernst, Foreclosures by Race and Ethnicity: The Demographics of a Crisis, June 18, 2010, available at <http://www.responsiblelending.org/mortgage-lending/research-analysis/foreclosures-by-race-and-ethnicity.pdf>

<sup>69</sup> <http://www.corelogic.com/about-us/news/corelogic-issues-us-residential-foreclosure-crisis-decade-in-review.aspx>.

dollars.<sup>70</sup> These losses were not to homeowners who actually suffered a foreclosure but to their neighbors who lived in close proximity to homes that had been foreclosed upon.

Today, rather than remediate the damage done by abusive subprime lending and its disproportionate impact on communities of color, lenders and FHFA responded by closing off lending options for these communities. The Urban Institute reports that from 2009-2014 there were 5.2 million mortgage loans missing from the secondary market system due to unnecessarily overly tight credit restrictions put in place by the GSEs.<sup>71</sup>

### **C. Maintain Flexibility in Determining Down Payments and Creating Initiatives to Fuel Lending**

Removing regulator flexibility in establishing down payments in housing finance reform and mandating down payments would unnecessarily restrict access to credit for lower-wealth families. As an initial matter, these mandates overlook the fact that borrowers must also save for closing costs – roughly 3 percent of the loan amount – on top of any down payment required. And, the mandates would increase the number of years that borrowers would need to save for a down payment. An analysis by the Center for Responsible Lending demonstrates that it would take the typical family 17 years to save for a 10 percent down payment and 11 years to save for a 5 percent down payment.<sup>72</sup> This time frame is greatly expanded for African-American and Latino borrowers. Considering that many of these households have limited wealth, down payment mandates could significantly reduce the number of future first-time homebuyers.<sup>73</sup> This reduced pool of buyers could lead to lower home prices, more difficulty selling an existing home, and even some existing borrowers defaulting on their mortgage.

<sup>70</sup>Debbie Gruenstein Bocian, Peter Smith and Wei Li, *Collateral Damage: The Spillover Costs of Foreclosures*, October 24, 2012, available at <http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/collateral-damage.pdf>.

<sup>71</sup>Bing Bai, Laurie Goodman, Jun Zhu, *Tight credit standards prevented 5.2 million mortgages between 2009 and 2014*, Urban Institute, January 28, 2016, available at <https://www.urban.org/urban-wire/tight-credit-standards-prevented-52-million-mortgages-between-2009-and-2014>.

<sup>72</sup>CRL years-to-save calculations are based on purchase of a 2011 median priced house (\$173,600) by borrower with median income in 2011 (\$50,502). Assumes an annual savings rate dedicated for down payment of 2.6%. Median income for 2011 is from American Community Survey. Savings rate assumption is derived from the Bureau of Economic Analysis's (the 1-year average of the BEA's personal savings rate from July 2012-July 2013 is 4.9 percent; the 20-year average was 5.0 percent). However, the BEA's rate is based on take home, not gross, income, and therefore, a 5.0 personal savings rate translates to a 3.6 percent rate for gross income, assuming a combined federal, state and local tax rate of 28 percent (see effective tax burden for the middle [http://www.nytimes.com/2012/11/30/us/most-americans-face-lower-tax-burden-than-in-the-80s.html?pagewanted=all&\\_r=2&](http://www.nytimes.com/2012/11/30/us/most-americans-face-lower-tax-burden-than-in-the-80s.html?pagewanted=all&_r=2&)). Assumes that, of this 3.6 percent, 1 percentage point must be used by families for retirement, college, and emergencies, leaving 2.6% available for homeownership savings.

<sup>73</sup>See *The State of the Nation's Housing*, Joint Center for Housing Studies, at 3 (2013) (stating that "[m]inorities—and particularly younger adults—will also contribute significantly to household growth in 2013–23, accounting for seven out of ten net new households. An important implication of this trend is that minorities will make up an ever-larger share of potential first-time homebuyers. But these households have relatively few resources to draw on to make downpayments. For example, among renters aged 25–34 in 2010, the median net wealth was only \$1,400 for blacks and \$4,400 for Hispanics, compared with \$6,500 for whites. Even higher-income minority renters have relatively little net wealth, with both blacks and Hispanics in the top income quartile having less than half the

Not only is there a huge cost to legislatively mandating down payments, but there is also a limited benefit in terms of reducing default rates. When looking at loans that already meet the product requirements for a Qualified Mortgage, a UNC Center for Community Capital and CRL study shows that these requirements cut the overall default rate by almost half compared with loans that did not.<sup>74</sup> Layering on a down payment requirement on top of these protections produces a marginal benefit.<sup>75</sup> This makes sense, because risky product features and poor lending practices caused the crisis by pushing borrowers into default, and the Dodd-Frank Act reforms address these abuses. The Qualified Mortgage and Ability to Repay reforms restrict risky features such as high fees, interest-only payments, prepayment penalties, yield-spread premiums paid to mortgage brokers, lack of escrows for taxes and insurance for higher priced mortgage loans, teaser rates that spiked to unaffordable levels even with constant interest rates and outlawing no-doc loans. These reforms address the unaffordable and abusive loan products that caused the crisis.<sup>76</sup>

**D. The U.S. Commission on Civil Rights Should Convene Hearings to Investigate the Impact of Mortgage Discrimination Within the Nation's Housing Finance System on Families of Color**

Throughout these remarks, the federal government's role in furthering housing discrimination within the mortgage market has been described. Now, is the appropriate time to fully investigate the impact of those discriminatory practices on the ability of families of color to build wealth through homeownership in an equitable manner with whites. According to recent research by Prosperity Now, it will take 228 years for the average African-American family to reach the level of wealth white families own today.<sup>77</sup> For the average Latino family, matching the wealth of white families will take 84 years.<sup>78</sup> The U.S. Commission on Civil Rights should convene hearings to probe and complete an official record of this discrimination similar to work done by the Financial Crisis Inquiry Commission following the Housing Crash of 2008. Once an official record is completed, Congress should request that the Congressional

---

average net wealth of whites. Proposed limits on low-downpayment mortgages would thus pose a substantial obstacle for many of tomorrow's potential homebuyers.").

<sup>74</sup> Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012) (stating that "[l]oans consistent with the QM product features—which include both prime and subprime loans—have fared extremely well, with just 5.8 percent of loans either 90+ days delinquent, in the foreclosure process, or foreclosed upon as of February 2011. In comparison, the default rate for prime conventional loans in our sample was 7.7 percent, nearly two percentage points higher...[T]he rates for the subprime and Alt-A market segments [were] 32.3 and 22.3 percent, respectively.") (available at <http://www.responsiblelending.org/mortgage-lending/researchanalysis/Underwriting-Standards-for-Qualified-Residential-Mortgages.pdf>).

<sup>75</sup> *Id.* at 18.

<sup>76</sup> See Debbie Gruenstein Bocian, Wei Li, Carolina Reid, and Roberto G. Quercia, *Lost Ground, 2011: Disparities in Mortgage Lending and Foreclosures*, Center for Responsible Lending and UNC Center for Community Capital (November 2011), available at <http://www.responsiblelending.org/mortgagelending/research-analysis/Lost-Ground-2011.pdf>.

<sup>77</sup> Dedrick Asante-Muhammad, et.al., *The Road to Zero Wealth: How the Racial Wealth Divide is Hollowing Out America's Middle Class*, Prosperity Now, p. 5, September 2017, available at [https://prosperitynow.org/files/PDFs/road\\_to\\_zero\\_wealth.pdf](https://prosperitynow.org/files/PDFs/road_to_zero_wealth.pdf).

<sup>78</sup> *Id.*

Budget Office issue a report on the economic impact of the discrimination and offer legislative action that directly addresses this discrimination.

#### **VIII. Conclusion**

This year, our nation celebrates 50 years of the passage of the federal Fair Housing Act of 1968. Many of the promises of that important legislation have yet to be realized, especially within the nation's housing finance system. Congress has a unique opportunity to reform the secondary mortgage market in a more equitable manner. Such action will allow far more American citizens the opportunity to thrive and keep smaller lenders on equal footing with large national banks. Congress must also act with extreme care and build upon existing reforms that have stabilized the marketplace and made it safe for consumers and lenders alike.



Testimony of  
**Edward J. DeMarco**  
President of the Housing Policy Council

House Financial Services Committee

Hearing on:

“A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk”

Thursday, September 6, 2018

Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

It is an honor to be here. My name is Ed DeMarco. I am the President of the Housing Policy Council, a trade association comprised of 30 of the nation's leading firms in housing finance. Ten years ago, I was the Senior Deputy Director and Chief Operating Officer at the Federal Housing Finance Agency, an agency I would later lead as Acting Director for 4.5 years.

Today's ten-year anniversary of the failures and conservatorships of Fannie Mae and Freddie Mac is not a cause for celebration. What happened ten years ago to Fannie Mae and Freddie Mac had been forecast by some but denied as a possibility by many. Yet, Fannie Mae and Freddie Mac did fail, and taxpayers were forced to take on extraordinary financial risks bailing them out. Moreover, the fundamental challenge posed by their failure remains today – how best should the United States Congress replace this inherently flawed structure with a far more resilient structure that puts mortgage credit risk on the private sector, not taxpayers.

My remarks cover four broad topics:

1. What happened ten years ago
2. What has improved and what has gotten worse
3. Why Congress still must act and what can Congress build upon
4. What could be accomplished administratively to assist Congress and markets

#### **September 2008 – A Look Back**

On July 30, 2008, Congress passed the Housing and Economic Recovery Act (HERA) that established the Federal Housing Finance Agency (FHFA) to replace the Office of Federal Housing Enterprise Oversight (OFHEO). Less than six weeks later, on September 6, 2008, FHFA used its new authorities in conjunction with the U.S. Department of the Treasury to place the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation into conservatorships. While these companies are more commonly known by their nicknames, Fannie Mae and Freddie Mac, I want to emphasize their formal names for the first word in those names – Federal. Where did that come from? It came from Congress. Congress created these companies, named them, wrote their charter, gave them their purpose, and endowed them with numerous benefits and privileges unavailable to other private firms.

This unique legal structure gave rise to the companies being referred to as Government-Sponsored Enterprises, or GSEs. Despite their private corporate status, with their shares trading on the New York Stock Exchange, Fannie Mae and Freddie Mac often were perceived as extensions of the U.S. government and they exercised substantial influence over policymakers. This gave rise to the frequently referenced, but officially denied, implicit guarantee of Fannie Mae and Freddie Mac securities. When the crisis hit, Congress authorized Treasury to extend substantial financial assistance to the companies. While at one level this was a bailout of the companies' debt and mortgage-backed securities holders (but not shareholders), at another level it was the long-predicted realization of the implicit government backing.

By September 2008, both the systemic risk and the conflicts of interest embedded in the GSE model – a public mission yet private shareholder interests to satisfy – could no longer be ignored. The markets spoke. Despite the quasi-governmental structure, market participants questioned



the firms' solvency; the GSEs were unable to raise new equity and the debt markets were closing off to them, giving rise to significant liquidity concerns.<sup>1</sup>

In creating FHFA, Congress provided new regulatory authority to put these two companies into conservatorship or into receivership and broad authority with respect to managing the conservatorships. But it did NOT give FHFA the authority to amend or extinguish these two charters, nor did it allow additional charters to be created. Even in the event of a receivership, Congress required that FHFA set up a bridge institution and re-establish the failed company under the same name with the same charter, rights, privileges and so on. In short, Congress created these two companies and Congress reserved for itself the authority to change them.

That bit of history helps explain the closing statement made by Treasury Secretary Paulson on September 7, 2008, in announcing the conservatorships along with my then boss, FHFA Director Lockhart. These words demand our attention ten years later:

Through the four actions we have taken today, FHFA and Treasury have acted on the responsibilities we have to protect the stability of the financial markets, including the mortgage market, and to protect the taxpayer to the maximum extent possible.

And let me make clear what today's actions mean for Americans and their families. **Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that a failure of either of them would cause great turmoil in our financial markets here at home and around the globe.** This turmoil would directly and negatively impact household wealth: from family budgets, to home values, to savings for college and retirement. A failure would affect the ability of Americans to get home loans, auto loans and other consumer credit and business finance. And a failure would be harmful to economic growth and job creation. That is why we have taken these actions today.

While we expect these four steps to provide greater stability and certainty to market participants and provide long-term clarity to investors in GSE debt and MBS securities, our collective work is not complete. At the end of next year, the Treasury temporary authorities will expire, the GSE portfolios will begin to gradually run off, and the GSEs will begin to pay the government a fee to compensate taxpayers for the on-going support provided by the Preferred Stock Purchase Agreements. **Together, these factors should give momentum and urgency to the reform cause. Policymakers must view this next period as a "time out" where we have stabilized the GSEs while we decide their future role and structure.**

**Because the GSEs are Congressionally-chartered, only Congress can address the inherent conflict of attempting to serve both shareholders and a public mission. The new Congress and the next Administration must decide what role government in general, and these entities in particular, should play in the housing market. There is a consensus today that these enterprises pose a systemic risk and they cannot continue in their current form.** Government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. And policymakers must address the issue of systemic risk. I recognize that there are strong differences of opinion over the role of government in supporting housing, **but under any course policymakers choose, there are ways to structure these entities in order to address market stability in the transition and limit**

<sup>1</sup> See Statement of FHFA Director James Lockhart before the House Financial Services Committee, September 25, 2008. <https://www.fhfa.gov/Media/PublicAffairs/Pages/Statement-of-James-B-Lockhart-III-Director-FHFA-Before-the-US-House-Committee-on-Financial-Services.aspx>

**systemic risk and conflict of purposes for the long-term. We will make a grave error if we don't use this time out to permanently address the structural issues presented by the GSEs.<sup>2</sup>**

We are here today, ten years later, to consider how Congress can respond to this call for action. While I will turn now to the advances that have been made in these ten years, and the opportunities to make further advances administratively, make no mistake: the job is not done until Congress acts. And the status quo is not a long-term answer.

### **We've Taken Steps Forward ... Yet Systemic Risk is Growing, Not Fading**

#### *Positive Developments Building for the Future*

During my tenure as FHFA's Acting Director and as Conservator of Fannie Mae and Freddie Mac, I submitted numerous letters and reports to this Committee. I also testified before the Committee on several occasions. I sometimes describe the course of the conservatorships as chapters in a book, with themes, priorities, and goals evolving over time and adapting to evolving circumstances.<sup>3</sup>

The early chapters of the conservatorship saga focused on establishing and maintaining market stability and liquidity. At the time, this was no small feat and there were many anxious moments awaiting the response of market participants here and abroad to the conservatorships. We also were deeply concerned with the response of home buyers, lenders, and Fannie Mae and Freddie Mac employees themselves, who were needed to maintain the ongoing operations of the two firms. Notwithstanding this unprecedented government action, there was no guarantee of success. Fortunately, our efforts were effective – liquidity was maintained in the secondary mortgage market for Fannie Mae and Freddie Mac mortgage-backed securities, new loans continued to be securitized, and confidence gradually returned.

The next chapters were the most challenging. As the recession worsened, house prices continued to fall, and mortgage delinquencies soared, our priority was assisting troubled homeowners avoid foreclosure while minimizing taxpayer losses. The FHFA team, working with the GSEs, continually tested, measured, and evaluated our efforts, working collaboratively with a wide range of government and private entities in search of tools that worked. The quality and results of our collective efforts improved with time and experience. FHFA recently reported that more than 4 million total foreclosure prevention actions and 3.5 million HARP refinances have been completed on GSE loans over these ten years.<sup>4</sup>

<sup>2</sup> "Statement by Treasury Secretary Henry Paulson on Treasury and Federal Housing Finance Agency action to protect financial markets and taxpayers," September 7, 2008. <https://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx> (emphasis added).

