S. HRG. 112–29

THE ADMINISTRATION'S REPORT TO CONGRESS: REFORMING AMERICA'S HOUSING FINANCE MARKET

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ADMINISTRATION'S REPORT TO CONGRESS: REFORMING AMERICA'S HOUSING FINANCE MARKET

MARCH 15, 2011

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

67–144 PDF WASHINGTON : 2011

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
ROBERT MENENDEZ, New Jersey
DANIEL K. AKAKA, Hawaii
SHERROD BROWN, Ohio
JON TESTER, Montana
HERB KOHL, Wisconsin
MARK R. WARNER, Virginia
JEFF MERKLEY, Oregon
MICHAEL F. BENNET, Colorado
KAY HAGAN, North Carolina

RICHARD C. SHELBY, Alabama
MIKE CRAPO, Idaho
BOB CORKER, Tennessee
JIM DEMINT, South Carolina
DAVID VITTER, Louisiana
MIKE JOHANNS, Nebraska
PATRICK J. TOOMEY, Pennsylvania
MARK KIRK, Illinois
JERRY MORAN, Kansas
ROGER F. WICKER, Mississippi

DWIGHT FETTIG, *Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director*

CATHERINE GALICIA, *Counsel*
LAURA SWANSON, *Professional Staff Member*
ERIN BARRY, *Professional Staff Member*
BETH COOPER, *Professional Staff Member*

ANDREW J. OLMEM, JR., *Republican Chief Counsel*
CHAD DAVIS, *Republican Professional Staff Member*
MICHAEL PIWOWAR, *Republican Chief Economist*

DAWN RATLIFF, *Chief Clerk*
BRETT HEWITT, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

C O N T E N T S

TUESDAY, MARCH 15, 2011

WITNESSES

Additional Material Supplied for the Record

THE ADMINISTRATION'S REPORT TO CONGRESS: REFORMING AMERICA'S HOUSING FINANCE MARKET

TUESDAY, MARCH 15, 2011

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

The Committee met at 9:58 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

I would like to thank Secretary Geithner and Secretary Donovan for coming before the Committee to discuss the Administration's White Paper, Reforming America's Housing Finance Market.

In February, I issued a Committee agenda which stated housing finance reform would be one of my top priorities. Today's hearing provides us an opportunity to start a long-term discussion with top Administration officials about the future of housing policy in America. We are here today to get down to the work of determining how our housing finance system should function.

I want to emphasize that the purpose of this hearing is not to lay blame for the housing crisis, nor is it to revisit every vote taken in this Committee before and during the crisis. We are not here today to merely point fingers and score political points. There is plenty of blame to go around. Members of both parties, Republican and Democrat administrations, that shunned regulation and pushed home ownership. Loan originators, investors, regulators, and the GSEs themselves all contributed to the formation of the housing bubble and its collapse.

Despite some persistent talking points to the contrary, the Financial Crisis Inquiry Report, including the dissenting views of Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas on page 437 concluded that Fannie Mae and Freddie Mac did not by themselves cause a crisis. In fact, others point out that they lagged well behind Wall Street. However, because Fannie Mae and Freddie Mac along with the FHA provided a backstop to the private market, mortgages continued to be available even as credit dried up in other sectors. According to Moody's Chief Economist, Mark Zandi, this Government backstop is one of the most important reasons why the economy suffered a great recession and not another Great Depression.

Today, Fannie Mae, Freddie Mac, and the FHA account for more than 90 percent of the mortgages in the country. Determining the proper level of Government involvement in the mortgage market is just one of the questions before this Committee and it is one that we need to thoroughly and carefully examine. As we consider our options for reforming the housing finance system, there are other questions we must answer. Do we want to preserve the availability of affordable 30-year fixed-rate prepayable mortgages? Should lenders have equal access to the secondary market? Will a new structure provide equal access for all qualified borrowers and market segments, including rural areas, to the mainstream housing finance system? Should we have stable, liquid, and official mortgage markets for single-family and multifamily housing? How will a new structure protect taxpayer dollars?

We must find workable solutions that protect current homeowners and preserve the option of responsible home ownership for future borrowers. The report for us today is a valuable starting point for this discussion and I would like to thank Secretary Geithner, Secretary Donovan, and the staff at the Treasury Department and HUD for the work putting it together. I look forward to your testimony and to a constructive discussion of the challenges ahead of us.

Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling this hearing.

Last month, the Treasury Department and the Department of Housing and Urban Development presented a report to Congress on options for ending the conservatorships of Fannie Mae and Freddie Mac and improving our housing finance system.

During the debate over Dodd-Frank, Republicans insisted on dealing with the failed housing enterprises. In response, the Democrats refused to even discuss the GSEs. Ultimately, they included a reporting requirement so that they could not be accused of completely ignoring the issue. It is that report that we will be discussing here today.

The joint report contains several positive items. First, the report recognizes many of the failures of the existing structure of the GSEs. It notes that Fannie and Freddie were undercapitalized, were poorly regulated, and took on excessive risk to maximize profits for their shareholders. These views are in sharp contrast to the position of Fannie and Freddie's defenders, who for years denied that there was anything wrong and aggressively fought reform until it was too late. The consequences of their actions have cost the American people, taxpayers, more than $150 billion.

I am pleased, however, to see that the Administration is beginning this debate by at least recognizing the serious structural flaws in GSEs. I believe that is a good place to start. The report also concludes that the housing finance system must be reformed and that the goal should be to scale back the Government's role in mortgage finance and promote the return of private capital to a healthier, more robust mortgage market. This is a goal I believe we must all embrace.

The report, however, is not without its flaws. First, it is a mere 31 pages. Given the vast resources of Treasury and HUD and the importance of this issue, I believe the American people deserved a more thorough and detailed study.

Second, the report is vague on exactly how the Administration thinks the housing finance system should be reformed. The report presents three options for long-term reform. However, subsequent statements by the Treasury Secretary suggest that the Administration really only sees its third option, which resembles the *status quo,* as a viable path forward. While I appreciate the willingness of the Administration to be flexible on the details of reform, it would have been helpful, I believe, to know which items the Administration believes should be included in a reform bill. For example, should there be any reform of housing goals, or should there be minimum down payments for any Government-backed mortgages?

It is impossible to tell what the Administration's priorities are at the moment for reform. Accordingly, I hope to learn today exactly what the Administration believes is the best way to reform our housing finance system.

Finally, the report is narrowly focused on reforming Fannie Mae, Freddie Mac, and the Home Loan Banks. It says nearly nothing about the numerous other housing programs operated by the Federal Government. Each year, the Federal Government spends billions of dollars on housing programs aimed at ensuring that every American has access to quality housing. From Section 8 to housing tax subsidies, these programs usually receive little scrutiny from Congress. However, they are an important part of our housing finance system. Accordingly, they should be included as part of the Committee's consideration on housing finance reform.

So far, the majority has yet to lay out a plan on how the Committee will develop its reform proposal. I would encourage the Chairman to promptly set forth such a plan that provides for a comprehensive examination of housing finance and the Federal Government's role in housing.

The Committee has before it a very difficult task. The vast subsidies the Federal Government presently provides to the housing industry, Wall Street, and special interest groups means that real reform will face an uphill battle. In 2005, when the Senate considered reforming our housing finance system, politics and special interests trumped. Millions were spent to lobby against reform. Ultimately, the antireform effort cost the American taxpayers, as I have said, billions in bailouts. For far too long, our housing system has been distorted to benefit special interests. Hopefully, the collapse of Fannie and Freddie means that Congress now has an opportunity to enact reforms that will correct our past mistakes. The question remains, however, will we seize the opportunity or will we squander it? We will see.

Thank you, Mr. Chairman.

Chairman JOHNSON. Before I introduce our witnesses, would other Members like to make a very brief opening statement?

Senator REED. Mr. Chairman?

Chairman JOHNSON. Yes, Jack.

STATEMENT OF SENATOR JACK REED

Senator REED. Just a very brief statement. I think it is important to note that there is bipartisan agreement that we need to restructure Fannie and Freddie, and how to do it is going to be terribly consequential, not just to these institutions, but to homeowners, taxpayers, the construction industry, you name it. Everybody, I think, has an interest in this issue of getting it right.

I think it is also important to note that a lot of the issues that we are dealing with, we have seen before. The evolution of Fannie and Freddie began in the 1930s because of the liquidity crisis, huge foreclosures. There was no mechanism, and the Government stepped in and created a mechanism.

Today, effectively, Fannie and Freddie, in many respects, is a liquidity mechanism for the entire market, and without its existence, we would have, I think, much more serious consequences in the financial markets and on Main Street, as well as the financial centers.

So we are wrestling with an issue that has come up repeatedly throughout our history. How do we provide support for the housing market without risking unnecessarily taxpayers and risking the stability of our financial system? That is not an easy challenge. It is one we have to accept, and it is one over the course of the next several months and years, I hope working on a bipartisan basis, we can accomplish, as we did, I think, looking back, in many respects, with many of the aspects of the Dodd-Frank bill, where there was agreement and there was support and we have moved forward.

Thank you.

Chairman JOHNSON. Does anyone else like to make a very brief statement?

Senator BROWN. Mr. Chairman?

Chairman JOHNSON. Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. I appreciate very much our two witnesses. I am eager to talk about, as my colleagues are, how we stabilize housing finance and bring private capital into the market, but we have got to walk before we can run. As long as we continue to have more than a million foreclosures a year, that crisis must be our priority. Secretary Donovan, thank you for acknowledging that problem in your testimony.

Policy Matters Ohio, a think tank in my State, in a recent report pointed out that 2010 was the first time in 15 years that we had not had more foreclosures than the year before. So until 2010, we had had an increased number of foreclosures every year for 14 years, and you know what that does to neighborhoods. You know what that does to an economy overall and the pain it inflicts on so many families. If several of the larger services had not temporarily suspended their foreclosure filings, that likely would have increased again in 2010. Four-hundred-thousand Ohioans, more than one in four homeowners, are still underwater. You know what that means to a neighborhood and to an economy.

I disagree with some of my colleagues who blame this crisis overwhelmingly on fair lending laws and irresponsible homeowners alone. Unlike some other States with similar foreclosure crises, the causes of Ohio's problems were not primarily limited to subprime loans and real estate speculation. Ohio families lost jobs because of Washington policies. That includes trade agreements. It includes a financial crisis brought on by financial deregulation. It includes a shift from an industrial to a service-based economy and, frankly, a bias that our Government had toward the financial industry in support of the financial industry and support of the financial industry and a bias against manufacturing in many ways.

That is why Senator Reed from Rhode Island and I are introducing legislation to fix a servicing model that has caused foreclosure fraud and homeowner abuse in Ohio and across the Nation. It means funding foreclosure counseling and legal services. These are common sense and high-reward investments that will help our economy recover. And it means providing constructive suggestions, not to improve the Administration's HAMP program. I have done conference calls with housing advocates. HAMP has been disappointing, but to eliminate it is clearly not the answer. To improve it is. All of those things. And it means ensuring that Fannie and Freddie are helping, not hurting, taxpayers. All of those things, we need to look at.

I appreciate the service of both of you at Treasury and Housing and thank you, Mr. Chairman.

Chairman JOHNSON. Does anyone else like to make a brief statement?

Senator MORAN. Mr. Chairman, I would just ask unanimous consent to submit my opening statement for the record.

Chairman JOHNSON. Everyone will have their statement included. I will remind my colleagues that we will keep the record open for 5 days for additional statements and questions.

Neither one of the two witnesses that we have here today need any sort of extensive introductions. First, we have the 75th United States Secretary of the Treasury, the Honorable Timothy Geithner. And finally, we have the 15th U.S. Secretary of Housing and Urban Development, the Honorable Shaun Donovan. We welcome both of you back to the Committee.

You may proceed, Secretary Geithner.