<sup>3</sup> "FHFA Sends Congress Strategic Plan for Fannie Mae and Freddie Mac Conservatorships," News Release dated February 21, 2012 with an accompanying letter to Congress and report titled "A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending." <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Sends-Congress-Strategic-Plan-for-Fannie-Mae-and-Freddie-Mac-Conservatorships.aspx>

<sup>4</sup> For industry data on loan modifications encompassing more than the GSEs, see, for example, data published by HOPE NOW. [http://www.hopenow.com/industry-data/HopeNow.FullReport.Updated\(June2018\).pdf](http://www.hopenow.com/industry-data/HopeNow.FullReport.Updated(June2018).pdf)

A new chapter in the saga of the conservatorships began in 2012 with the release of the first Strategic Plan for the conservatorships.<sup>5</sup> FHFA directed a series of actions designed to further limit risk to the taxpayers, prepare the companies for final resolution, and build an infrastructure for the housing finance system that would facilitate the return of private capital and support Congressional action. Some of these initiatives are well-known to this committee, others less so. Key initiatives included:

- **Credit Risk Transfers (CRT).** The first CRT transaction was completed in 2013. Today, FHFA reports that more than 90 percent of standard, 30-year fixed rate mortgages securitized by Fannie Mae and Freddie Mac involve some form of credit risk transfer. This is a critically important development for the market and for taxpayers. For the market, CRT represents the formation of a credit market backed by private capital to hold mortgage credit risk. For taxpayers, CRT shifts some degree of Fannie Mae and Freddie Mac's mortgage credit risk to private investors, drawing private capital in to supplement taxpayer capital.
- **The Uniform Mortgage Data Program (UMDP).** Initiated in 2010, this is the umbrella title for a series of data initiatives aimed at simplifying and standardizing certain data collection and reporting processes. Always understood to be a long-term set of initiatives aimed at improving data quality while lowering collection costs, improving data accuracy, and reducing barriers to entry, many of the individual initiatives are completed and operating in the marketplace today. Since data is foundational to underwriting and financial risk management, this program has been a significant, positive development for the housing finance system.
- **Underwriting Standards.** In the years leading up to the conservatorships, Fannie Mae and Freddie Mac lowered their underwriting standards, thereby increasing their risk profile. Post-conservatorship, FHFA ensured this weakening was reversed although there are signs that standards have been weakening again.
- **Pricing (Guarantee Fees, or G-Fees).** Fundamentally, Fannie Mae and Freddie Mac operate as financial guarantors of mortgages. By guaranteeing that investors in their mortgage-backed securities will not lose principal and interest, even if the underlying mortgage defaults, Fannie Mae and Freddie Mac assume that credit risk. Pre-crisis, the companies vastly underpriced this risk. Since conservatorship, and at FHFA's direction, they have gradually increased their g-fee pricing although the current pricing, at least in some segments, may be lower than what private markets backed by private capital would require.<sup>6</sup> Any underpricing should be understood as a subsidy provided by taxpayers as well as a subsidy provided by lower risk borrowers to higher risk borrowers.
- **Common Securitization Platform (CSP).** Prior to the crisis and up to today, Fannie Mae and Freddie Mac have operated separate, proprietary platforms for "manufacturing" mortgage-backed securities. Those securities have distinct rules governing when investors get paid, what information is disclosed to them, and how their interests are

<sup>5</sup> Ibid.

<sup>6</sup> As required by statute, FHFA produces an annual report on guarantee fees. Each year the report shows that the pricing of new loan acquisitions falls short of that needed to meet target returns for lower credit quality loans and for 30-year fixed rate mortgages relative to other mortgages. See FHFA's latest annual report: "Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2016," October 2017. <https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFeeReport10172017.pdf>

protected. In 2012, FHFA determined that neither of these proprietary platforms was capable of supporting a future securitization market. We concluded that the most efficient way to invest taxpayer dollars in upgrading the outdated technology was to build a new, open-architecture, standardized system that could be a cornerstone for a post-conservatorship secondary market. Today, the CSP remains under development, with only Freddie Mac using some of its features to-date. FHFA projects both GSEs utilizing the CSP next year, with the introduction of the uniform MBS. While the CSP has not developed at the pace or in the way that I and others had envisioned, it remains an important development upon which to build for the future.

- Disclosures. Prior to the conservatorships, one indicator of investor reliance on implicit taxpayer support of Fannie Mae and Freddie Mac debt was the very weak disclosure regime. Fannie Mae published no loan level data on the mortgages in its MBS and Freddie Mac published very little. An important development since, in part aligned with the introduction of CRT, has been the movement to provide more loan level disclosure to the market. Also, as part of initiating CRTs, FHFA directed the two companies to release millions of historical loan level data files to assist the market in calibrating models to support CRT investment. This is also an important development although there is much unfinished business here that I will return to later in my testimony.

#### *The Current State of the Mortgage Market*

In conservatorship, investor confidence in Fannie Mae and Freddie Mac mortgage-backed securities and debt stems from the Treasury commitment, which assures them that the American taxpayer will make good on the companies' obligations. In other words, it is the pledge of capital from the U.S. taxpayer that bolsters the profitability of these companies, funding their extensive technology investments, expanded lines of business, personnel and facilities enhancements, and other growth strategies.

A gradually recovering economy combined with taxpayer support of Fannie Mae and Freddie Mac, foreclosure prevention efforts, and substantial federal intervention, such as Federal Reserve purchases of MBS, have all contributed to the strengthening of our housing markets and liquidity in the housing finance system. The Federal Housing Administration (FHA) and Veterans Affairs (VA) mortgage guarantee programs also have grown substantially during this time, lending additional support to the recovery.

According to the FHFA purchase-only index, U.S. housing prices peaked in April 2007 before dropping more than 20 percent over the next four years. Since then, national house prices have generally recovered and now surpass the 2007 peak level.<sup>7</sup> However, there really is not a national market for houses, so some communities have experienced greater or lesser fluctuations during this time. Moreover, the foundation upon which this house price recovery has been built is not as strong as it should be.

#### *Growing Risks to Taxpayers, Markets, and Homebuyers*

The federal government has long been a significant player in U.S. housing finance, both directly and indirectly. The federal government provides direct support through mortgage guarantor programs such as FHA and VA, numerous tax subsidies, and various laws and regulations

<sup>7</sup> [https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/HPI\\_May2018.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/HPI_May2018.pdf)

ranging from bank capital requirements to fair lending, fair housing, and consumer protection laws. It provides indirect support through institutions such as Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

As significant as the government's involvement was ten years ago, it has grown substantially since. Members of the Housing Policy Council believe this evolving state of our housing finance system is adding risk that requires congressional attention and action. I will review four categories of risk.

#### *1. Government Programs and Regulations*

The FHA and VA loan guarantee programs grew rapidly as the financial crisis took hold. These programs provided a critical source of counter-cyclical support to the market but with markets since stabilized, these programs remain larger than their traditional market share would predict. This likely reflects several factors, including but not limited to, the collapse of the subprime market, higher Fannie Mae and Freddie Mac guarantee-fees, growth in higher risk FHA loans, and the increase in eligible FHA loan size instituted during the crisis but not reset to normal levels. The bigger concern we have is more structural, particularly with the FHA program.

Several factors have contributed to the reduction in participation in the FHA program by well-capitalized lenders, including inefficient servicing rules, challenging claims processes, and aggressive lawsuits filed against FHA lenders under the federal False Claims Act. As a result, non-depository lenders and servicers have become more significant participants in the FHA program and larger banks less so. While banks and non-bank lenders alike should be able to offer FHA loans, the trend has at least three important consequences for the marketplace. First, it limits the financing options for potential homebuyers; in some cases, they cannot obtain a mortgage from the bank where they maintain checking, savings, or other credit accounts. HUD Secretary Carson and Treasury Secretary Mnuchin have acknowledged this problem.<sup>8</sup> Second, addressing the challenges of doing business with FHA would lead to a more competitive market that would drive down costs for borrowers. Third, non-depositories do not have access to all the liquidity resources available to banks. In a credit-constrained environment, this poses liquidity and solvency risk to the system and especially to Ginnie Mae, something Ginnie Mae has warned.<sup>9, 10</sup>

In addition, FHA suffers from prolonged resource constraints that have prevented investment in systems and technology advances with the rest of the market. This is a source of great concern to lenders, servicers, and FHA itself. We are encouraged by the new FHA Commissioner's focus

<sup>8</sup> Remarks of Dr. Ben Carson before the National Association of Home Builders Executive Board Meeting, May 23, 2018. [https://www.hud.gov/press/speeches\\_remarks\\_statements/Speech\\_052318](https://www.hud.gov/press/speeches_remarks_statements/Speech_052318) and "A Financial System That Creates Economic Opportunities Nonbank Financials, Fintech, and Innovation," U.S. Department of the Treasury Report to President Donald J. Trump, July 2018, page 97. <https://home.treasury.gov/sites/default/files/2018-08/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financials-Fintech-and-Innovation.pdf>

<sup>9</sup> "An Era of Transformation," Ginnie Mae, September, 2014. [https://www.ginniemae.gov/newsroom/Documents/ginniemae\\_an\\_era\\_of\\_transformation.pdf](https://www.ginniemae.gov/newsroom/Documents/ginniemae_an_era_of_transformation.pdf)

<sup>10</sup> Preliminary research reported in a Federal Reserve staff working paper supports this conclusion and highlights the liquidity risks in the current environment. Kim, You Suk, Steven M. Laufer, Karen Pence, Richard Stanton, and Nancy Wallace (2018). "Liquidity Crises in the Mortgage Market," Finance and Economics Discussion Series 2018-016. Washington: Board of Governors of the Federal Reserve System, <https://doi.org/10.17016/FEDS.2018.016>.

on this issue and urge the House to join the Senate in providing appropriations to fund needed technology upgrades.

While a tightening of federal mortgage regulations was both an inevitable and needed response to the financial crisis, it is also not surprising that some of these regulations missed the mark and, in certain cases, new regulations have created inefficiencies that increase loan origination and servicing costs, which boost costs for borrowers and may have restrained the emergence of private-label securitization. This does not mean these reforms should be repealed or regulations rescinded but it does mean that they should be evaluated for their efficacy and impact, and moderated or refined as appropriate. We appreciate that the Treasury Department and federal financial regulators are undertaking such a review and recalibration.

## *2. Macroeconomic Risks*

Thankfully, the deep recession has given way to a prolonged period of slow but positive economic growth and stability. Yet macroeconomic risks remain. Interest rates have been historically low throughout most of this period. With the Federal Reserve on a path to unwind its mortgage portfolio while pursuing gradual rate normalization, markets will need to adjust to these changes.

## *3. Housing Supply Constraints*

Perhaps the most significant legal and regulatory risks to housing affordability are not driven by federal regulation but result from state and local housing policy. Housing supply constraints are a meaningful contributor to housing affordability concerns in both the rental and ownership markets.<sup>11</sup> Enhancing credit subsidies at the federal level, including the GSEs' increasing acceptance of loans with high debt-to-income ratios, in the face of supply constraints at the local level drives up house (and apartment) prices, thereby exacerbating, not aiding, affordability concerns.

## *4. Control of the Nation's Mortgage Market*

Despite the many positive developments over the past ten years, less apparent to casual observers but more threatening to long-term stability has been the growing level of control of the mortgage market exercised by Fannie Mae, Freddie Mac, and their conservator. I opened my remarks by highlighting the systemic risks that led directly to the need for Congress to authorize, and Treasury to carry out, a massive financial intervention to protect GSE MBS and debt holders. If anything, the level of systemic risk posed by the GSEs has grown over these ten years.

For starters, Fannie Mae and Freddie Mac MBS outstanding today (approximately \$5.1 trillion) is about \$750 billion greater than ten years ago. But there is much more to it than that.

While the emergence of CRT has spread some credit risk previously retained by the GSEs, most of that risk-sharing is mezzanine risk, not first dollar or equity risk, and it has been accompanied by even greater reliance on the GSE risk management infrastructure and practices. In other words, the risk of loss has shifted to another party, but not the means to control or contain that risk. The same holds for credit pricing. This is not a fully competitive private market; it is a GSE-dominated credit market with the attendant systemic risk we have already witnessed. So,

<sup>11</sup> "Housing Development Toolkit," The White House, September, 2016.  
[https://www.whitehouse.gov/sites/whitehouse.gov/files/images/Housing\\_Development\\_Toolkit%20f.2.pdf](https://www.whitehouse.gov/sites/whitehouse.gov/files/images/Housing_Development_Toolkit%20f.2.pdf)

while CRT continues to be an important development and has shifted some amount of future loss away from the GSEs, there is much more to do here.

End-to-end, the mortgage market depends upon the risk analysis, pricing, and risk-bearing of Fannie Mae and Freddie Mac. These two companies determine which counterparties can participate in the system – with broad reach to all stakeholders whose functions are intended to manage and mitigate risk, from lenders and servicers to mortgage insurers, appraisers, and title companies. Meanwhile, they set the rules of business for the entire market, including the underwriting box, which determines what loans may be sold into the secondary market. With their conservator, they price the guarantee fees but also determine the external credit enhancement via CRT, setting the terms and pricing of these enhancements, and the rules governing these structures. They determine where and when to relax their traditional lending standards, whether through appraisal waivers, alterations to underwriting, or direct reductions in credit costs for some borrowers at the expense of other borrowers.

The companies continue to have a significant information advantage over other market participants, in terms of loan level data, appraisal data, and market prices. They set the capital and operational rules for mortgage insurers, have direct access to mortgage insurers' financial and pricing data, and they now offer a product that competes with existing mortgage insurance products.<sup>12</sup>

The companies' cash window purchases have grown significantly, making them the largest whole loan aggregators in the system, a function once performed by a number of the larger banks and independent mortgage companies.<sup>13</sup> This used to be a competitive activity in the primary market, one that lent additional oversight to the quality of loan manufacturing and compliance monitoring and embraced "skin in the game" through traditional commercial counterparty contracts that held multiple institutions accountable to one another for loan quality and performance. While some lenders may argue that this development benefits them because they sell directly to the GSEs, the system is concentrating risk in Fannie Mae and Freddie Mac and making lenders more beholden to, and reliant upon them. That reduces competition and increases systemic risk.

During the first six years of conservatorship, FHFA stopped Fannie Mae and Freddie Mac from entering new lines of business and focused them on their core mission. More recently, however, the companies' activities have expanded, bringing with it new risks to manage while operating in conservatorship and backed just by taxpayer capital. Examples include financing support for

<sup>12</sup> The mortgage insurance pilots (Freddie Mac's Imagin program and Fannie Mae's Enterprise Paid Mortgage Insurance) are good examples of the one-step forward, one-step back characteristic of some developments in conservatorship. As an alternative execution structure for pooling and laying off mortgage risk, the pilots may be seen as just another development in the set of credit risk transfer structures designed to attract private capital and shift risk away from the GSEs. And so they are. Yet they also reflect the level of control the GSEs exercise over all aspects of credit assessment, risk management, pricing, participation eligibility, and master servicing. These products compete with existing mortgage insurance products, yet the GSEs have a full view into their competitors' pricing and rules and do not offer the same transparency back. If these structures are good enough for the GSEs, FHFA should make the rules of participation clear and allow other firms to offer the same structure in the marketplace, rather than force the execution through the GSEs.

<sup>13</sup> "Recent Trends in the Enterprises' Purchases of Mortgages from Smaller Lenders and Nonbank Mortgage Companies," Federal Housing Finance Agency Office of Inspector General, July 17, 2014.  
[https://www.fhfaog.gov/Content/Files/EVL-2014-010\\_0.pdf](https://www.fhfaog.gov/Content/Files/EVL-2014-010_0.pdf)

institutional single-family rental (something previously authorized and now just halted by FHFA), debt financing of non-bank mortgage servicers, and expansion into multifamily finance out of proportion to pre-crisis market share.

Collectively, these new activities add risk and complexity while putting the GSEs into direct competition with private market participants. This would be fine if the playing field were level, but it is not. The GSEs operate with a substantial advantage that guarantees that they will be able to offer better terms and lower pricing than other market participants. They can access taxpayer, not private, capital, they continue to benefit from a host of special privileges accruing to them as GSEs, and they issue debt at approximately government pricing levels.

### **Why Congress Must Act and What Congress Can Build Upon**

To pursue a resilient liquid market in the future, we should be working to restore private capital and a competitive market in housing finance. In its simplest terms, ending the conservatorships and achieving housing finance reform is about creating a safe, liquid, and competitive market for mortgage credit risk, where private companies can thrive and innovate to serve the diverse array of U.S. households, and perform critical risk management functions that complement those of any governmental entities serving in a backstop capacity for the system. There is nothing unique or special about mortgage credit risk that requires wholesale reliance on the risk management practices of the government.

Put another way, ten years ago, virtually all the mortgage credit risk on \$5 trillion of mortgages was held by Fannie Mae and Freddie Mac. The market relied heavily on their credit judgment and credit risk management practices. Yet, the two companies had weakened their underwriting, underpriced their risk, and operated with far less capital than any potential competitor. Ten years ago today, we realized the result. Ten years later, Fannie Mae and Freddie Mac perform most of the risk management functions for the system, albeit pushing some modest amount of loss to the private market through CRT.

What we need now, more than ever, is to rebuild a future housing finance system that is more transparent, where the playing field is level, and where substantial amounts of private capital from numerous sources are brought together in a competitive marketplace that allows big lenders and small lenders, banks and non-banks, an equal chance to compete for the business of families seeking to own a home.

Restoring private capital, and relieving taxpayers of bearing so much mortgage risk, is not just a question of credit risk transfers. To better focus the government's role, we should strive toward a future state with greater private securitization, which would also lower catastrophic risk placed on taxpayers. Among the avenues for lawmakers to examine as ways to restore private capital are: establishing uniform national servicing standards, opening a common securitization platform to the option of private label securitization, addressing the regulatory inefficiencies holding back the market, encouraging innovation, and reconsidering loan limits.