STATEMENT OF TIMOTHY GEITHNER, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary GEITHNER. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thanks for giving us the chance to come testify before you today.

Last month, the Administration released a report to Congress outlining our reforms, our proposed reforms to the housing finance market. Our plan, as you know, is designed to create a housing finance system in which the Government's role is limited to robust oversight and consumer protection, targeted assistance for low- and moderate-income homeowners and renters, and carefully designed support for market stability and crisis response.

Now, under this plan, private markets, subject to strong oversight and standards for consumer and investor protection, would be the primary source of mortgage credit and bear the burden for losses. Banks and other financial institutions will be required to hold more capital to withstand future recessions or significant declines in house prices and to adhere to more conservative underwriting standards. Homeowners will hold more equity in their homes, and the securities markets, alongside credit from the banking system, will play a major role in housing finance, but subject to risk retention disclosure and other key reforms and requirements.

We proposed a three-part plan. First, we proposed to wind down Fannie and Freddie and help bring private capital back to the mortgage market. As you know, in the wake of this crisis, private capital receded, retreated, and has not yet returned, leaving the Government to guarantee more than 9 out of 10 new mortgages today, and that assistance has been absolutely essential in helping bring a measure of stability to the housing market and to help ensure that Americans have continued access to mortgage credit, but it is not a long-term solution.

Our report recommends using a combination of policy tools to wind down Fannie and Freddie over time, such as increasing guarantee fees, reducing conforming loan limits, gradually tightening underwriting standards. We also support a continued wind-down of Fannie and Freddie's investment portfolio, and these actions will help shrink the Government's footprint in the housing market and help bring private capital back.

Now, we are not going to get private capital to come back and replace the Government's role unless we fix the very substantial remaining problems in the private mortgage market. So a second part of our plan is to make the necessary reforms to provide better protection for borrowers, for lenders and investors, and help restore confidence to that market. Again, this means helping consumers make informed decisions about mortgages and providing them better protection from unfair predatory deceptive practices. It means requiring participation in the securitization chain to retain risk, to improve access to information, increase accountability and transparency. It means requiring banks to hold more capital, including against, of course, high-risk mortgages so that they are in a better position to withstand future housing downturns. And it means addressing the chronic problems we still see in servicing and foreclosure processes by setting national servicing standards and improving industry incentives.

Our third objective, which Secretary Donovan will speak to in more detail, is to more effectively target the Government's support for access to sustainable credit and to affordable rental housing options.

Now, our report puts forward a limited number of options for structuring the Government's future role in the housing market for replacing Fannie and Freddie. Each of these three options would produce a market where the private sector plays the dominant role in providing mortgage credit and bears the burden for losses. Each has unique advantages and disadvantages that Congress must consider carefully.

In the first option, the overwhelming majority of mortgages would be financed by lenders and investors and would not benefit from a Government guarantee. This would limit the Government's role to initiatives at the Federal agencies, principally FHA, but also

VA and USDA, that provide targeted support for affordable housing and access to sustainable mortgage credit.

In the second option, that function, the Government's role through the FHA, would be complemented by a Government backstop available only at times of mortgage stress, of crisis, to help to provide continued access to mortgage credit even in a very deep recession.

In the third option, alongside the Government's role in FHA, for example, FHA and VA, USDA, the Government would provide a form of reinsurance for certain securities backed by high-quality mortgages. These securities would be guaranteed by carefully regulated private companies under strict capital standards and oversight so that private investors take the first loss on any mortgages reinsured by the Government.

Now, we considered but opposed two alternative models. We did not recommend Congress embrace a complete privatization of the mortgage market with no role for the Government in providing access to affordable housing, nor did we recommend what some have called the full nationalization option in which the Government would provide an explicit guarantee and directly bear the cost of most of the credit risk in the housing finance system. The alternatives we propose that you consider lie between those two more extreme options.

Now, a key criteria in evaluating these options—there are a number of criteria you have to use in evaluating these options and we encourage you to carefully consider their advantages and disadvantages. Our challenge is to strike the right balance between providing access to mortgages for American families and communities, limiting the ultimate risk to the taxpayer, maintaining more stable, healthy, mortgage and housing markets, and whatever path you choose will require some tough decisions and some tradeoffs.

Although comprehensive reform will take time, we cannot put this process off indefinitely and leave the market with too much uncertainty about the ultimate solution. Delay will make it harder to get private capital to return and to replace the role the Government is playing today.

Each of the options we considered would require legislation from the Congress, and, of course, we look forward to working with you, with this Committee, and with your colleagues in helping designing comprehensive legislation as quickly as we can, and we would like to try to do that within the next 2 years.

But we have to proceed with care. As all of you know, many of you emphasized, the housing market is still in crisis and we have to make sure that we proceed very carefully to avoid adding to the many burdens still on this market and with care not to disrupt the economy recovery now underway.

Thank you.

Chairman JOHNSON. Thank you, and you go ahead, Secretary Donovan.

STATEMENT OF SHAUN DONOVAN, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary DONOVAN. Thank you, Chairman Johnson, Ranking Member Shelby, and Members of the Committee, for this opportunity to testify before you today on the Obama administration's report to Congress on reforming America's system of housing finance.

Mr. Chairman, today, I would like to focus on the Administration's commitment to housing affordability and access to mortgage credit, the critical role the Administration proposes for the FHA going forward, and how the Administration and Congress must work together to ensure housing finance advances opportunity in every community.

Since taking office, the Obama administration has acted to help stabilize the housing market and provide critical support for struggling homeowners. Working with Congress, we helped avert a deeper economic collapse and a more severe housing crisis. Our efforts preserved access to our mortgage markets at a moment they were threatening to seize up entirely.

Since April 2009, more than 9.5 million homeowners have been able to refinance their mortgages to benefit from lower interest rates, collectively saving $18.1 billion annually. More than 4.2 million distressed borrowers have received modifications since April 2009, more than twice the number of foreclosures completed during that time.

Looking forward, the President believes that an integral part of reforming the housing finance system must be ensuring that Americans have access to quality housing they can afford. This involves supporting a range of affordable options. We are committed to promoting sustainable home ownership, predicated on safe mortgages, a process significantly strengthened under the Dodd-Frank law.

Every American who has the credit history, the financial capacity, and the desire to own a home should have the opportunity to take that step with fairly priced access to mortgages in all communities. For the millions of Americans who rent, affordable options means a system that can consistently provide the financing needed to maintain those rental properties and support development of affordable housing in communities with decent jobs and good schools. The question today is how we provide those options.

In our report, the Administration lays out four key principles for access to mortgage market and housing affordability that will form the foundation of a reform system. First, reforming and strengthening the FHA. Mr. Chairman, in all three options for long-term reform the Administration identifies, a reformed and strengthened FHA remains an important participant in the market. That is why we will continue to ensure that creditworthy low- and moderate-income borrowers have access to affordable mortgages. And as we have done over the past 2 years, we will do so in a way that is healthy for FHA's long-term finances. Indeed, because of the reforms we have implemented with the help of this Committee these last 2 years, FHA is projected to generate approximately $9.8 billion in receipts for the taxpayer this fiscal year.

Further, thanks to the Committee's work, FHA received additional authority to raise premiums, and we look forward to working with both chambers of Congress to enact broader FHA reforms that protect the taxpayer. While FHA has already changed policy to require that borrowers with lower FICO scores make larger down payments, FHA will consider other options, as well, such as lowering the maximum loan- to-value ratio for qualifying mortgages more broadly.

In considering any changes, FHA will continue to balance the need to manage the risk to the taxpayer and the borrower with the need to ensure access to affordable loans for lower- and middle-income Americans, including providing access to credit for first-time homebuyers and underserved markets.

Second, we must provide targeted, transparent support for affordable rental housing. Right now, half of renters spend more than a third of their income on housing and a quarter spend more than half. With the 2007 to 2009 period showing the largest increase in worst-case housing needs in a quarter century, the need to express strong support for affordable housing has never been clearer.

Historically, private credit markets have not served affordable multifamily rental properties terribly well, preferring to invest in high-end developments. However, the GSEs were able to assist this market segment without the losses that occurred on the single-family side. As we move forward, we must ensure that the infrastructure and capacity they built in this critical area remains. One option could be to share risk with private lenders to expand FHA's capacity to support lending to the multifamily market. We could also develop dedicated programs that ensure we capture hard-to-reach segments, like smaller properties, particularly in rural areas.

Third, the plan commits us to helping ensure that capital is available to creditworthy borrowers in all communities, including rural areas, economically distressed regions, and low-income communities. The plan calls for greater transparency by requiring securitizers to disclose information on the credit, geographic, and demographic characteristics of the loans they package into securities. A key lesson we have drawn from this crisis is that decisions made in the secondary market very clearly drive lending practices in the primary market, and the potential for disparate impact in the availability and quality of mortgages in underserved communities is very real. To that end, the Administration is fully committed to exploring other measures to make sure that secondary market participants are providing capital to all communities in ways that reflect activity in the private market, consistent with their obligations of safety and soundness.

Last, support for affordable housing requires consistent, flexible, and transparent funding. That was the goal of the National Housing Trust Fund that was authorized by Congress in 2008 but has yet to receive funding. That is why the Administration will work with Congress on developing a new dedicated financing mechanism to support affordable home ownership and rental housing that current policies cannot adequately address.

I have described this Administration's bedrock commitment to affordable and accessibility, and Secretary Geithner has just described the three options that the report presents. As we considered these options, one element I would like to highlight that impacts affordability, not just when consumers buy but over the long term, is the question of the availability and pricing of long-term fixed-rate loans. For decades, the 30-year fixed-rate mortgage has allowed families to safely build wealth and climb the ladder to the middle class. As such, I believe we should carefully consider the implications for availability and pricing of those mortgages.

Ultimately, this plan is about bringing private capital back to pave the way toward the balanced national housing policy that ensures Americans have access to credit for those in a position for sustainable home ownership, rental options near good schools and good jobs, assistance for those who feel the strain of high housing costs, and above all, choices in housing that make sense for them and for their families. The more the American people can participate in this debate to expand beyond necessary discussions of capital markets, G-fees, risk-based capital, and mortgage-backed securities and consider how essential the system is to the futures of their own families and communities, the better system we will build, the stronger our country will be, and the more opportunity we will be able to provide to every American.

Thank you, and we look forward to taking your questions.

Chairman JOHNSON. Thank you.

For both Secretaries, there have been reports that large financial institutions are closing branches in historically underserved communities. How would each of the Administration's options ensure that mortgages would continue to be available to Americans in rural underserved areas and that small community banks and credit unions would have access to an independent secondary market?

Secretary DONOVAN. Mr. Chairman, this is a very important question and it is one of the elements that we highlight as important to focus on as we are looking at the three options. We have seen with the effects of the crisis a significant consolidation in mortgage originations to the point where the top five lenders today account for about 60 percent of all new mortgages. It is important that we consider the ability of community-based lenders, community banks, and others to be able to originate mortgages.

First of all, through FHA, we would continue to provide that option, but it is important to recognize that the potential for the lack of any guarantee outside of FHA, the VA, and USDA to further increase consolidation in the market because of the requirements for substantially more capital to originate those mortgages under a system. So that is an important element that we should consider as we consider these three options.

Chairman JOHNSON. For both Secretaries, looking at the Administration's GSE housing finance reform report, it states that we need to have a plan to address multifamily mortgage finance, but does not provide much detail. What are your recommendations to provide for stable, liquid, and affordable financing for multifamily housing, including affordable multifamily housing and housing in rural areas?

Secretary DONOVAN. As I mentioned in my testimony, one of, I think, the often forgotten aspects of this crisis is that we have not seen multifamily finance, and particularly multifamily finance at the GSEs, contribute substantially to their failure. And, in fact, they have been able to continue to originate multifamily mortgages profitably through this crisis.