Without progress in these areas, the uncertainty about the future of the GSEs and about the government's next steps stymies innovation and long-term strategic investment by private lenders and servicers and other stakeholders in the system. Since a stable housing market is



essential to consumer well-being and the opportunity for long-term household wealth-building, these ongoing risks and uncertainties need to be resolved. Simply put, Congress must act.

While significant differences of opinion remain on some key aspects of housing finance reform, these are in relatively few areas and, in some instances, multiple solutions may be workable and acceptable. The critical point is that reform cannot be completed without Congress.

Members of this Committee have put forth three comprehensive reform proposals, all warranting consideration in reaching a bipartisan consensus. The Chairman has been a thought leader in developing and advancing the PATH Act. Ranking Member Waters' HOME Forward Act and Representatives Delaney and Himes' Partnership to Strengthen Homeownership Act have also contributed very positively to the framework for a path forward. Notwithstanding clear differences across these bills, the bills have more in common than is recognized and the differences are reconcilable. HPC's members stand ready to help the Committee forge the bipartisan consensus needed to get comprehensive housing finance reform legislation to the finish line.

Enacting such reform will put the country on a better course to ensure that future homebuyers have broad access to credit and that our financial system can deliver this credit with much less systemic risk. Comprehensive housing finance reform also can protect taxpayers from another bailout, even if we face a deep recession and a nationwide collapse in house prices as we did last decade. While ending the GSE conservatorships dominates housing finance reform discussions, any comprehensive restructuring of the system should include the FHA. The Housing Policy Council has developed a set of ideas to strengthen the organizational and operational structure of FHA that we would be glad to share with the Committee.

An appropriate starting point for discussing major legislation that will affect so many citizens and a large segment of the economy is to agree upon a set of principles that can guide reform. The Housing Policy Council centers its reform views on the following principles:<sup>14</sup>

1. Fix what is broken and preserve what works in support of consumers and the market.
2. The transition from the old system to the new one should avoid disrupting consumers and markets.
3. Private capital should bear all but catastrophic mortgage credit risk so that market discipline contains risk. The government should provide an explicit, full faith and credit guarantee on MBS but with a pre-set mechanism to ensure any catastrophic losses that call upon taxpayer support will be repaid fully.
4. Government should provide a regulatory framework that is clear and equitable across all participating companies and ensures that participants in the housing finance system operate in a safe and sound manner.

<sup>14</sup> For a complete explanation of the Housing Policy Council's principles and a more detailed discussion of HPC's perspective in housing reform issues, see Testimony of Edward J. DeMarco before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 29, 2017. <https://www.banking.senate.gov/imo/media/doc/DeMarco%20Testimony%206-29-17.pdf>. The Housing Policy Council has a long track record, dating back to its founding in 2003, of testifying before Congress on the need to strengthen the regulatory regime governing Fannie Mae and Freddie Mac and, over the past ten years, in advocating for comprehensive housing finance reform that replaces the GSE structure with an approach more reliant on meaningful private capital and related reforms.

5. The government-protected GSE duopoly should be replaced with a structure that serves consumers by promoting competition, affordability, transparency, innovation, market efficiency, and broad consumer access to a range of mortgage products.

The good news is that these principles align well with those that motivate the aforementioned three bills as well as those that motivate similar legislation introduced in the Senate and those reflected in leading reform proposals from others.

The appendix to my statement maps HPC's reform principles to key provisions in the leading House and Senate bills, demonstrating the broad agreement with replacing the GSE duopoly with a system that relies more on a competitive market for distributing and containing mortgage credit risk. In short, there is a broad, bipartisan consensus on most, if not all, of the principles guiding reform. Leading legislative proposals to-date, including those from the Chairman and from the Ranking Member, have the following features in common:

- Fannie Mae and Freddie Mac would be wound down and then ended as GSEs. Whether and how they are merged or broken up or otherwise repositioned in the marketplace under a new charter and ownership regime is unresolved.
- The GSEs' current affordable housing goals regime would be eliminated (or at least altered), typically replaced by a funding stream generated from a small fee placed on all of the new government-backed MBS created by reform. The use and control of these funds to support affordable housing varies by proposal. Most proposals also include some expression of a duty of secondary market entities to serve the broad market, including low- and moderate-income borrowers and communities.
- A common securitization platform operating either as an industry utility or a government corporation.
- A single, government-backed MBS to give rate investors (the private capital backstopping interest rate risk and the source of the long-term funding for long-term mortgages) freedom from credit risk concerns and deepening the universe of MBS investors. Some proposals call for creating a new government entity to provide this insurance (for example, the Johnson-Crapo bill created the Federal Mortgage Insurance Corporation (FMIC)) while others recommend using an existing government MBS guarantor (Ginnie Mae), and yet others are silent on this point.
- Substantial private capital would back each mortgage pool, supplemented by the capital of the pool aggregator (the entity bundling mortgages for securitization) and by an industry-funded, government-backed reserve fund (as described just above).
  - The credit risk transfer market that FHFA directed Fannie Mae and Freddie Mac to initiate is the basis for continuing to attract private capital using multiple structures and appealing to multiple types of investors in credit risk assets.
  - A government regulator would oversee this credit risk syndication and the sufficiency of the capital backing that risk.

#### **What Could be Accomplished Administratively to Assist Congress and Markets**

Mr. Chairman, in your letter of invitation, you asked that I address potential actions the Administration and FHFA could take to further the cause of reform. Given the broad areas of consensus I have outlined, I believe the Administration and FHFA should be working together to

use this period of conservatorship to prepare for legislative reform. FHFA and the Administration should look to reverse the growing systemic risk that I described earlier. They should take administrative actions to build upon the steps already taken in conservatorship to develop the market infrastructure, standards, and activities that are the foundation for a post-conservatorship housing finance system. Keeping in mind that keys to a competitive credit market include access to data, industry standards, and a level regulatory playing field, examples of such steps include:

- Direct the GSEs to release to the public the rest of their historical loan level and other data sets they've accumulated over time as part of their risk analytics capabilities, such as their extensive appraisal and property records data.
- Give the industry a greater role in the development of the common securitization platform and consider expanding this technology beyond the GSEs.
- Establish a standards-setting board that would operate on behalf of the broader marketplace and regulatory community, to bring a level of alignment and harmony in mortgage rules and requirements across all types of products and programs.
- FHFA and other regulators develop a consistent approach to evaluating counterparties that is transparent and applied consistently across regulatory regimes.
- Determine a path to break the proprietary, duopoly control on mortgage underwriting exercised through the GSEs automated underwriting systems and loan manufacturing technology, either by transitioning those tools to a market-wide utility or the securitization platform, or by defining a path for competing systems to emerge that could approve loans eligible for government-backed securitization on the same terms as the GSEs have. An even better approach may be to take each of these steps while also encompassing government programs such as FHA so that they may benefit from the taxpayer investment in GSE technology during conservatorship and from future private innovations.
- Increase transparency related to guarantee fee pricing, including the capital assumptions and the guarantee-fee pricing offsets given third-party credit enhancement.
- Freeze (and perhaps consider lowering) the conforming loan limits. For a purely private securitization market to re-emerge, there should be some room at the higher-end of the mortgage market for private lending activity, which is needed to ensure sufficient liquidity in this jumbo segment of the market. A commensurate adjustment to FHA loan levels would also be appropriate to prevent further market share distortions.
- Future GSE "pilot programs" should have (1) a clear articulation of their purpose relative to being in conservatorship, (2) specific, measurable, and time bound outcome metrics, (3) an avenue for public comment and transparency around pilot results, and (4) an intent to make the results, including any permanent establishment of a new activity, generalizable to the market not specific to Fannie Mae and Freddie Mac.

Additionally, Congress should encourage FHFA to use its current capital rulemaking process and its oversight of the developing credit risk transfer market to ensure a more open, transparent, standardized, and competitive market for mortgage credit risk. There has been substantial interest in the CRT asset class across mortgage insurers, reinsurers, mortgage REITs, banks, and a broad array of other capital market participants. They all seek the opportunity to compete in this segment and FHFA's openness to ensuring that opportunity will go a long way to shaping that future market. Congress also should encourage FHFA and other federal financial regulators

to examine other regulatory and conservator policies that extend the reach of the GSEs and alter competitive balance in the marketplace.

#### *Capital Rules*

HPC welcomes FHFA's recent proposed capital rule for the Enterprises. This proposal should be a catalyst for a thoughtful discussion across regulators and market participants.<sup>15</sup> Notwithstanding that FHFA intends to suspend the rule while the conservatorships remain in place, the proposal marks the beginning of a complex and critical discussion of restoring private capital, creating competitive balance, and protecting taxpayers while mitigating the systemic risk inherent to the GSEs.

A grave failing of the pre-crisis regulatory regime for Fannie Mae and Freddie Mac was a regulatory capital standard for the GSEs that was divorced from other regulatory capital standards and from the risks associated not only with mortgage assets and GSE counterparties, but also with the extensive set of roles, responsibilities, and risk management operations of the GSEs. The GSEs compete with other sources of regulated capital in the mortgage credit market but seldom on equal footing. With FHFA, today, effectively regulating the capital of mortgage insurance companies and approving standards and eligibility for credit risk transfer (CRT) structures, the need to align GSE capital requirements with other regulatory capital standards and related credit protection standards is more obvious and consequential than ever before.

Our initial review suggests that FHFA's proposed rule perpetuates the misalignment of regulatory capital requirements across the system. Therefore, we hope the Committee would join us in urging FHFA to begin discussions with the bank and insurance regulators to identify where regulatory capital rules are misaligned with actual risk and to align those rules to avoid competitive imbalances based upon regulatory arbitrage. FHFA's analysis may reveal that the bank regulators have excessive requirements relative to actual mortgage credit risk, so perhaps some portion of the regulatory alignment needs to happen there. Yet, the FHFA proposal also gives much less weight to systemic risk and counter-cyclical capital concerns relative to bank capital rules. Surely the experience from 2008 demonstrates the need for a sizeable buffer beyond any "measured" risk levels.<sup>16</sup>

Through this rule-making, FHFA also has an opportunity to provide clarity to the market on the interplay between CRT and capital. By defining the capital offset, the GSEs may gain from having CRT protection, FHFA effectively sets the standard for other credit enhancers that may

<sup>15</sup> Since establishment of the conservatorships, regulatory capital rules have been suspended. FHFA Director Watt testified earlier this year that "FHFA has worked with the Enterprises to develop a Conservatorship Capital Framework that establishes aligned capital guidelines for both Enterprises across different mortgage loan and asset categories. Both Enterprises now use this aligned framework to make their regular business decisions. FHFA also uses this framework in its role as conservator to assess Enterprise guarantee fees, activities, and operations and to guard against the Enterprises making competitive decisions that could adversely impact safety and soundness." Statement of Melvin L. Watt, Director, FHFA, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, May 23, 2018. Greater transparency regarding that framework would also be welcome.

<sup>16</sup> The absence of regulatory coordination and consistency in capital requirements created regulatory arbitrage that contributed to enormous taxpayer losses during the financial crisis. This is not the only area in mortgage regulation where such coordination is lacking. Another example is FHFA's go-it-alone approach in pursuing rule changes regarding Limited English Proficiency in mortgage origination. Other banking, consumer, and housing regulators who have more direct responsibility for primary market lending regulation should be engaged in this effort, which could have far-reaching and unintended consequences for consumers and the market.

compete with the GSEs. To be clear, FHFA should explicitly pursue standards that will define a level playing field for private capital including banks, mortgage insurance companies, reinsurance companies, and other CRT structures and investors. To do otherwise would encourage risk to migrate where the capital requirements are lowest.

*GSEs Should Not Get Preferential Treatment*

There are numerous ways in which the GSEs get preferential treatment. Some I have already discussed, such as the privileges embedded in their congressional charters. Others arise from favorable treatment bestowed on them by regulators, partially because of those charters. For example, GSE securities receive favorable treatment under bank liquidity and capital rules. Mortgages approved by the GSEs get favorable treatment under the Bureau of Consumer Financial Protection's qualified mortgage rule. Appraisals may be waived for GSE mortgages under special exclusions in federal law. The list goes on. If we are to wean the system from its dependency on the GSEs, a systematic review of these preferences is needed and regulators, starting with FHFA, should be seeking pathways to end preferential treatment. Such a systematic review also should identify those preferences that are worth preserving because they enhance market efficiency. The best course may be to make the preference broadly available to the mortgage market, not just to two companies.

In the end, the goal should be achieving a more open and competitive market, not an unstructured market. HPC's first principle for housing finance reform is relevant here: fix what is broken and preserve what works in support of consumers and the market. Over time, the standardization and structure the GSE model has brought to the market have made important and valuable contributions to the way the market works today. An example is the emergence of the to-be-announced (TBA) market that allows lenders to offer their customers interest rate locks. But we need to move to a system in which we have a more open and competitive system, not one where just two companies garner the benefits.

*Continuing the Development of the Credit Risk Transfer Market*

Today, the development of a market for mortgage credit risk assets can move the secondary mortgage market to a place where we can greatly diminish systemic risk by pricing, managing, and distributing credit risk across multiple channels to attract private capital. However, that will not happen so long as Fannie Mae and Freddie Mac are (1) at the center of every decision regarding credit risk management, and (2) retain advantages such as lower capital requirements or an ability to control the rules affecting their competitors.

All capital providers should be encouraged to compete in the assessment, management, and holding of mortgage credit risk, with clear standards to ensure safety and soundness and a level playing field. As FHFA continues the development of the CRT market, it should look to expand eligible CRT structures to those developed and implemented by entities beyond Fannie Mae and Freddie Mac. If a structure is eligible for CRT when executed by a GSE, the terms of that eligibility should be transparent, allowing other parties – banks, mortgage insurers, mortgage REITs, and other capital market participants – to also establish and execute such structures. Making that adjustment alone would constitute an enormous advance towards mitigating the systemic risk in the current system.

### **Preparing Borrowers to Become Sustainable Homeowners**

Before closing, it is important that I also address the other critical element of housing finance reform – how reform might advance the public policy interest in supporting home ownership opportunities for all Americans, especially for segments of our society that face heightened challenges in achieving home ownership. These are challenges HPC members address every day and they remain committed to seeking innovative and sustainable approaches to expanding home ownership opportunities.

A common element across many housing finance proposals is a goal to ensure homeownership is sustainable; that is, reducing the likelihood of default by borrowers, especially borrowers with less-than-perfect credit profiles. This requires more work and thought than simply subsidizing the cost of credit to low down payment, low credit score, or lower-income borrowers. It requires greater attention to saving both for down payments and for cash reserves once in the home, greater financial literacy, homebuyer education and home ownership counseling, and more effort to repair credit histories. Many HPC members sponsor and support programs that do these things.

A challenge facing many lower income renter and owner households, indeed even moderate and some higher income households, is increased income volatility. Many people lack the resources to buffer themselves from life's disruptions, and income disruptions are more common today than in the past. Housing policy and our housing finance system need to become more attuned to this challenge so better solutions may be found.

Loan qualification standards also need to evolve and improve. Too often, Fannie Mae and Freddie Mac are looked to as the only means by which marginalized communities can be served, as the entities that bestow mortgage credit when private lenders will not. Instead, we should ask our secondary market to be open and available for securitizing eligible, privately credit enhanced mortgages while encouraging lenders in the primary market to innovate and to develop responsive and responsible products to serve the special needs of people and communities that face greater obstacles to home ownership.

### **Conclusion**

Thank you for the opportunity to testify today. For the next milestone anniversary of GSE conservatorship, let us ensure that the Committee's hearing focuses on how we are progressing with the final implementation of housing finance reform, not whether we should pursue this critical objective.