I think it points, first of all, to the need to look carefully at multifamily financing distinctly from single-family financing, and, in fact, to recognize that often for multifamily financing, because of the broader mix of products, the broader range of housing types, the broader range of communities, from rural to urban, that have different types of multifamily properties, that the need for standardization is more significant and can contribute more to giving us lower interest rates and making multifamily housing more affordable.

And so, therefore, having a targeted guarantee as we do through FHA to multifamily housing has been a significant contributor to improving the provision and the building of multifamily housing, but also the affordability of that housing over time. And so there are a number of ways that we suggest we ought to keep that strong commitment to multifamily housing.

One of the lessons I think we have learned is that we should be looking in FHA, for example, at risk sharing or other forms of insurance that would put more private capital in front of the guarantee that we provide. That is an option that we suggest in the report and it is one that we would look forward to looking at with the Committee as we consider potential legislation.

Chairman JOHNSON. Quickly, the report says that the Administration believes that the securitization market should continue to play a key role in housing finance, and they agree. In the rulemaking to define the qualified residential mortgage, what appears to be the most challenging issues to address? Will the agencies take sufficient time and care to make sure you get it right and to avoid unintended consequences that might restrict credit? Either of you.

Secretary GEITHNER. Mr. Chairman, yes, we will—the entities responsible will take care in designing this to make sure they get it right, and, of course, one of the great strengths of our system is they will put out a draft for comment so that all affected parties will have a chance to provide advice directly in the shaping of the final rule.

Among the many challenges we have to confront in this context is not just how to get all the agencies that are part of this on the same page with a reasonably integrated approach, but fundamentally, this comes down to the question about, for example, how much equity you think homeowners should hold in their homes. How do you get the incentives better between the originator of a mortgage, the servicers, and the investors? It is a whole range of complicated problems, but we are getting close to a consensus and I suspect we will be able to put out a draft for public comment reasonably quickly. And, of course, that is just a draft.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Secretary Donovan, would you describe your involvement in the well-publicized negotiations on a global mortgage service settlement currently underway between mortgage servicers, Federal agencies, and States Attorneys General. Have you been involved in establishing a settlement figure, which has been reported as high as $30 billion?

Secretary DONOVAN. Senator Shelby, we are one of the Federal regulators that has been involved in the discussions. That is because FHA, obviously, and ultimately the American taxpayer, has a significant stake in the performance of servicing by the lenders that originate and service FHA loans.

Senator SHELBY. Secretary Geithner, has Elizabeth Warren been participating in these discussions that Secretary Donovan referenced as your Special Advisor on the BCFP or as Assistant to the President, in either of those roles?

Secretary GEITHNER. Senator Shelby, I sent you a copy of a letter this morning that I sent to Chairman Bachus in the House on this basic question and I thought maybe it would be helpful if I just quote directly from this letter. I think it will be responsive to your question.

Senator SHELBY. And who is the letter from?

Secretary GEITHNER. It is from me.

Senator SHELBY. OK. Can we make the letter part of the record?

Secretary GEITHNER. Absolutely.

But I will read you briefly these three sentences.

Senator SHELBY. OK.

Secretary GEITHNER. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFPB, the Consumer Financial Protection Bureau, does not currently have authority to administer penalties and will, therefore, not be a party to any formal settlement with mortgage servicers. Under that same law, though, the CFPB will obtain significant authority to set standards for the mortgage servicing industry on July 21, 2011, the date when the consumer finance protections of other agencies transfer to the Bureau. For this reason—and this is very important—for this reason, the CFPB has been invited to, and I personally invited Elizabeth Warren to advise the other agencies that are part of this process on how to design appropriate servicing standards for the mortgage servicing industry.

Senator SHELBY. So she has been involved in the process?

Secretary GEITHNER. We invited her to advise on this because, again, that agency——

Senator SHELBY. You invited her, but my question is, has she been involved in the process?

Secretary GEITHNER. Yes, she has. She has been involved in helping to advise on the design of servicing centers because that is part of the formal authority of the Bureau under the law that Congress passed last year.

Senator SHELBY. OK. Secretary Geithner, the recently released draft of the proposed global servicer settlement would force financial institutions to submit to third-party monitoring of their compliance with the agreement. These third parties, I believe, would be selected at the discretion of the Attorneys General and the BCFP. As Secretary of the Treasury, do you believe it is appropriate for Federal financial regulators to outsource compliance monitoring to third parties, and does this raise any safety and soundness concerns, and if not, why not?

Secretary GEITHNER. Senator Shelby, that is an excellent question and I want to be a little careful in how I respond to this. This is an enforcement proceeding. It is a very complicated set of questions and I am not going to comment on any of the detailed provisions in that draft or have been discussed in the press. What we are trying to do is to get all parties together, State AGs and all the

Federal agencies with direct regulatory authority, enforcement authority in this area to come together and bring about a set of reforms that will help improve what is still broken in the mortgage servicing process, and a lot is still broken, and I think all parties have a really strong interest in trying to resolve this quickly so we can bring more certainty to the mortgage market and help encourage the process of repair, make sure that people who are still vulnerable get some assistance, and that is what we are trying to do.

Senator SHELBY. With respect to the housing financial reform which we are all interested in, what role do you believe third parties, such as community activist groups, for example, like the former ACORN, should play here, or should play at all?

Secretary GEITHNER. In the debate?

Senator SHELBY. Yes, in the recommendations and so forth.

Secretary GEITHNER. Well——

Senator SHELBY. Should they play a role at all?

Secretary GEITHNER. Well, again, Congress will get to decide who they hear from, and you will want to hear from a broad range of people, and I would expect you want to hear from people who spend their days every day trying to help people caught up in this mess, housing counselors, *et cetera.* But you will have the chance to consult with anybody you choose to consult with.

Senator SHELBY. Going back to housing, reform of the finance system, I would like for you to clarify your position on a few key issues. Do you believe that the formerly implicit, now explicit, Government guarantees of the GSE's mortgage-backed securities should cease or merely be modified?

Secretary GEITHNER. Well, Senator Shelby, in the report, the three options we suggested Congress focus on all involve some form of Government guarantee, either just through the FHA and USDA and VA, or potentially through one of two other options. One is a backstop only available in crisis, or a much more limited, carefully designed guarantee, as in what we called option three.

Now, as you know, guarantees are perilous. Governments are not very good at doing them, not very good at designing them, not very good at pricing them, not very good at limiting the moral hazard risk that comes with them. And as we saw in this crisis, when you make those mistakes, you can leave the taxpayers with huge losses in this context, and, of course, we are committed to avoiding that.

Fundamental to design of any guarantee that works is trying to take the politics out of setting the standards and the eligibility requirements and the pricing, and that is why we have been very careful to say that any of these options, they have advantages and disadvantages, but whether they work or not will depend a lot on how they are designed, and in particular in this case, whether you can keep the politics out of the design of the guarantee itself.

Senator SHELBY. If we do not keep the politics out of it, we are going to repeat where we are today down the road, are we not?

Secretary GEITHNER. That is right. Well, I would say, even if you keep the politics out of it, it is a challenge to get right, and humans are not perfect in this stuff. As you know, banks and credit rating agencies, insurance companies themselves made lots of mistakes in this area, too. So it is a hard thing to do even without the politics, but if you do not keep the politics out of it, you have got no chance for getting it right.

Secretary DONOVAN. Let me, if I could just add on this, as well——

Senator SHELBY. Sure.

Secretary DONOVAN. It is not just the implicit or explicit nature of the guarantee. It is the pricing of that guarantee that is critical, as well. One of the key failures that the report points to is that the guarantees at Fannie and Freddie, in significant part because they were implicit, were not set at the right pricing levels and that contributed to their lack of adequate reserves to withstand the crisis.

I would point out, though, that in the case of FHA, while the crisis has substantially challenged those reserves, we have remained able to operate through the crisis without our reserves dropping below zero. And because of our work——

Senator SHELBY. They have dropped a lot, though, have they not?

Secretary DONOVAN. They have dropped significantly——

Senator SHELBY. Yes.

Secretary DONOVAN. ——and because of our work with this Committee, we have been able to gain more flexibility to price those guarantees. We have been able to raise our pricing 25 basis points just recently, thanks to that flexibility. And that has allowed us, because we have an explicit, fully paid for guarantee at FHA, to be able to thus far operate effectively through this crisis.

Senator SHELBY. Secretary Geithner, do you believe that conforming loan limits should be reduced beyond HERA levels, and if so, what figure would you target and what timeframe?

Secretary GEITHNER. As we proposed in the report, Senator Shelby, we think that they should be allowed to revert, as current law would suggest, on the current schedule. Beyond that, we have not made a judgment yet. I think, again, that we want to make sure that you design a carefully phased-in set of tools to reduce the Government's role, allow the private market to come in. The pace at which we do that, how we do that will depend a little bit on the evolution of the market.

Senator SHELBY. Mr. Secretary, one last question and I will move on. Secretary Geithner, do you have any confidence that the new European bank stress test will provide any meaningful results? It seems like they might have a credibility problem getting off to a second start.

Secretary GEITHNER. Senator, a very important question, and I would say that, as our question implies, it is very important that for these things to work, they have got to be tough, they have got to be transparent and disclosed, and they have to provide a—they have to come with a clear commitment to provide the capital banks need if the stress test reveals a shortage of capital. But I am not in a position—not close enough to the details right now to know whether it will meet that test, and ultimately, the market will judge whether——

Senator SHELBY. Absolutely.

Secretary GEITHNER. ——the design is strong enough.

Senator SHELBY. Transparency helps the market judge, does it not?

Secretary GEITHNER. It is essential. Now, markets do not always get these things right, but they have no chance to get it right without better disclosure.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman REED [presiding]. Thank you, Senator Shelby.

Secretary Geithner, in the context of this ongoing discussion about a global settlement, which has, frankly, been dragging on many, many months, and I think personally should come to an appropriate conclusion, if it does not, there is the potential for numerous suits by Attorneys General in 25, 30 States, both in terms of consumer protection laws and other statutes, including criminal statutes. There is potential for the bond holders with, I am guessing, billions of dollars of notional value at risk, of suing, based on potential breaches of representations and warranties. There are individual suits by homeowners who claim they were unfairly foreclosed. This would have, I would presume, a very deleterious effect on the marketplace and on the standing of the companies that you are talking to right now. Is that accurate?

Secretary GEITHNER. Yes, Senator Reed. It is very important, and I think all parties have a stake in bringing this to resolution as quickly as possible, and it would help resolve the remaining legal uncertainty around the broader mortgage servicing foreclosure process that itself is very important, and it would give us a better chance to move beyond this and focus more directly on the remaining things we have to do to help repair the damage in this market as a whole.

It is very important that we try to bring this to bed as quickly as we can. I think all parties in this, not just the servicers, but the State AGs and the Federal agencies, have a strong stake in doing that.

Senator REED. Just a follow-on point is that many of these—these are allegations, in many respects, but a legal process that would take several years to determine multiple cases about liability, responsibility, that itself could have a very significant impact on the market, both the value of these companies and their ability, frankly, to move forward and to more robustly contribute to the recovery, is that right?

Secretary GEITHNER. That is right, and a comprehensive settlement like what is being discussed cannot solve all these problems, but it will help provide at least a measure of certainty with respect to the Government and the servicers and I think that is an important thing to do.

Senator REED. Thank you——

Secretary DONOVAN. Senator, if I could just add on that, as well——

Senator REED. Secretary Donovan.

Secretary DONOVAN. One of the issues that would potentially result, as well, we have made very clear, Secretary Geithner in his testimony, that ensuring we have clear, consistent standards for servicing mortgages is an important element of our recommendations. One of the clear reasons we ended up in this crisis is that there were no consistent strong standards for servicing those mortgages, how first mortgages interacted with seconds, and a result which had a fragmented set of standards that might come from individual settlements with various States or various agencies would be a real negative result.