## Appendix:

**Aligning Key Provisions of Congressional Housing Finance Reform Proposals to the  
Housing Policy Council's Principles for Reform\***

**H.R. 2767 Garrett/Hensarling (PATH Act)**

**Waters Draft Housing Opportunities Move the Economy (HOME) Forward Act**

**H.R. 1491 Delaney/Carney/Himes**

**S. 1217 Johnson/Crapo Substitute to Corker/Warner Bill**

<b>HPC Principles for GSE Reform*</b>	<b>GSE Reform Proposals</b>
<i>Principle 1a: Fix what is broken</i>	<p><i>Wind-down of GSEs</i> – Each of the proposals recognizes that the structure of the GSEs is inherently flawed, and each calls for replacing the GSEs with a new structure to facilitate a secondary market for conventional single-family and multifamily mortgages</p> <p><i>Transparency</i> – Each of the proposals calls for standardized securitization agreements to improve transparency of securitization process for all stakeholders</p> <p><i>Data</i> – Each of the proposals (other than Delaney/Carney/Himes) calls for loan level data dissemination / publication to give investors and other stakeholders greater insight into risks associated with securitization</p> <p><i>Housing Goals</i> – Each of the proposals (other than the PATH Act) replaces the existing housing goals with an affordable housing fee</p> <p><i>FHA Reform</i> – The PATH Act includes reforms to FHA</p>
<i>Principle 1b: Preserve what works</i>	<p><i>30-Year Fixed-Rate Mortgage</i> – Each of the proposals preserves the To-Be-Announced (TBA) market so the 30-year fixed rate mortgage can remain an option for consumers</p>

	<p><i>National Market</i> – Each of the proposals seeks to preserve a secondary market that serves all credit-worthy borrowers</p> <p><i>Small Lender Access</i> – Each of the proposals includes provisions to ensure small lenders access to the secondary market</p>
<i>Principle 2: Ensure a smooth transition</i>	<p><i>Phased Wind-down</i> – Each of the proposals provides for a multi-year transition on the wind-down of the GSEs</p> <p><i>Protection for Existing Securities</i> – Each of the proposals provides for explicit federal support for outstanding GSE debt and MBS issuances to avoid market disruption</p> <p><i>Securitization Platform</i> – Each of the proposals provides for a centralized platform to facilitate the securitization of MBS</p>
<i>Principle 3: Place an explicit federal guarantee on MBS, but provide for private capital to stand in front of that guarantee</i>	<p><i>Explicit Federal Guarantee</i> – Each of the proposals (other than the PATH Act) calls for an explicit federal guarantee on conventional and multifamily MBS. Chairman Hensarling has since acknowledged that such a guarantee will likely be a feature of any reform legislation</p> <p><i>Private Capital</i> – Each of the proposals that include an explicit federal guarantee on MBS requires meaningful private capital to stand in front of that guarantee, and provides for the creation of an insurance fund to absorb any losses before taxpayers</p>
<i>Principle 4: Establish a clear and equitable regulatory structure that ensures a safe and sound housing finance system</i>	<p><i>Regulator</i> – Each of the proposals calls for a strong, independent federal regulator to oversee the housing finance system:</p> <ul style="list-style-type: none"> <li>• the PATH Act provides for FHFA to serve this function;</li> <li>• the Waters proposal creates a new federal National Mortgage Finance Administration (NMFA) to replace FHFA;</li> <li>• the Johnson/Crapo bill calls for the creation of a Federal Mortgage Insurance Corporation (FMIC) to replace FHFA; and</li> <li>• the Delaney/Carney/Himes bill transfers the functions of FHFA to Ginnie Mae, and makes Ginnie Mae an independent federal agency</li> </ul>



	<p><i>Safety and Soundness Standards</i> – Each of the proposals calls for the establishment of appropriate standards for the operations of the secondary market and the participants in that market</p>
<p><i>Principle 5: Replace GSE duopoly with a structure that promotes competition, affordability, transparency, innovation, market efficiency, and consumer access to a range of mortgage products</i></p>	<p><i>New Structure</i> – Each of the proposals replaces the GSEs with a new structure that is intended to promote greater competition and innovation than the existing duopoly:</p> <ul style="list-style-type: none"> <li>• the PATH Act provides for the establishment of a stakeholder administered Utility that sets standards for the qualified issuers of MBS;</li> <li>• the Waters proposal creates an industry-owned Cooperative to issue federally guaranteed MBS;</li> <li>• the Johnson/Crapo bill provides for a central securitization platform to issue federally guaranteed MBS and for FMIC to license qualified private guarantors to assume risks ahead of the federal guarantee; and</li> <li>• the Delaney/Carney/Himes bill directs Ginnie Mae to establish an Issuing Platform for federally guaranteed MBS on behalf of mortgage originators and aggregators</li> </ul>

\*Testimony of Edward J. DeMarco, President of the Housing Policy Council, on “Principles of Housing Finance Reform,” before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, June 29, 2017.



Statement before the House Committee on Financial Services  
On "A Failure to Act: How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk"

## **How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk**

Prompt Administrative Action Is Advisable Now

**Edward J. Pinto**

Resident Fellow and Codirector of Center on Housing Markets and Finance

September 6, 2018

The American Enterprise Institute (AEI) is a nonpartisan, nonprofit, 501(c)(3) educational organization and does not take institutional positions on any issues. The views expressed in this testimony are those of the author.

Chairman Hensarling and Ranking Member Waters, thank you for the opportunity to testify today.

“A Failure to Act: How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk” is an appropriate title for this hearing.

The last house price boom and subsequent bust was the result of ill-advised and risky government housing policy. Today we are in the midst of another boom, and, once again, it is the result of ill-advised and risky government housing policy.

In 2014 I cofounded the AEI Center on Housing Markets and Finance. My prior research had established that the financial crisis largely stemmed from a failure to understand buildup of housing risk. I am pleased to report the center now produces the most comprehensive set of risk measures—providing accurate, real-time tracking of leverage that, when left unchecked, results in destructive housing booms and busts. **Unfortunately, we are now able to document that we are in the midst of another potentially dangerous buildup of policy-induced housing risk. This policy is making entry-level homes less, not more, affordable.**

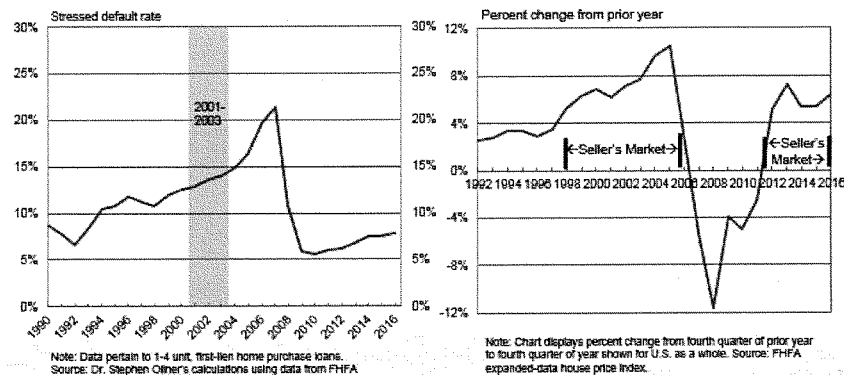
My testimony today uses the results from risk rating of 60 million individual mortgage loans dating back to 1990.

I will start our analysis with the buildup of risk in the 1990s and 2000s that was the result of ill-advised and risky government housing policy. The left panel below shows that the government-sponsored enterprises’ (GSEs’) Mortgage Risk Index (MRI) began rising in the early 1990s, not the early-2000s as many have incorrectly claimed. This increase in risk was the direct result of the passage of The Federal Housing Enterprises Financial Safety and Soundness Act of 1992. By 2007 the GSEs’ MRI had tripled to 21 percent. The right panel in Figure 1 demonstrates that home prices started climbing at an unsustainable annual rate in the late-1990s and continued until 2006. During this entire period there was a seller’s market, indicative of tight supply versus demand.<sup>1</sup> Then for five years the market was a buyer’s market (2007–11), and home prices plummeted, severely damaging our economy and inflicting untold harm on millions of Americans.

---

<sup>1</sup> The National Association of Realtors defines a seller’s market as six months or less remaining inventory at the current monthly sales rate. A buyer’s market is greater than six months inventory.

**Figure 1. GSE Historical Mortgage Risk Index and National House Price Increases**



Note: Data pertain to one to four unit, first-lien home purchase loans. The figure displays percentage change from fourth quarter of the prior year to fourth quarter of year shown for US as a whole.

Source: Stephen Oliner's calculations using data from the Federal Housing Finance Agency; and Federal Housing Finance Agency expanded-data house price index.

As the left panel above demonstrates, the GSEs' MRI is once again on the rise. As I will demonstrate later in my testimony, it is of even more concern that the Federal Housing Administration's (FHA's) MRI now stands at 28 percent, well above the level reached by the GSEs in 2007 and up from the FHA's 19 percent in 2012.

The right panel indicates that we have been in a continuous seller's market since mid-2012, one even stronger than in the last boom. **The current boom is once again fueled by ill-advised and risky government housing policy. We clearly did not learn the lessons of the last boom and bust. And once again, this unsustainable home price boom is making entry-level homes less, not more, affordable and is a threat to low-income homebuyers and taxpayers.**

We have long known what causes unsustainable home price increases in a seller's market. In 1951, Ernest Fisher, the FHA's first chief economist in the 1930s, made the following observation, based on empirical studies of FHA and VA lending.

In a seller's market, when choice is restricted and the seller virtually dictates sales terms, more liberal credit is likely to be [capitalized] in price with probably a reduction in housing standards.<sup>2</sup>

<sup>2</sup> Ernest Fisher, *Financing Home Ownership*, National Bureau of Economic Research, 1951

**For many decades US housing policy has relied almost exclusively on increasing borrower leverage in an ineffectual attempt to make housing more affordable. Instead, as Fisher points out, the result in a seller's market is to make homes less affordable. For the same reason, policies such as duty to serve, affordable housing fees, and cross-subsidization have the same effect—higher prices in a seller's market.**

The history of GSE debt-to-income ratios (DTIs) over the past 30 years helps confirm this. Figure 2 traces the history of DTIs greater than or equal to 42 percent from 1990 through 2018.<sup>3</sup> This percentage has ranged from less than 5 percent in 1988–91 up to 15 percent in 1998, hitting a peak of 43 percent in 2007, back down to 17 percent in 2012, and now back up to 38 percent in 2018 (the same as the average level attained in 2005–06). Seller's market coincides with both rapid rises in real home prices.

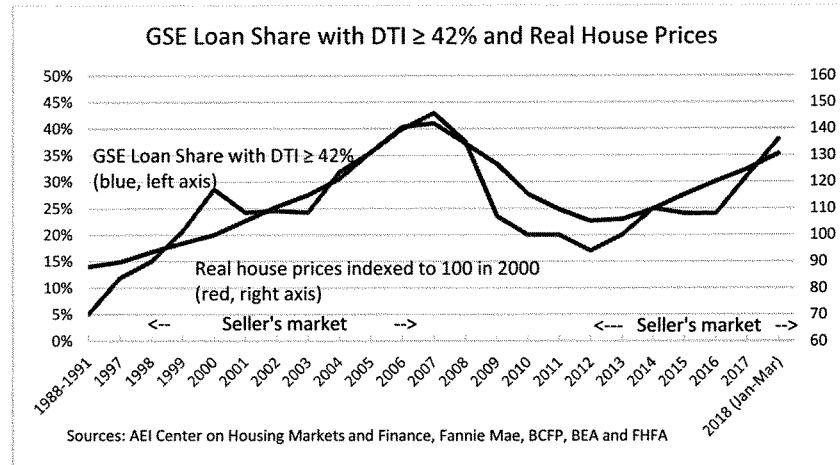
---

<sup>3</sup> Greater than or equal to 42 percent is a common data point available for the entire time period.

- Except for 1988–91 common data point, which is based on loan counts, all other calculations are based on loan dollars.
- Loan type used for BCFP analysis: first-lien mortgages on first or second homes that have fully documented income and are fully amortizing with a maturity that does not exceed 30 years. The BCFP further noted that the tabulations do not include the following types of loans: loans for investor-owned properties; low- or no-document mortgages; interest-only (IO) mortgages; negatively amortizing mortgages such as payment option-ARMs; or mortgages with a balloon payment feature.
- Except for 1988–91, all calculations use the same defined subset of GSE loans.

Data sources:

- 1988–91: Fannie Mae random sample for loan acquisitions, percentage greater than or equal to 42 percent based on extrapolation of data results, document in files of Edward Pinto
- 1997–2009: Derived from Bureau of Consumer Financial Protection, 2012, [http://files.consumerfinance.gov/f/201205\\_cfpb\\_Ability\\_to\\_Repay.pdf](http://files.consumerfinance.gov/f/201205_cfpb_Ability_to_Repay.pdf)
- 2010–16: Fannie Mae and Freddie Mac, loan performance files
- 2017–March 2018: Fannie Mae and Freddie Mac loan level securitization data

**Figure 2. GSE Loan Share with DTI  $\geq$  42 Percent and Real House Prices**

Source: AEI Center on Housing Markets and Finance; Fannie Mae; Bureau of Consumer Financial Protection; US Bureau of Economic Analysis; and Federal Housing Finance Agency.

The inflation-adjusted house price trend looks quite similar to the DTI trend above. The DTI trend is remarkable for two reasons: (1) the tremendous volatility in the incidence of high DTIs and (2) the interest rate trend's decline to flat for 1991–2017. The house price trend is also unprecedented for two reasons: (1) the amplitude of the booms and (2) their occurring so close together.

I now turn to the deleterious actions of Fannie Mae, Freddie Mac, and the Federal Housing Finance Agency (FHFA) since the beginning of the conservatorship that relate to the proliferation of high DTI lending, quite similar to what happened during the boom of the late-1990s and early- to mid-2000s.

In January 2013 the Bureau for Consumer Financial Protection (BCFP) promulgated, under authority granted in the Dodd Frank Act, its Qualified Mortgage (QM) rule, which set a maximum DTI of 43 percent and simultaneously exempted GSE, FHA, the Veterans Affairs (VA), and Rural Housing Service (RHS) ("Agency") guaranteed loans from QM's 43 percent DTI limitation. Both provisions took effect in January 2014. Since 2013, about 85 percent of all primary home purchase financing has been guaranteed by these agencies.

The bureau believed that the patch would "provide an adequate period for economic, market, and regulatory conditions to stabilize" and that it would "provide an *orderly transition period*, while preserving access to credit and effectuating the broader

purposes of the ability-to-repay statute during the interim period.”<sup>4</sup> (Emphasis added.) The patch has expired for the FHA, the VA, the US Department of Agriculture (USDA), and the RHS because each agency has issued its own QM rules.<sup>5</sup> For Fannie and Freddie, the patch will sunset in seven years from the effective date of the rule (January 10, 2014) or when their federal conservatorship ends. Given the current state of the conservatorship, the patch—which now applies only to Fannie and Freddie loans—will expire in January 2021.

Rather than undertake “an orderly transition period” to the QM’s 43 percent DTI limitation during the patch period, the FHFA, the GSEs, the FHA, and the VA all took advantage of the patch to promote the proliferation of high DTI loans, in many cases doubling or more the percentage of their DTIs greater than 43 percent. **Because the patch allows government agencies and the GSEs to increase DTIs, the patch is helping fuel the current house price boom. When mortgage risk expands alongside of home prices, there is little “friction” in mortgage markets to slow the growth of a housing boom. This serves to make entry-level housing less, not more, affordable.**

We conducted an examination of the five-year trend of DTIs greater than 43 percent across purchase; rate and term refinance; cash-out refinances for all market participants for the GSEs, the FHA, the VA, and the RHS; and private portfolio lenders. It discloses a common pattern by the FHA, the VA, and the GSEs to take advantage of the patch to promote the proliferation of high DTI loans, including in the case of the GSEs, apparently at the urging of the FHFA. However, private portfolio lenders and the RHS have been the exceptions, showing *less* usage of DTIs greater than 43 percent over time. Furthermore, the results are similar for portfolio loans *below* the GSE national conforming loan limit.

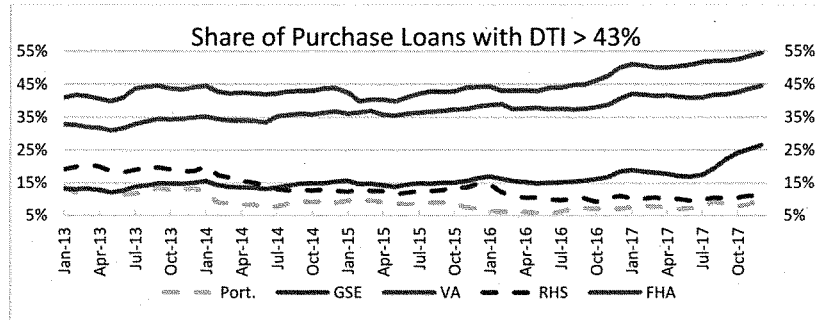
As a result of the broadly applicable patch, 36 percent of agency purchase guaranteed loans that were originated in March 2018 had a DTI in excess of 43 percent, double the level the month before the patch was announced. This rate continues to rise.

Figures 3–5 show the five-year trend of DTIs greater than 43 percent across purchase; rate and term refinance; cash-out refinances for the GSEs, the FHA, the VA, and the RHS; and private portfolio lenders.

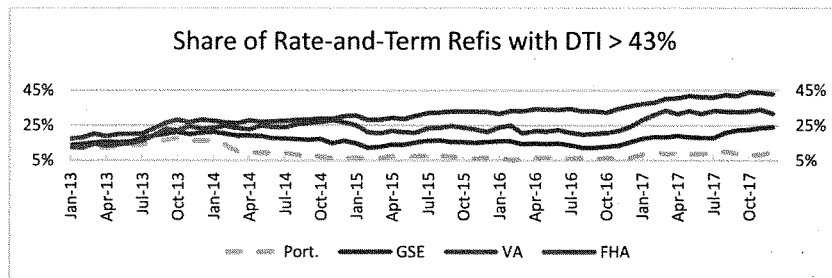
---

<sup>4</sup> Bureau of Consumer Financial Protection, 6534.