But I would also point to the fact that for many homeowners waiting, who have not been offered the options that they should, that have ended up in foreclosure because early on in the process they were not contacted as they were required to, for example, by FHA requirements, means that we have not only hurt them, but lengthened potentially the foreclosure process, and a significant part of what we are aiming for here is to speed up the process, to make it better and to get resolution, therefore, not just for the homeowners but for the market, as well. When a homeowner has to contact a bank three or four times, when paperwork is lost, when these types of things happen, it is good for no one in the process. And so it is important that these standards get established in a single concerted way as much as possible rather than in a fragmented way.

Senator REED. Thank you, Mr. Secretary.

Secretary Donovan, just let me follow up. One of the, I think, insights of the report you submitted—in looking back, it should have been more obvious to us—is that we, I think, the Nation, Congress, regulators, were obsessed with home ownership in terms of that as the primary housing policy, and rental property, affordable rental property, multifamily, was sort of a distant second, a far distant second. And I think this report says we really have to have a balance.

Many people, the best form of housing for them is affordable, decent rental housing, and that should be—our goal should be providing people the options that they can choose the best form of housing for their family, their proximity to work, their lifestyle.

Now, one of the things that—and I am glad you commented upon this—is the National Housing Trust Fund, which is devoted to trying to build and construct affordable housing for relatively low-income Americans, to make it affordable to them and affordable to all of us, and I wonder if you might comment upon this aspect of the report.

Secretary DONOVAN. Very important, Senator, and thank you for raising it. One of the things I think many people miss in terms of what has happened, as we have seen, gone through this housing crisis, we have, in fact, seen rents come down at the top end of the market, vacancies increase. But at the same time, at the lower end of the market, for those lowest-income and even some moderate-income renters, rents have actually increased and to the point where between 2007 and 2009, we saw the single greatest increase in worst-case housing needs that we have ever measured in the study that we do every 2 years.

And so, clearly, the range of options that we are providing to focus on affordable rental housing has not been strong enough to meet those needs, and so the need for some kind of targeted, focused effort that improves on many of the shortcomings that we had in the affordable housing goals that the GSEs had, a much more targeted, transparent way of meeting those needs, we think would help to significantly reverse the declines in affordability that we have seen through the crisis while at the same time protecting against some of the negative impacts that the goals had at the GSEs.

Senator REED. Thank you very much, Mr. Secretary and Mr. Secretary.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

Thank you both for being here. It is always good to hear from you. I know that the Administration has laid out three options, and I am one of those folks that believes the Administration—we work best when the Administration lays out something clear and then we offer editorial comment here. I think we have made a lot of mistakes over the last several years where 535 folks try to craft something on their own with no supervision and we end up with major problems.

Secretary Geithner, you have laid out three options, I know. Which one of the three do you like the most?

Secretary GEITHNER. I am going to disappoint you and not answer that question directly at this stage because, as I said before, they each——

Senator CORKER. But we would like some adult supervision.

Secretary GEITHNER. But I will say this. I do believe that—and I think it is likely that we will do this, but we have to consult with your colleagues on how to do this—I do think that after a period of debate and discussion and further exploration of these options, then I think it makes sense for us to tell you what we think makes sense, what is the best mix of them, what is the best alternative. And we will reflect and consult with you and your colleagues about whether we should do that in the form of legislation or not. But I expect we will take that step.

Senator CORKER. And I understand that is kind of a punt. I mean, there are three options. I guess you are sort of letting those lay out there for a while and people will comment on them. But they all—the second and third options involve pricing risk. The first option, to a limited degree, does because you keep three programs in place for low to moderate targeting, as you talked about.

But if we can price risk effectively, is there any need for Government involvement? I mean, it is kind of self-predicting, is it not? I mean, if you can actually price risk for option two and option three appropriately, there would never need to be involvement by the Government in the first place, would there?

Secretary GEITHNER. Well, I am not sure you are making the case for and against, but I would say the two classic arguments people make for a Government role in the form of something like a guarantee are, first, the affordable access argument, and second, in terms of how an economy can best weather recessions and house price collapses. They are slightly different arguments.

In option one, we are suggesting the Government limit its role fundamentally to the affordability option. Now, of course, even in that option, you could have the FHA dramatically expand what it does in a crisis, providing some protection against a deep recession even in a crisis. But in that option, the Government would be left with a lot of exposure to risk, because as you know, the FHA provides guarantees for mortgages with very little down payment. The Government has a lot of exposure to risk.

So I guess my suggestion, Senator, is that, again, look very carefully at the impact you have on concentration in the industry on small community banks. Look very carefully about what the ultimate exposure to the taxpayer is. Look carefully at how much flexibility you have to protect the economy, protect the innocent from the kind of mistakes you see that you might see in a future crisis. And look at the moral hazard risk. And remember that, as you said, in any guarantee, you need to make sure you separate it from political influence, from banks, from the real estate community, from other people, however noble their objectives are, so that you can price it and design is so the taxpayer is not too exposed to risk of loss.

Secretary DONOVAN. If I——

Senator CORKER. Again, I would just say one more time—I am running out of time—if you have the ability to price risk appropriately, again, which we do not because you do not know when——

Secretary GEITHNER. Right.

Senator CORKER. ——that 100-year issue is going to occur, then you do not need the Federal Government in the first place.

But let me go to Fannie and Freddie. I think all of your options say that Fannie and Freddie end.

Secretary GEITHNER. That is right.

Senator CORKER. And right now, they are under conservatorship. What technically occurs to cause Fannie and Freddie to end? I mean, who really owns Fannie and Freddie today?

Secretary GEITHNER. Well, under the law that Congress passed, the conservator, in which case is FHFA, owns those responsibilities and judgments, and without legislation, without new legislation to allow us to wind them down definitively, there is a substantial risk, and that is really the only option created under the legislation, is that they be re-created in a somewhat different form, recapitalized and privatized. And we do not believe that will be a sensible path for the Government to take and that is why it is important to recognize that we need to legislate in this. If we do not legislate, the risk is we are more likely to face a system where they get re-created in a different form.