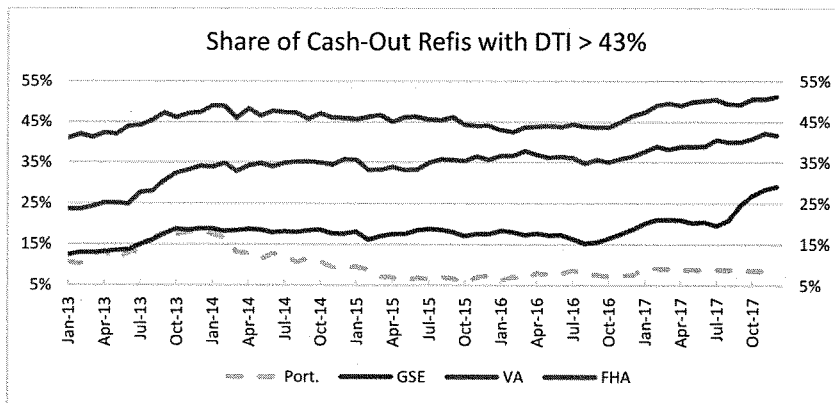
<sup>5</sup> Section 1412 of Dodd Frank requires each of these agencies to issue its own QM rules. See 15 USC § 1639c(b)(3)(B)(ii).

**Figure 3. Share of Purchase Loans with DTI > 43 Percent**

Source: AEI Center on Housing Markets and Finance.

**Figure 4. Share of Rate-and-Term Refinance Loans with DTI > 43 Percent**

Source: AEI Center on Housing Markets and Finance.

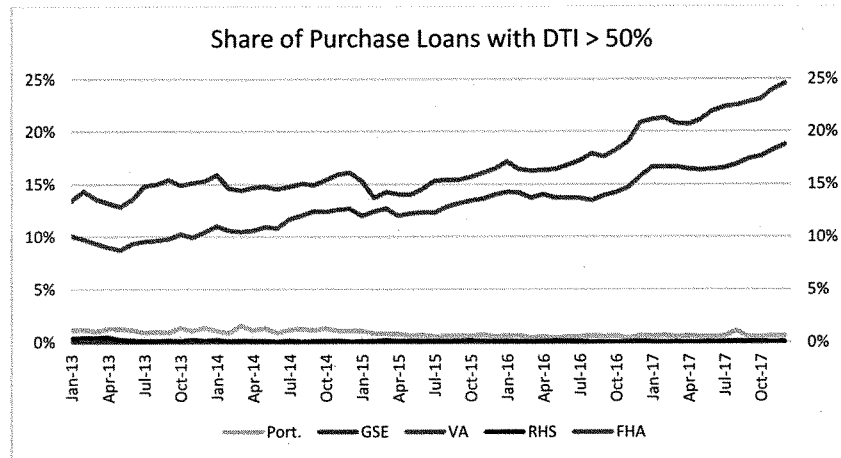
**Figure 5. Share of Cash-Out Refinance Loans with DTI > 43 Percent**

Source: AEI Center on Housing Markets and Finance.



Figure 6 presents one final point regarding DTI trends: *Purchase* loans with DTIs over 50 percent are almost entirely FHA or VA insured. The GSEs and RHS back only a negligible number of loans, if any, over 50 percent.

**Figure 6. Share of Purchase Loans with DTI > 50 Percent**



Source: AEI Center on Housing Markets and Finance.

To better understand this boom and the impact of US housing policy and attendant credit easing, one needs to measure home sales, price trends, mortgage risk trends, and other characteristics over time. To this end, AEI's Housing Center has developed an 8.3 million sale transaction study covering five years of home price appreciation (HPA) for over 40,000 census tracts in 73 large metros areas. This data set was used to create a new tiered House Price Index (HPI) that allows for the most thorough analysis of home price trends ever available. In particular it allows for a detailed analysis of the role equity and income leverage, and high risk lending in particular, play on home prices.

Price tiers at the county level are defined as follows:

- Low:  $\leq$  40th percentile of FHA sales price;
- Low medium:  $>$  40th and  $\leq$  80th percentile of FHA sales price;
- Medium high:  $>$  80th percentile of FHA sales price and  $\leq$  125% of GSE limit; and
- High:  $>$  125% of GSE limit.

We found a generally strong correlation between increasing tract HPA and increasing tract mortgage risk index or MRI (a measure of equity and income leverage).

Figure 7 below sets forth key characteristics of the four price tiers. First-time buyers (FTBs) were 68 percent of buyers in low and medium-low priced tiers. At 14 percent, these tiers have a much higher MRI and prices have increased much faster (+38 percent) than for medium-high and high tiers (+28 percent), which have much lower FTB share (35 percent) and an MRI of 7 percent).

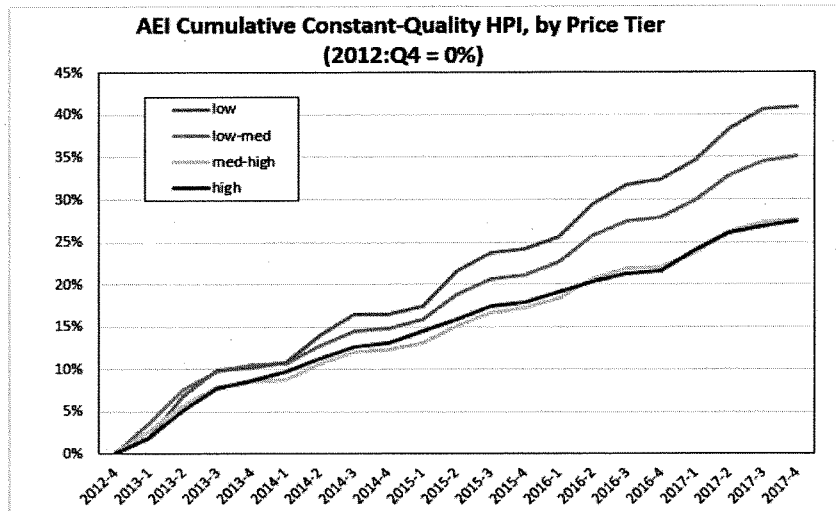
**Figure 7. Key Characteristics of the Four Price Tiers**

Price Tier	Home Price Increase (2012-Q4 - 2017-Q4)	Share of Market (2017)	FHA Share (2017)	Mortgage Risk (Leverage) Index (2017)	Percentage of First-Time Buyers (Agency loans only) (2013-2017)	Median Sales Price 2017
Low	41%	26%	32%	14.50%	74%	\$157,000
Low-Med	35%	30%	29%	13.50%	63%	\$229,900
Med-High	28%	36%	12%	8.40%	39%	\$365,000
High	27%	8%	0.30%	3.20%	23%	\$870,000
Combined Low & Low-Med	38%	56%	30%	14%	68%	\$197,000
Combined Med-High & High	28%	44%	10%	7%	NA	\$405,000

Source: AEI Center on Housing Markets and Finance.

Figure 8 demonstrates how constant quality home prices by tier have increased since 2012:Q4, which was just about the beginning of the current boom. The low and low-medium tiers, largely consisting of first-time buyers and with about 30 percent of these two tier's home sales financed with FHA-insured loans, had substantially higher price increases. In the case of the low tier, prices went up 41 percent, compared to 27 percent for each of the medium-high and high tiers. **If low tier prices had increased at the same rate as the medium-high and high tiers, entry-level buyers would today be able to buy these homes at much more affordable prices and with less risk of default—an average of \$17,000 per home less than today.**

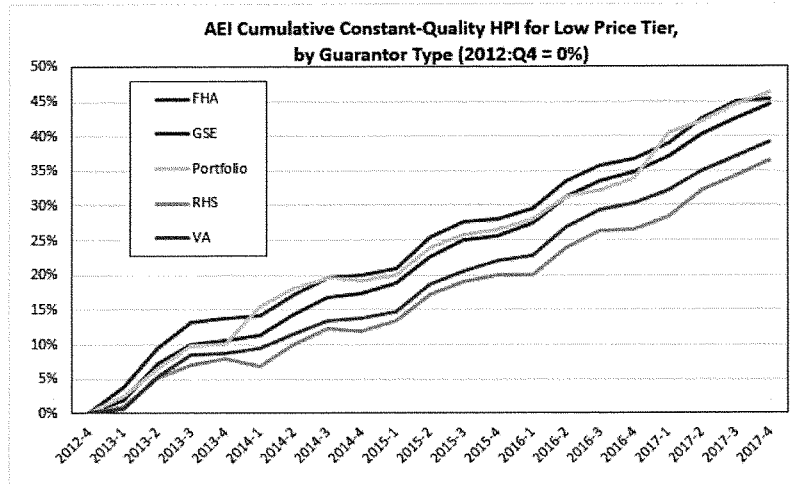
**Figure 8. AEI Cumulative Constant-Quality HPI, by Price Tier (2012:Q4 = 0 Percent)**



Source: AEI Center on Housing Markets and Finance.

Figure 9 shows low tier price trends by financing source. It is noteworthy that the FHA, GSE, and private HPIs for the low-priced tier all went up about the same amount over five years: 45 percent. This is because the FHA and other buyers with access to high levels of equity and income leverage set the price for that market segment (the “FHA effect”). The VA and RHS had lower price gains, likely due to differing appraisal practices and DTI limitations.

**Figure 9. AEI Cumulative Constant-Quality HPI for Low Price Tier, by Guarantor Type (2012:Q4 = 0 Percent)**



Source: AEI Center on Housing Markets and Finance.

Most importantly, our research demonstrates that high-risk home purchase lending is fueling home price appreciation. Currently 41 percent of agency purchase lending is high risk. As shown in Table 1, FHA accounts for 57 percent of such high-risk lending, down from 74 percent in 2012. Significantly, the GSEs account for nearly all of this high-risk share shift, increasing from 10 percent in 2012 to 30 percent in 2018.

**Table 1. High-Risk Loans by Loan Type (High Risk = >12 Percent Mortgage Risk Index)**

	FHA	GSE	Portfolio	RHS*	VA	Total	weighted count
2012	74.4%	10.4%	1.9%	4.9%	8.4%	100.0%	124,052
2013	66.5%	16.8%	2.0%	5.3%	9.5%	100.0%	515,921
2014	60.8%	20.6%	2.4%	5.1%	11.2%	100.0%	555,358
2015	65.9%	18.9%	1.9%	3.3%	10.1%	100.0%	667,255
2016	63.6%	21.5%	2.1%	2.7%	10.1%	100.0%	760,591
2017	58.6%	26.6%	2.2%	2.6%	10.0%	100.0%	762,629
Q1:2018	56.6%	29.9%	3.5%	NA	10.0%	100.0%	132,673

\* Unable to identify RHS loans as HMDA data for 2018 not yet available

Source: AEI Center on Housing Markets and Finance.

There is a strong positive correlation between higher mortgage risk (higher expected default rates under stress) and higher home price appreciation, lower home prices, and lower income. Figures 10–12 show correlations at the census tract level relating to: (1) mortgage risk, which measures expected default rates under stress (x-axis) and ratio of tract home price appreciation (HPA) to county HPA, (2) mortgage risk (x-axis) and median home price appreciation, and (3) mortgage risk (x-axis) and income as a percentage of metro area income. The scatter dots for each figure are color coded based on the percentage of high risk purchase loans as a share of all purchase loans in the tract. Those from the green color palette have a high risk share of less than 30 percent. Those from the blue color palette have a high risk share of greater than or equal to 30 percent.

**Correlation 1: Census Tract Mortgage Risk and House Price Appreciation, by Tract Share of High-Risk Lending**

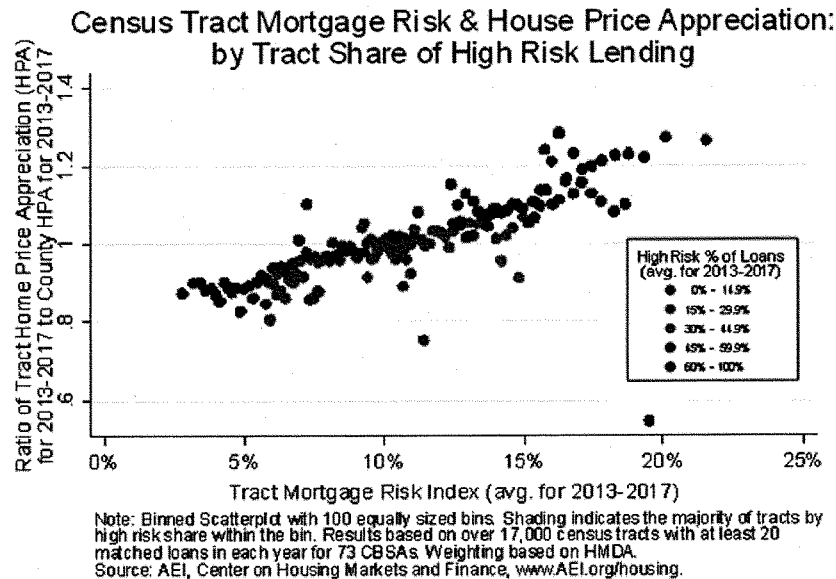
There is a strong positive correlation between higher mortgage risk (higher expected default rates under stress) and home price appreciation.

The binned scatterplot below shows that the greater a census tract's MRI, the faster house prices have appreciated for 2013–17. The scatterplot has a clear upward trend: As the tract MRI increases (x-axis), the ratio of tract home price appreciation relative to county home price appreciation also increases (y-axis). For example, the dark green dots on the right, which had <15 percent high risk loans, had low average tract MRIs (about 3–6 percent) and the dark purple dots on the right, which had ≥60 percent high risk loans, had high tract MRIs (about 17–23 percent). For the dark green dots, the median ratio of tract to county house price appreciation is 0.86, while for the dark purple dots, the median ratio of tract to county appreciation is 1.19—a 38 percent higher level of price appreciation for the dark purple over dark green tracts.

Further, the blue color palette tracts all had a high risk loan share of 30 percent or more. Together these tracts represent about 50 percent of all sale transactions and had higher price appreciation relative to the county than did the green color palette tracts. In these tracts, a critical mass of buyers (at least 30 percent) has access to high-risk loans providing higher equity and income leverage, thereby allowing this group to essentially set the price for all buyers (and for borrowers in the tract who are refinancing). Therefore, all these borrowers (and lenders and mortgage guarantors) in a tract with a greater share of high-risk lending are exposed to dangerous home price volatility that is not related to fundamentals but to increases in leverage.

The BCFP's DTI patch, announced in 2013 and still in effect, bears special mention in this regard. Because the patch allows government agencies and the GSEs to increase DTIs, the patch is helping fuel the current house price boom. When mortgage risk expands alongside of home prices, there is little "friction" in mortgage markets to slow the growth of a housing boom.

**Figure 10. Correlation 1: Census Tract Mortgage Risk and House Price Appreciation, by Tract Share of High-Risk Lending**



Note: Binned scatterplot with 100 equally sized bins. Shading indicated the majority of tracts by high-risk share within the bin. Results based on over 17,000 census tracts with at least 20 match loans in each year for 73 CBSAs. Weighting is based on the Home Mortgage Disclosure Act.  
Source: AEI Center on Housing Markets and Finance.

**Correlation 2: Census Tract Mortgage Risk Index and Home Price by High-Risk Loan Share of Tract Lending**

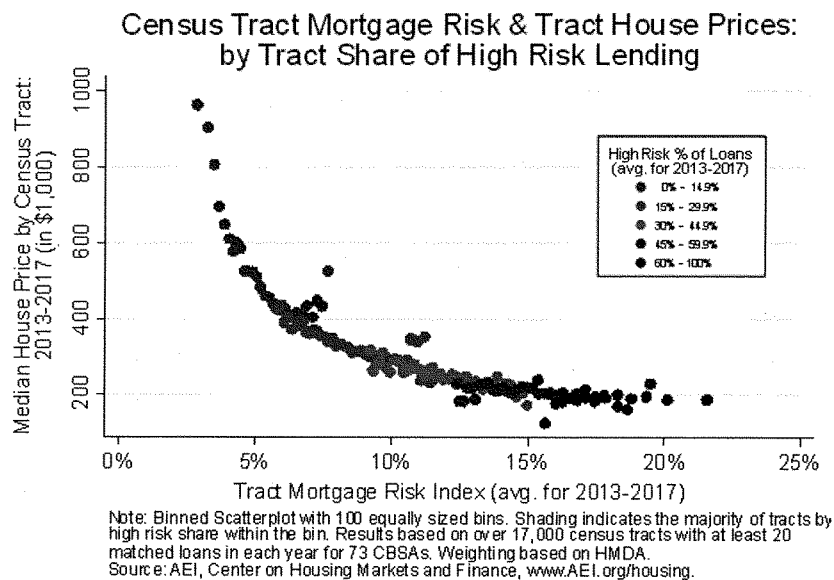
There is a strong positive correlation between higher mortgage risk and lower home prices.

The binned scatterplot below shows that the greater a census tract's MRI, the lower the median home price. Low mortgage risk census tracts are present among the entire range of tracts by average home price (green color palette dots). High-risk census tracts are concentrated among tracts with median home prices of \$300,000 or less. High-risk lending is associated with at least 30 percent of purchases for all these tracts (blue color palette dots).

Further, the scatterplot has a clear downward trend: As the tract MRI increases (x-axis), the median tract home prices decreases (y-axis). For example, the dark green dots on the right, which had <15 percent high risk loans, had low average tract MRIs (about 3–6 percent) and the dark purple dots on the right, which had  $\geq 60$  percent high risk loans, had high tract MRIs (about 17–23 percent). For the dark green dots, the median tract home price is \$482,000, while for the dark purple dots, the median tract home price is \$176,000.

Eighty-three percent of the binned census tracts with median home prices below \$300,000 had average tract MRIs of 9 percent or greater. As was demonstrated by Correlation 1 above, there is a strong positive correlation between higher mortgage risk and home price appreciation. When the inevitable reversion of real house prices to their trend growth path occurs, these lower-priced census tracts and their residents, who are more likely to be low-income and minority, will again be subjected to more price volatility, greater loss of equity, and higher rates of loan default.

**Figure 11. Correlation 2: Census Tract Mortgage Risk Index and Home Price by High-Risk Loan Share of Tract Lending**



Note: Binned scatterplot with 100 equally sized bins. Shading indicated the majority of tracts by high-risk share within the bin. Results based on over 17,000 census tracts with at least 20 match loans in each year for 73 CBSAs. Weighting is based on the Home Mortgage Disclosure Act.

Source: AEI Center on Housing Markets and Finance.

**Correlation 3: Census Tract Mortgage Risk Index and Income, by High-Risk Loan Share of Tract Lending**

There is a strong positive correlation between higher mortgage risk and lower tract income as a percentage of metro area income.

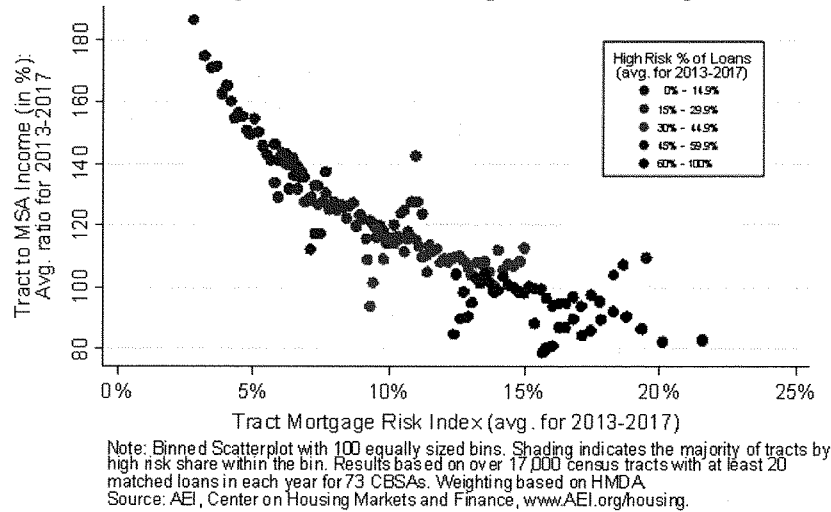
The binned scatterplot below shows that the greater a census tract's MRI, the lower tract income as a percentage of metro area income. The scatterplot has a clear downward trend: As the tract MRI increases (x-axis), the median tract home prices decreases (y-axis). For example, the dark green dots on the right, which had <15 percent high risk loans, had low average tract MRIs (about 3–6 percent) and the dark purple dots on the right, which had  $\geq 60$  percent high-risk loans, had high tract MRIs (about 17–23 percent). For the dark green dots, the median tract income was 158.2 percent of metro area income, while for the dark purple dots, the median tract income was 88.8 percent of metro area income.

Seventy-five percent of the binned census tracts with median income below 120 percent income of metro area income had average tract MRIs of 9 percent or greater. As was demonstrated by Correlation 1 above, there is a strong positive correlation between higher mortgage risk and home price appreciation. Once again, the residents of these lower-income census tracts will be subjected to more price volatility, greater loss of equity, and higher rates of loan default.

**Figure 12. Correlation 3: Census Tract Mortgage Risk Index and Income, by High-Risk Loan Share of Tract Lending**



### Census Tract Mortgage Risk & Tract Income: by Tract Share of High Risk Lending



Note: Binned scatterplot with 100 equally sized bins. Shading indicated the majority of tracts by high-risk share within the bin. Results based on over 17,000 census tracts with at least 20 match loans in each year for 73 CBSAs. Weighting is based on the Home Mortgage Disclosure Act.  
Source: AEI Center on Housing Markets and Finance.

#### **Correlation 4: 73 CBSAs Predicted Census Tract-Level Home Price Appreciation by Census Tract Average Mortgage Risk, with Housing Demand as a Factor**

This fourth correlation shows there is a strong positive correlation between leverage and house price appreciation.

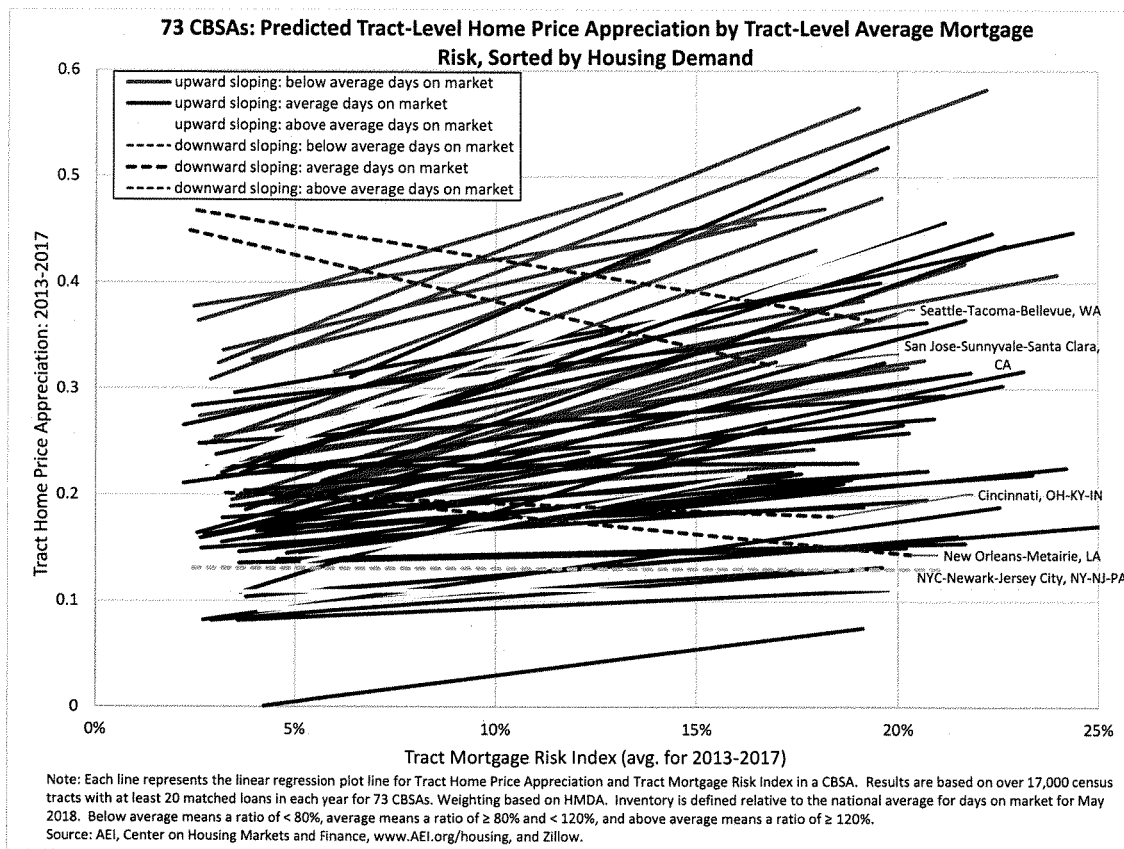
In a 5.7 million sales transaction study of five-year home price appreciation (HPA) rates for over 17,000 census tracts with at least 20 loans per year, we examined the relationship between tract house price appreciation from 2013 to 2017 and tract-level average mortgage risk between 2013 and 2017 within 73 large core-based statistical areas. (See Appendix 1 for a list of CBSAs.) We found that within these CBSAs, leverage is positively correlated with house price appreciation.

The scatterplot below (Figure 13) shows the predicted tract-level home price appreciation by tract-level average mortgage risk. Each line represents the

relationship between the two variables for a given CBSA. The color coding of the line represents a snapshot of market tightness.

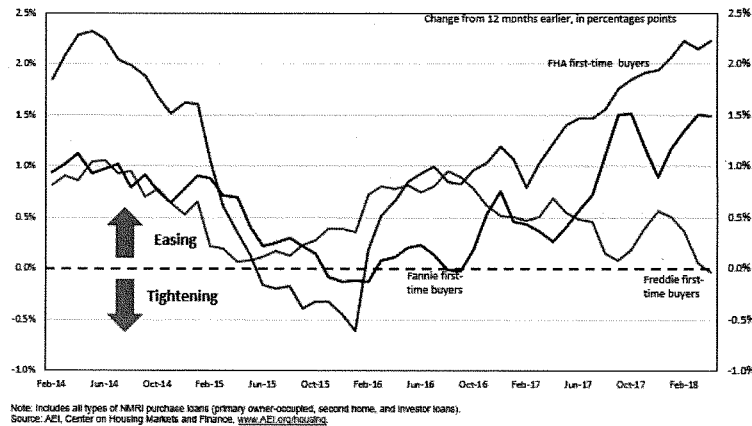
- This correlation was positive in 68 of the 73 CBSAs.
  - The positive correlation between tract house price appreciation and tract mortgage risk was statistically significant at the 5 percent level in 62 of 68 CBSAs.
  - This positive correlation was observed across a range of demand conditions as measured by days on market relative to the national average.
    - Twenty-four of the 68 were in metros with below average days on market (high relative demand),
    - Thirty-eight of the 68 were in metros with average days on market (average relative demand), and
    - Six of the 68 were in metros with above-average days on market (below average relative demand).
  - The correlation was even stronger when markets are tighter (as measured by the average days on market of listings between 2013 and 2017.)
- The correlation was negative in five of the 73 CBSAs.
  - The negative correlation was, however, only statistically significant in three CBSAs (San Jose-Sunnyvale-Santa Clara, California; Seattle-Tacoma-Bellevue, Washington; and New Orleans-Metairie, Louisiana).
  - For San Jose and Seattle, both with below-average days on market, strong demand in the high-price tier may have outweighed the mortgage risk effect. In San Jose for example, the share of sales in the high price tier increased from 35 percent in 2013 to 65 percent in 2017. In Seattle, sales growth in the high-price tier also far outpaced sales growth in the low tier. Additionally, when King County (Seattle) and Pierce County (Tacoma) were examined individually, while the correlation in King was still negative, the correlation in Pierce was positive.
  - New Orleans was an outlier.

**Figure 13. Seventy-Three CBSAs Predicted Tract-Level Home Price Appreciation by Tract-Level Average Mortgage Risk, Sorted by Housing Demand**



I will now turn to the deleterious actions of Fannie Mae and FHFA during the past few years of the conservatorship that relate to the growing competitive battle between Fannie and FHA for high-risk first-time buyers (Figure 14). Worryingly, the pace of credit easing by FHA and Fannie is increasing. Over the past nine months, Freddie has largely resisted this trend but will likely eventually have to compete as well.

**Figure 14. First-Time Buyer Agency Loan NMRI**



Note: This includes all types of NMRI purchase loans (primary owner-occupied, second home, and investor loans).

Source: AEI Center on Housing Markets and Finance. [www.aei.org/housing](http://www.aei.org/housing)

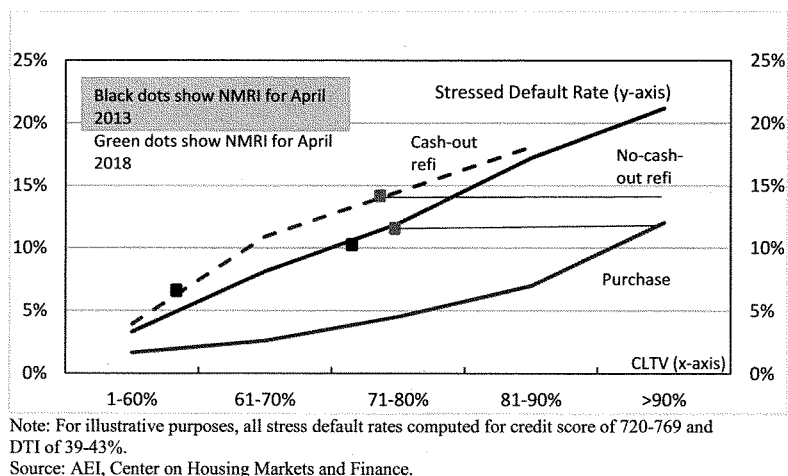
Given that the GSEs' purchase share is nearly three times that of FHA, impact of relatively modest increases in high-risk lending by the GSEs will be amplified by their greater share. The share of GSE loans that are high risk (an MRI >12 percent) has risen from 7 percent in late-2012 to 21 percent today. This will have a commensurate impact on driving home prices unsustainably higher.

Before turning to potential actions that the administration and the FHFA could take with respect to the GSEs and the FHA, I want to briefly point out some of the many areas where the long-running conservatorship has been used to strengthen the GSEs' taxpayer-guaranteed duopoly and compete unfairly with the private sector.

- GSE's Common Securitization Platform (CSP), pricing, and credit risk transfers
- Expansions into private-sector business activities including:
  - Mortgage insurance,
  - Lines of credit to nonbank mortgage companies to assist with their mortgage servicing operations, and

- Services and technology that help mortgage bankers raise cash from mortgage servicing rights.
- Multifamily GSEs' loan acquisitions grew by 256 percent from 2013, reflecting an increase from \$54.5 billion in 2013 to \$139.3 billion in 2017.
- Expansion into risky cash out refinance loans

Compared to an identical purchase loan, refis have higher stressed default rates across all CLTV buckets. Cash-out refis are even riskier than no-cash-out refis. For example, a purchase loan with a 720-769 credit score, a DTI of 39-43 percent, and a CLTV of 71-80 percent has a stressed default rate of 4.5%, however, a cash-out with the same characteristics has a MRI that is three times as high at 14 percent, the same as a purchase loan with a CLTV of >90 percent.



I will now turn to potential actions that the administration and the FHFA could take regarding the GSEs and the FHA.

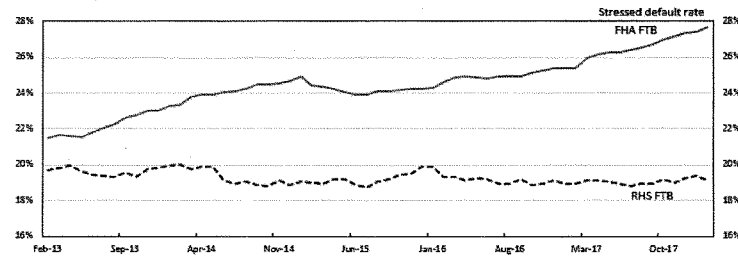
Let me start off by stating that measured steps now would moderate the current pace of unsustainable home price increases and not lead to home price declines.

Unlike FHA, RHS has not moved out risk curve during the current boom, keeping housing more affordable for RHS buyers. This is demonstrated in the next chart. The upper portion shows that FHA borrowers are able to buy a 26 percent more expensive home than five years ago (more than triple the rate of inflation), yet with a smaller down payment. At the same time, homes purchased by RHS buyers have only gone up 9 percent, about the same as the rate of inflation. RHS's stressed default rate is unchanged over the past five plus years, while FHA's first-time

buyer risk index has increased from 21.5 percent to 27.5 percent. At the same time, our research shows that the median income of home buyers served by the FHA and RHS over the last five years have both gone up by about the same percentage, further evidence that RHS' policy has helped RHS borrowers buy home at more sustainable prices and with less leverage.

**Figure 15. Not Moving Out the Risk Curve During the Current Boom Has Helped Keep Housing More Affordable for RHS Buyers**

	Median downpayment		Median saleprice
	Feb. 2013	Feb. 2018	Change from Feb. 2013 to Feb. 2018
RHS	\$-1,900	\$-1,000	+9%
FHA	\$4,100	\$3,900	+26%



Source: AEI Center on Housing Markets and Finance, [www.AEI.org/housing](http://www.AEI.org/housing).

Source: AEI Center on Housing Markets and Finance.

Turning now to my recommendations for administrative actions addressing housing finance reform, I will cover the need for prompt action, which may be taken by three parties: the Department of Housing and Urban Development (HUD)/FHA, BCFP, and FHFA/Treasury.

**Step 1: Actions by HUD/FHA That Should Be Taken in 2019.** As suggested in recent testimony by Benjamin Carson, HUD/FHA should “closely examine policies that go beyond FHA’s core mission” and be “mindful of concerning trends.”

The evidence is clear that during a seller’s market, with FHA’s share at 20 percent and its MRI at nearly 30 percent, FHA and other FHA-like lending will result in an unsustainable increase in home prices.

In light of this, HUD/FHA should takes steps to:

- Reduce FHA’s footprint by better targeting to FHA’s core mission of serving low-income home buyers
  - Cap FHA’s QM at loan limits equal to a multiple of area median income:
    - Three times income for all but high-cost areas and new construction
    - Four times income for high-cost areas and new construction
  - FHA’s volume would drop by 42 percent with share at about 12 percent, down from 20 percent today

- Trim several risky parts of FHA’s credit box by:
  - Limiting DTIs to 50 percent along with other corresponding DTI changes
  - Reducing seller’s concessions from a maximum of 6 percent to 3 percent
  - Restricting equity leverage risk layering resulting from simultaneous use of down payment assistance and seller concessions
  - Eliminating all or a substantial portion of FHA’s cash-out refinance loan activity
- Promote wealth building by crowding in loan terms of 20 years or less and crowding out 30-year loans
- Use QM authority to implement countercyclical changes:
  - Evidence that a creditor’s ability-to-repay determination was reasonable and in good faith:
    - Underwriting standards that have historically resulted in comparatively low rates of delinquency and default during adverse economic conditions
    - Underwriting standards based on empirically derived, demonstrably, and statistically sound models
  - Evidence that a creditor’s ability-to-repay determination was not reasonable or not in good faith:
    - The creditor disregarded evidence that the consumer may have insufficient residual income to cover other recurring obligations and expenses, taking into account the consumer’s assets other than the property securing the loan, after paying his or her monthly payments for the covered transaction, any simultaneous loans, mortgage-related obligations, and any current debt obligations
- Institute a consumer disclosure regarding a loan’s likelihood to default under stress conditions
- Net present value (NPV) claims-paying capacity, MIP revenue and capital resources
  - At end of FY 2018, assuming a portfolio of \$1.19 trillion and a need to withstand a Great Recession-sized event, FHA should have:
    - NPV claims-paying capacity equal to 9.0 percent or \$107 billion
    - Capital resources portion equal to 5.0 percent or \$60 billion
    - However, home prices, particularly entry-level prices, have been inflated by excess leverage, most of which has been provided by FHA
    - Therefore, a buffer of an additional 2 percent in capital resources should be provided for each 10 percent that low and low-medium FHA home prices have increased faster than medium-high and high home prices (currently +18 percent)
    - This would require \$24 billion in additional capital resources for a total of \$84 billion to support \$1.19 trillion in outstandings

The above steps would go a long way toward reducing the FHA’s pro-cyclical impact of driving up entry level home prices in a seller’s market.

**Step 2: Actions by BCFP in 2019.** The bureau should, coincident with its five-year review of the QM regulation and attendant “patch” due by January 2019, announce that the GSE

patch will not be renewed when it expires in January 2021. It should also provide guidance to the GSEs that they should immediately begin reducing industry reliance on the patch in a measured manner, thereby reducing any market impacts between now and the 2021 expiration of the patch. Providing guidance to the GSEs would go a long way toward eliminating the capture by the GSEs of the high DTI FHA business that the FHA would be cutting back under Step 1 above. Finally, it should coordinate these actions with HUD/FHA's own actions to reduce FHA's DTIs.

**Step 3: Actions by FHFA in Concert with Treasury.** The only plausible reason for government to back the housing market is to help low- or moderate income families buy homes. An evaluation of the GSEs 2017 business shows, that the GSEs fail to meet this simple test. **Almost half of the GSEs' 2017 volume wasn't even related to buying a primary residence. Another 41% went to help well-to-do buyers, of which 25 percentage points went to well-to-do repeat buyers of primary residences and 16 percentage points went to well-to-do first-time buyers. Only 6.5% (1 in 16) GSE Dollars went to first-time buyers of more modest homes and only 3.7% (1 in 30) GSE Dollars went to repeat buyers of more modest homes.**

Therefore, even before a new permanent or acting FHFA director named by the president takes office, the Treasury should announce a strategic plan to implement at least a 50 percent reduction in the GSEs' single-family and multifamily acquisition footprint. Once a director named by the president has taken office, Treasury and FHFA should work together to implement this strategic plan.

Single-family-plan reductions might be accomplished by the following steps over three to four years with minimal impact on the primary owner-occupied home finance market and the availability of the 30-year fixed rate mortgage:

- End acquisition of cash out refinance loans (25 percent footprint reduction based on 2017 acquisition volumes)
- End acquisition of high-cost limit loans (3 percent additional footprint reduction based on 2017 acquisition volumes) and freeze conforming loan limit at \$453,100
- End acquisition of second home and investor loans (9 percent additional footprint reduction based on 2017 acquisition volumes)
- End acquisition of noncash-out refinance loans (15 percent additional footprint reduction based on 2017 acquisition volumes)

Multifamily:

- A 50 percent reduction in combined GSE annual acquisition volume to \$65 billion/year would return their share to 2012 levels, taking into account the growth of outstanding multifamily debt since 2013.
  - The GSEs' loan acquisitions grew by 256 percent from 2013, reflecting an increase from \$54.5 billion in 2013 to \$139.3 billion in 2017.
  - This reduction will be achieved through some combination of increased pricing, more limited product offerings, and tighter overall underwriting standards.



GSE's Common Securitization Platform (CSP), pricing, and credit risk transfers. Treasury and FHFA should:

- Conduct a detailed study of the issues and options on the GSE's CSP and credit risk transfers.

Treasury should work with FHFA to:

- Either implement the suspended standby fee as compensation for the taxpayer backstop as originally provided for under the PSPA or raise guarantee fees a commensurate amount
- Examine the GSEs' guaranty fee pricing, capital requirements, and full implementation of Section 401 of the Temporary Payroll Tax Cut Continuation Act of 2011. This statutory provision directs FHFA to require GSE guarantee fees to be set so as to appropriately reflect the cost of capital allocated to similar assets held by fully private regulated financial institutions
- Examine current cross-subsidies in the guarantee fee pricing, effect of competing with FHA, and impact on home prices
- Expand the credit risk transfer program to maximize the amount of credit risk transferred to or retained by the private market, with emphasis on front-end, first-loss transfers. Also to review CRT pricing, structure, and entities (including where domiciled)
- Review the current wind down of the GSE's retained portfolios to ensure the size is commensurate with the operational needs of the GSE's and Treasury's exposure as effective guarantor
- Examine Affordable Housing Program
  - Reduce combined loan to value ratio on >20 year loan term to 95 percent
  - Implement wealth building home loan (<=20 year loan term) at 100 percent combined loan to value ratio
  - Examine Affordable Housing Trust Fund and Capital Magnet Fund funding while in conservatorship
- Reduce maximum DTI to:
  - 43 percent on >20 year loan term by January 2021
  - 46 percent on <=20 year loan term by January 2021
- Promptly examine all program and product expansion approvals that have been given while in conservatorship, with the immediate termination of those that compete with the private sector

In conclusion, prompt administrative action is advisable now. We are in the midst of a strong home price boom that is unsustainable and fueled by leverage. While we do not know when real house prices will revert to their trend growth path, what is certain is that when such a reversion occurs, low-income and minority home buyers will again be unduly subjected to volatile home prices, loss of equity, and attendant loan defaults. As a nation we can and must do better.

Testimony of

Phillip L. Swagel

Before the Committee on Financial Services

U.S. House of Representatives

**“A Failure to Act: How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk”**

Thursday, September 6, 2018

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify on the subject of GSE Reform. I am a professor at the University of Maryland’s School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a senior fellow with the Milken Institute’s Center for Financial Markets. I was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Housing finance reform remains the notable unfinished legislative task of the financial crisis. Indeed, when Fannie Mae and Freddie Mac were taken into conservatorship ten years ago—while I was at the Treasury Department—it was scarcely imagined that the two Government Sponsored Enterprises would remain in government control a decade later and that the vast majority of mortgages in the United States would be guaranteed by taxpayers.

Housing finance reform is still needed. While the housing finance system seems to work well for many Americans, access to mortgage financing remains crimped for many families even as the dominant government role means that taxpayers are taking on too much risk and consumers are missing out on potentially beneficial innovation. In other words, the current housing finance system should satisfy neither those who care most about considerations of taxpayer safety and healthy markets, nor those for whom concerns over affordability and access are paramount.

Housing finance reform can mean a better system in several dimensions:

1. Better taxpayer protection and diminished systemic risk of another financial crisis;
2. Improved access to mortgage financing for families who still face difficulty getting loans;
3. Better targeted and more effective subsidies for affordable housing;
4. Increased transparency in the expenditure of public resources for those subsidies;
5. A more innovative housing finance system with a well-defined role for the government.

Importantly, reform can do better on both taxpayer protection/efficiency and affordability/access.

**The Flawed System Before the Financial Crisis**

Understanding the flaws of the pre-crisis housing finance system is helpful to ensure that we avoid them in moving forward with reform, whether future changes come about through legislation or through administrative actions.

The central flaw of the old system was the **implicit guarantee** under which Fannie and Freddie, though private companies, were viewed by market participants as having the financial backing of the U.S. government. As David Scharfstein and I explain in a recent overview paper,<sup>1</sup> this implicit guarantee allowed Fannie and Freddie to fund themselves at lower rates than otherwise would have been the case given their modest capital ratios, earning a spread between the yield on the MBS they held in portfolio and their artificially low debt financing costs. The implicit guarantee meant that Agency MBS (mortgage backed securities guaranteed by Fannie and Freddie) traded as if they were free of credit risk even though the two firms were **woefully undercapitalized**; the two firms were required to fund themselves with only 40 bps of capital (four-tenths of one percent) for each \$100 of single family mortgages they insured.

In retrospect, given the incredibly favorable situations enjoyed by Fannie and Freddie, it is astonishing that the two firms put themselves in position to fail.<sup>2</sup> And yet they did, presenting great peril to the U.S. financial system and economy. Indeed, the risks taken by the two firms leading into the crisis embodied the **moral hazard** in the pre-crisis system in which the implicit—and uncompensated—guarantee meant that GSE shareholders and management got the upside in good times, while U.S. taxpayers were left covering the risk in a catastrophe – as happened in 2008. Flaws in securitization and origination of non-Agency lending were the initial driving factors behind the housing bubble and thus the financial crisis, but the actions of the GSEs made the crisis worse.

With the two firms then (and still) the linchpins of the U.S. mortgage system, allowing them to fail would have seriously disrupted the flow of mortgage credit at a time when the U.S. financial system and broader economy were facing considerable challenges. Moreover, with GSE debt held widely in the United States and around the world, allowing the two firms to default on their obligations could have had systemic consequences. Many U.S. financial institutions might have been required to recapitalize or shrink their balance sheets, while foreign investors might have hesitated to provide the capital flows that support U.S. investment and consumption and help finance the U.S. government. The terms of the taxpayer support in September 2008 were stiff but appropriate. Fannie and Freddie shareholders had their stakes diluted through the government's 79.9 percent ownership in each firm, with new senior preferred shares issued ahead of the pre-crisis common and preferred equity and paying a 10 percent coupon (or higher if the dividend was paid in kind). Investors in GSE debt and MBS were bailed out, however—much as had been predicted by those who warned about the dangers of the implicit guarantee.<sup>3</sup> While taxpayers remain on the hook to support the firms indefinitely in conservatorship, the commitment of taxpayer resources achieved its purpose, as mortgage financing remained available throughout the crisis even while many other parts of U.S. financial markets exhibited severe strains.

<sup>1</sup> David Scharfstein and Phillip Swagel, 2016. "Legislative Approaches to Housing Finance Reform," in *Principles of Housing Finance Reform*, Edited by Susan M. Wachter and Joseph Tracy, University of Pennsylvania Press.

<sup>2</sup> An account of the misjudgments at Freddie Mac can be found in Susan Gates, *Days of Slaughter: Inside the Fall of Freddie Mac and Why It Could Happen Again*, Johns Hopkins University Press (2017), while Timothy Howard, *The Mortgage Wars: Inside Fannie Mae, Big-Money Politics, and the Collapse of the American Dream*, McGraw-Hill (2013) discusses missteps at Fannie Mae.

<sup>3</sup> See, for example, N. Gregory Mankiw, "Remarks at the Conference of State Bank Supervisors, State Banking Summit and Leadership Conference," November 6, 2003. <http://scholar.harvard.edu/files/mankiw/files/stbank.pdf>

Ten years later, the problems of the pre-crisis GSE system remain in place: we still have two undercapitalized firms that are too important to be allowed to fail. In short, we have failed to address a problem that long has been in front of us.

In addressing these dangers, housing finance reform should clarify the roles of the private sector and the government, making clear what would happen in the event that Fannie, Freddie or any future competitors in securitization and guaranty face collapse. Ensuring that these firms, once they exit conservatorship, fund themselves with more capital will reduce the likelihood of another failure. But if firms remain too important to be allowed to fail, then simply stating that there will not be another bailout is not credible—indeed, a return to a duopoly of private firms such as with “recap and release” would reconstitute the implicit guarantee that was the most problematic aspect of the pre-crisis system. This would be the case even in a recap and release approach that increased the amount of capital over the meager amount required in the pre-crisis system. More capital is important, but not enough: simply adding capital to the model that failed in the crisis does not enough address its structural problems. Reform should make the GSEs and any successor or competitor firms safer and also foster more competition outside of the now-dominant government-guaranteed sector of the mortgage market.

#### **The Housing Finance System since the Crisis**

While the current situation with the GSEs is not satisfactory, considerable progress has been made in addressing some problems of the old system.

Most importantly, there is now private capital taking on housing credit risk in the GSEs’ single-family guaranty business through a variety of risk transfer transactions (the GSEs’ multi-family businesses already shared risk with private capital). The Federal Housing Finance Agency under the leadership of Director DeMarco and Director Watt deserves praise for moving forward with this initiative, as do the people involved at both Freddie and Fannie. While having private capital at risk provides welcome protection ahead of the government, with a duopoly, taxpayers are still on the hook to ensure the continued operations of the two firms. Addressing this latter concern is a key objective of reform – to arrive at a system in which there are sufficient competitors in securitization and guaranty that one or more of them can be allowed to fail without posing a risk to the financial system or the economy. Reform further would usefully increase the share of non-guaranteed origination.

The retained portfolios of MBS have shrunk at the two firms, reducing a way in which the GSEs posed a systemic risk by their massive issuance of debt to fund the portfolios. There is no need for Fannie and Freddie to act as “buyers of last resort” to support demand for mortgages—a rationale sometimes put forward for having massive retained portfolios—since the Federal Reserve can purchase MBS again in the future if needed to support the broad economy as it did during the financial crisis. Indeed, reform should leave the Federal Reserve and the Treasury Department and not the housing finance regulator as the policymakers responsible for responding to macroeconomic threats.

Other steps taken with the GSEs in conservatorship likewise have improved the housing finance system. The Private Mortgage Insurer Eligibility Requirements (PMIERS) that establish capital standards for private mortgage insurers reduce the chance of problems among these firms as happened during the crisis. The development of a common security for GSE MBS will improve liquidity by unifying the pools in

which Fannie and Freddie MBS trade, ultimately reducing mortgage interest rates. More could be done to turn this initiative into a vehicle for longer term reform by opening the architecture of the common securitization platform to allow additional firms to compete with Fannie and Freddie in the securitization of MBS with a government guarantee.

#### **Future Reforms**

Even with this progress, the housing finance market will remain in limbo absent legislation to move to a better system. Importantly, the current situation imposes a cost in lost activity—we do not see what we are missing in terms of foregone investment and innovation by people who are standing on the sidelines because they are unsure about the structure of the future housing finance system. Legislation would be preferable, but in the meantime, it would be useful for the next FHFA Director to consider administrative measures to push forward with aspects of a reform agenda within the bounds of the Agency's legal authority. I first discuss aspects of legislative reform and then consider administrative steps.

In contemplating the future housing finance system, it is important to keep in mind that taxpayers are now on the hook for housing credit risk, both explicitly through the terms of the Treasury support for Fannie and Freddie and implicitly because the two firms remain too important to the housing finance system and to the broader economy to be allowed to fail. A reduction in taxpayer exposure would be brought about through a reform that involves an explicit guarantee on specified MBS protected by an ample cushion of private capital. The guarantee and taxpayer exposure already exist. Reform that recognizes this risk would improve taxpayer protection and make the government role transparent rather than implied. Reform can also usefully separate the critical infrastructure of the housing finance system such as the common securitization platform from the firms that serve as guarantors or credit enhancers, among whom there can be competition for the benefit of borrowers and the overall economy.

#### **Legislation**

There are important dimensions of agreement among the various legislative proposals for housing finance reform, including 1) the key role for private capital in taking credit risk ahead of a government guarantee; 2) the secondary government guarantee covering MBS and not the firms such as Fannie and Freddie involved in securitization and guaranty; 3) support for affordable housing to be made explicit, transparent, and more effective; and 4) provisions to ensure that smaller originators have equal access to the processes by which mortgages receive government backing. I would add a fifth principle: the importance of fostering competition within the mortgage finance system.<sup>4</sup>

This approach would open the business of guaranty and securitization to multiple private firms that would compete with the existing GSEs. This could be done in various ways, including along the lines of

<sup>4</sup> See Susan Gates, Ann Schnare, and Phillip Swagel, "Privatize Fannie and Freddie, yes. But be pragmatic," March 2017. [https://www.rhsmith.umd.edu/files/Documents/Centers/CFP/research/swagel\\_march\\_2017.pdf](https://www.rhsmith.umd.edu/files/Documents/Centers/CFP/research/swagel_march_2017.pdf)

the PATH Act; as proposed by Ed DeMarco and Michael Bright<sup>5</sup> or by Jim Parrott et al;<sup>6</sup> or following the approach in the Senate Banking Committee with the Crapo-Johnson and Corker-Warner proposals. In the latter approach, firms that purchase the secondary government guarantee on their MBS would be required to fund themselves with considerable private capital that would be extinguished ahead of the taxpayer obligation. MBS would be guaranteed but the firms undertaking securitization and guaranty would not; with sufficient entry, one or more of the private guarantors could fail without posing a systemic risk. In the event of a broad crisis that threatens the collapse of all guarantors, there is little doubt that the federal government would step in, but this is the case with any system. Indeed, legislation should contemplate this possibility and include a resolution regime that ensures that the private shareholders are wiped out ahead of such federal support. Even so, the essential – and I think achievable – goal of reform is to ensure more capital and instill more competition and market discipline to avoid another catastrophic failure in the first place.

The amount of capital and the pricing of the secondary government guarantee are crucial decisions.<sup>7</sup> The key insight remains that ample private capital is essential both to shield taxpayers and to provide the private sector firms with an incentive for prudence. Policymakers should look skeptically at the suggestion that ensuring appropriate capital levels will have an especially large impact in pricing people out of mortgages. After all, if a specified amount of capital is enough to protect taxpayers against all but the most catastrophic housing credit risk, then incremental capital past this point would hardly be at risk and therefore cannot be expensive. It cannot be the case that taxpayers are safe and yet incremental capital has a large impact on mortgage interest rates—if adding capital is expensive, then taxpayers are not safe and the capital requirement is insufficient.<sup>8</sup> A recent CBO report, for example, indicates that a structure for the secondary mortgage market along the lines of the 2014 cost estimate for the Crapo-Johnson proposal (S.1217) would result in a small impact of 10 to 20 basis points on mortgage interest rates – and this modest impact easily could be offset with better targeted subsidies to improve affordability for low- and moderate-income borrowers.<sup>9</sup>

The proposal by Representatives Carney, Delaney, and Himes provides an example of an innovative approach by which to price the government guarantee. In their setup, five percent private capital would be required in the first-loss position, and then 10 percent of the mortgage credit risk of the remaining 95 percent of the securitization would sold to private investors *pari passu* to the government exposure. The pricing of this 9.5 percentage points of capital would be used to set the price of the secondary government insurance. The precise details of a pricing mechanism would have to be worked out, but the

<sup>5</sup> Ed DeMarco and Michael Bright, “Toward a New Secondary Mortgage Market,” September 29, 2016. <https://www.milkeninstitute.org/publications/view/823>

<sup>6</sup> Jim Parrott, Lewis Ranieri, Gene Sperling, Mark Zandi, and Barry Zigas, “A More Promising Road to GSE Reform,” March 2016. <https://www.economy.com/mark-zandi/documents/2016-03-22-A-More-Promising-Road-To-GSE-Reform.pdf>

<sup>7</sup> See Eric Kaplan, Michael Stegman, Phillip Swagel, and Ted Tozer, “Bringing Housing Finance Reform over the Finish Line,” January 2018, Milken Institute. <https://www.milkeninstitute.org/publications/view/898>

<sup>8</sup> See Scharfstein and Swagel (2016) for an analytic discussion, or the numerical analysis in Jim Parrott, Michael Stegman, Phillip L. Swagel, and Mark M. Zandi, “Access and Affordability in the New Housing Finance System,” Urban Institute, February 13, 2018. <https://www.urban.org/research/publication/access-and-affordability-new-housing-finance-system>

<sup>9</sup> Congressional Budget Office, “Transitioning to Alternative Structures for Housing Finance: An Update,” August 23, 2018. <https://www.cbo.gov/publication/54218>

key insight of the Carney-Delaney-Himes proposal is to harness private incentives to price the government guarantee.

Entry of new firms to compete in securitization and guaranty is useful for two related purposes: to ensure that one or more firm can fail without an undesirably large disruption to the availability of mortgage financing, and to ensure that competition among firms pushes down the costs involved with home loans for the benefit of consumers.<sup>10</sup> A challenge for housing finance reform is thus to ensure that an adequate number of new firms enter to compete. With the annual earnings of Fannie and Freddie together more than \$10 billion in recent years, there would seem to be adequate incentive for others to enter into this market. Opening the common securitization platform to entrant firms would ensure that new competitors are not at an initial liquidity disadvantage. And as noted previously, housing finance reform must ensure that smaller lenders are not disadvantaged as was the case in the pre-reform system.

#### **Administrative Measures**

While housing finance legislation remains difficult, it would be useful to take administrative measures that move in the direction of an improved housing finance system. Such steps would not foreclose any particular legislative outcome. The broad direction of administrative measures in housing finance reform would be to focus the GSEs' activities while improving their effectiveness.

Ahead of legislation, it is useful that the FHFA in July of this year put forward for comment a proposal for Enterprise Capital Requirements that would apply in the event the GSEs emerge from conservatorship. It is common for the level of capital requirements for the GSEs to be compared to the firms' losses in the financial crisis—for example, to note that the amount of capital implied by the recent capital proposal or by the FHFA's annual stress test would have been enough for Fannie and Freddie to make it through the crisis. This comparison is inapt. The losses of the two firms during the crisis came in the face of massive interventions by the federal government to support the housing market and the economy. Capital requirements should be set so that problems in the housing finance system do not require another TARP, an \$800 billion fiscal spending binge, or extraordinary policy actions by the Fed and FDIC. And even then, capital requirements are set to ensure that firms have not just the capital to squeak past a severely stressful environment but to continue operating through the stress. If the future housing finance system involves a duopoly, those two firms must have fortress balance sheets – they will be essentially akin to utilities.

While the duopoly continues in the present, additional competition and innovation in the housing finance system can be fostered by actions that increase the share of non-Agency securitization and thereby reduce the exposure of taxpayers to mortgage risk. An approach in line with the second of the three options in the Obama Administration's white paper on housing finance reform would be to limit the scope of the government guarantee on MBS in normal times when there is little need for it, and expand the availability of the government backstop in periods of financial stress. This is similar to the provisions of the PATH Act, in which a government guarantee is available through the FHA for low-

<sup>10</sup> Evidence on the importance of competition in housing finance is provided by David Scharfstein and Adi Sunderam, "Market Power in Mortgage Lending and the Transmission of Monetary Policy," April 2015. <https://www.hbs.edu/faculty/Pages/item.aspx?num=44239>

income and first-time homebuyers in normal times, and made widely available in times of stress. Administrative changes to the GSE capital regime and the pricing of GSE insurance premiums could move in this direction.

The expiration of the QM Patch in January 2021 provides a natural opportunity to consider the scope of GSE activities and the broader set of regulations around origination, with the FHFA usefully coordinating with other federal regulators. As noted by Kaul and Goodman (2018), “The non-QM market is small because most lenders are wary of taking on the risk that a borrower in default will sue, citing lender failure to verify ability to repay.”<sup>11</sup> The problem is that overly rigid regulation discourages private sector capital from taking on mortgage risk outside the confines of the GSEs. It would be useful to coalesce on one set of standards that avoid favoring the GSE channel—ultimately doing away with the QM patch rather than broadening it to encompass additional lending. FHFA should further examine whether elements of the GSEs’ automated underwriting systems represent critical infrastructure in the sense that the favored status of loans approved by those systems poses a barrier to entry. This would lead to consideration of putting those systems into the common securitization platform.

In making changes to capital standards, insurance pricing, and acceptable origination parameters at the GSEs, it would be useful as well to coordinate with the FHA and with the regulators of other lending securitized by Ginnie Mae. The goal is to avoid having borrowers migrate to FHA, presenting a yet greater risk to taxpayers since FHA loans have no private capital at the MBS level and typically modest down payments such as 3.5 percent.

Administrative reforms can also improve the effectiveness with which the housing finance system supports affordable housing. As documented in my February 2018 paper with Parrott, Stegman, and Zandi, the current GSE system provides an estimated \$4.1 billion in annual resources to subsidize affordable housing, of which \$3.8 billion comes through cross-subsidization that takes place within the pricing structure of the insurance premiums charged by Fannie and Freddie, and another \$300 million each year results from the affordable housing fee imposed on the two firms.<sup>12</sup> The \$3.8 billion in cross-subsidization comes about because lower risk borrowers pay relatively higher insurance premiums than would be implied by considerations of risk and return, in order to reduce insurance premiums and thus borrowing costs for higher-risk borrowers.

This approach to subsidizing affordable housing is poorly targeted to help low- and moderate-income borrowers who most need assistance to become homeowners, because the measure of risk by which the subsidies are allocated does not correspond to measures of income or need. In the current GSE system, a lower-income family that has prudently accumulated money for a 20 percent down payment on their home and has lived within their means to end up with a high FICO score in effect will subsidize a higher-income or wealthier borrower with a smaller down payment and a lower FICO score. In my February 2018 paper with Parrott, Stegman, and Zandi, we estimate that approximately 23 percent of borrowers receiving a subsidy under the current system are not low- and moderate-income households. We describe an alternative in which the cross-subsidy would go only to low- and moderate-income

<sup>11</sup> Karan Kaul and Laurie Goodman, “What, If Anything, Should Replace the GSE QM Patch?” Urban Institute, August 2018. [https://www.urban.org/sites/default/files/publication/98949/qualified\\_mortgage\\_rule.pdf](https://www.urban.org/sites/default/files/publication/98949/qualified_mortgage_rule.pdf)

<sup>12</sup> For a discussion of the affordable housing fee and initial review of the uses of the funds, see Michael Stegman and Phillip Swagel, “An Affordable Housing Fee in the Context of GSE Reform,” Milken Institute, June 2018. <https://www.milkeninstitute.org/publications/view/916>



borrowers, providing \$4,500 in assistance per borrower, equal to 29 basis points—an amount that would more than offset the impact of higher capital requirements as calculated by the CBO. Restricting affordable housing assistance to new low- and moderate-income homebuyers (rather than those refinancing a loan) would increase the amount of assistance to \$6,000 per family and yet more carefully target assistance to those looking to become homeowners.

Administrative measures could take immediate steps to more carefully target affordable housing assistance even ahead of a full-scale revision of the GSE insurance premiums by removing the cross-subsidy from cash-out refinances. It might make sense for a family to borrow against the value of their home, which for many is their largest asset. But there is no need for the federal government to subsidize the use of a home as an ATM when the private sector can do this effectively.

Administrative measures could further improve the targeting of other GSE activities aimed at affordable housing. In this respect, the decisions made during conservatorship merit careful examination. As an example, the FHFA's implementation of the Duty to Serve provisions mandated by the Housing and Economic Recovery Act of 2008 (HERA) provides Fannie and Freddie with credit for financing energy or water-efficiency improvements through provisions that are not mentioned in the statute. As shown in research by a former top economist in the Obama White House, however, for residential energy efficiency investments, "the cost to deploy the efficiency upgrades was about double the energy savings."<sup>13</sup> There is nothing wrong with people deciding to put up solar panels, but federal subsidies for cost-ineffective activities means less support for low- and moderate-income families looking to become homeowners. A similar approach should guide consideration of other GSE activities to ensure that subsidies embodied in the single-family and multi-family activities are effective and well targeted to those who most need assistance to become homeowners or to afford decent housing.

### **Conclusion**

Housing finance reform remains necessary ten years after Fannie Mae and Freddie Mac were taken into conservatorship. Not moving forward with housing finance reform leaves too many families still facing difficulty obtaining mortgages and taxpayers taking on too much risk. Reform can improve the safety of the housing finance system and better protect taxpayers, and also provide for more access to mortgage financing and better support for affordable housing.

---

<sup>13</sup> "Energy Efficiency Upgrades Cost Double the Projected Benefits." UChicago News. June 23, 2015. <https://news.uchicago.edu/story/energy-efficiency-upgrades-costdouble-projected-benefits-0>.

**AN OPEN LETTER TO THE ADMINISTRATION AND CONGRESS****A Defining Moment for Housing Finance:  
The Need to Preserve Access and Affordability**

While the nation is in the midst of one of the longest economic expansions on record, the wounds of the 2008 financial crisis have not completely healed. Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs), remain mired in government conservatorship a decade later. And yet despite this limbo status, the housing market has recovered in many respects. Home prices have broadly recovered, the numbers of foreclosures and underwater borrowers have steadily fallen, and the multifamily market has responded to meet increased demand for rental housing.

Reforms put in place during conservatorship have better positioned the GSEs to continue to play a vital role in facilitating mortgage liquidity. Such reforms include pricing parity across lenders, the transfer of risk off of taxpayer shoulders, a new infrastructure for the single-family secondary market, and support for strong and sustained liquidity in the multifamily rental market. But none of these reforms are etched in stone, and thus the stability of the housing market is more illusory than appearances may initially indicate. The GSEs' long-term ability to support the housing market, without exposing taxpayers to excessive risk, depends on the outcome of efforts to permanently reform the structural problems that contributed to the crisis. Only with the certainty that comes from these reforms and the end of conservatorship will the private market be able to establish a more permanent and reliable presence in housing finance.

Indeed, as policymakers consider options to remove the GSEs from conservatorship, retain adequate capital to support GSE operations and foster a system that relies more heavily on private capital, there is a pressing need to ensure that the existing progress is cemented rather than cast aside. Any efforts to change the role played by the GSEs must contain safeguards against higher costs or other market disruptions that reduce access to mortgage credit in both the single-family and multifamily markets. They must also include enforceable mechanisms to serve the entire market of renters and qualified homebuyers, including underserved markets and manufactured housing.

The undersigned organizations believe that a well-functioning housing finance system should provide consistent, affordable credit to borrowers across the nation and through all parts of the economic cycle. This credit should be broadly available through responsible lenders operating in the single-family and multifamily markets. Lenders and other market participants should feel confident that they can access the secondary market on a level playing field with their competitors, through clear and transparent standards that do not discriminate based on charter type, asset size or loan volume. Investors should feel confident that channeling long-term capital into the housing market is sustainable. Consumers should feel confident that they can obtain affordable mortgage credit and that they can secure decent housing that meets their needs, whether they rent or own, in both high- and low-cost markets.

To achieve these goals, policymakers must take great care that further actions to reform the GSEs are prudently developed and implemented over a sensible time horizon. Moreover, reforms should reflect a pragmatic understanding of the market and the mechanisms by which credit is delivered. Housing is simply too important to our national economy and our local communities to risk disruption of the system by which it is financed.

Together, we urge policymakers to lock in recent reforms to the GSEs and complete the necessary additional reforms to protect taxpayers, provide liquidity and promote stability while taking care not to roll back aspects of the GSEs' operations that are supporting the foundation of the housing market. Only through such efforts can we ensure an affordable, accessible housing finance system that works for American homeowners and renters alike.

Sincerely,

Asian Real Estate Association of America	National Apartment Association
Center for Responsible Lending	National Association of Affordable
Community Home Lenders Association	Housing Lenders
The Community Mortgage Lenders of America	National Association of Home Builders
Credit Union National Association	National Association of REALTORS®
Enterprise Community Partners, Inc.	National Council of State Housing Agencies
Habitat for Humanity International	National Housing Conference
Housing Partnership Network	National Housing Trust
Independent Community Bankers of America	National Multifamily Housing Council
Leading Builders of America	Real Estate Services Providers Council
Local Initiatives Support Corporation	The Realty Alliance
Make Room	Stewards of Affordable Housing for the Future
Manufactured Housing Institute	U.S. Mortgage Insurers
Mercy Housing Lakefront	United States Conference of Mayors
Mortgage Bankers Association	Up for Growth Action