Senator CORKER. And over what timeframe should they end?

Secretary GEITHNER. Well, it depends a lot on how quickly the mortgage market heals, how successful we are in bringing private capital back in. But I think our sense is that a realistic expectation is this is a 5- to 7-year period of time. It could be somewhat longer. It is possible it could be a little shorter——

Senator CORKER. And how do we benefit from the—inside Fannie and Freddie, there are numbers of databases and other kinds of things that have value. There are also the newer legacy loans that have value. So how do we make sure that the Federal Government benefits from that value?

Secretary GEITHNER. Excellent question. It is not just there are a lot of very talented people with experience there, but a lot of systems with a lot of intellectual property in them, a lot of value in those systems, and we have a variety of ways we could try to make sure that the Government maximizes the benefit and the housing market can benefit from the talent in terms of people and the talent in terms of systems and resources. But a very important question.

Senator CORKER. I know my time is up, and I notice we talked about maybe giving more time to people who do not give opening comments, so I might ask one more question, then, because he nodded.

On the debit issue—this is sort of off-subject, but I know we have had numbers of regulators in on the Durbin Amendment, talking about how it was such a narrow situation, narrow definition that it really did not price the interchange rate appropriately. Do you have any comments on that?

Secretary GEITHNER. I do not, Senator, because you did not give me the authority under the law to resolve this. I know that the Fed has got a lot of advice on how to deal with these challenges and they are thinking through carefully how to do that, but it is not my authority.

Senator CORKER. And on the qualified residential mortgages, where they did set a 20 percent, is that something you support or——

Secretary GEITHNER. Well, have not yet, but there is a draft working its way through the system now and I will say that I do believe that there is a very strong case as we build this new system that we have a system in which most homeowners hold more equity against the value of their house, and we should look at a way to do that, achieve that, in a sensible, careful balanced way, and that would be one tool for doing that.

Senator CORKER. What is the timeframe upon which we should pass reform for housing?

Secretary GEITHNER. As I said in a response to an earlier question, I think you should, as an objective, try to do it within the next 2 years. Again, if you do not give the markets clarity about the end game, it is going to be harder to get people to come in and take risk in the interim. Banks and investors, it would be a hard time trying to figure out what are the economics of housing finance. And so I would try and do it in the next 2 years.

Senator CORKER. Thank you both. Thank you, Mr. Chairman.

Chairman JOHNSON [presiding]. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman.

I have a few questions. I just want to say a brief thing—I did not make an opening statement, either—about Fannie and Freddie. There are some people who try to lay the entire blame of the financial crisis at Fannie and Freddie's feet. I think it is ideological as opposed to looking at the facts. When you look at the facts, it is hard to pin exclusively or even predominately the blame on Fannie or Freddie, because here are some facts that cannot be explained away by Fannie and Freddie, and I wish my colleagues who think that Fannie and Freddie are the center of the crisis would explain these.

First, the housing bubble was international. There were housing bubbles in Ireland, Spain, Eastern Europe, and elsewhere. There were no Fannies and Freddies there.

Second, the peak of the housing bubble was in 2004, 2005, and 2006, when Fannie and Freddie were losing market share to private label securitizations.

Third, there was a bubble and a bust in commercial real estate as well as residential. No Fannie and Freddie loans in commercial.

So I think certainly Fannie and Freddie need reform, but this idea that they are at the center of the crisis, as I say, I believe is ideologically driven as opposed to fact-based driven. They deserve some of the blame, as do banks, as do regulators, as do even consumers. I will leave it at that.

I want to ask you questions about, first, about covered bonds, which is something I care about. Whatever we do with Fannie and Freddie, we are going to need to get private capital back into housing finance sooner rather than later. Covered bonds work in Europe, have not caught on in the U.S. because we do not have a statutory framework that provides certainty regarding their treatment in the event of insolvency. There has been a bill introduced just recently in the House that I am considering introducing in the Senate by Representatives Garrett and Maloney on covered bonds.

So, Secretary Geithner, you mentioned in your written testimony you are willing to work with Congress to explore creating a legislative framework for covered bonds, so here are my questions. What do you think of the legislation that Garrett and Maloney put in? The FDIC has argued that covered bonds could potentially put the Deposit Insurance Fund at some increased risk, but I cannot see how covered bonds are any different than any other secured obligations. Banks always have secured obligations that put those at a higher thing. And finally, do covered bonds put the taxpayer at risk? Secretary Geithner, let me ask you first and then ask Secretary Donovan to——

Secretary GEITHNER. Yes, we would support legislation that would help create better conditions for a covered bond market. It is important to recognize that we do have a covered bond market in the United States today in the form of the Federal Home Bank financing structure that is essentially the functional equivalent.

The questions you raised about the FDIC are very legitimate concerns. We have to work through those.

Again, for this to work, you would be putting the taxpayer, in some sense, behind private investors and that has its own consequences. But that is something we can work through and I think it could play a better role, a greater role in our system——

Senator SCHUMER. How are they different than any other secured obligation?

Secretary GEITHNER. Well, it depends how the law defines it.

Senator SCHUMER. Do not have to be——

Secretary GEITHNER. I do not think this is rocket science, Senator. I think it is something we can work through. But it is——

Senator SCHUMER. Yes, that is why I want to get involved. It is not rocket science, so I can probably deal with it.

[Laughter.]

Senator SCHUMER. Secretary Donovan.

Secretary DONOVAN. I would just add to Secretary Geithner's point, it is important that we create the conditions for more innovation in the system. I do think, though, it is important to point out, as well, given that GSE obligations are the second-largest securities market in the world, there really is no precedent for covered bonds operating in a market as broad and deep as the U.S. market.

And so I think it is an important element, but I do not think, as some have suggested, that it is a sort of silver bullet, if you will, in terms of——

Senator SCHUMER. Or a total replacement——

Secretary DONOVAN. ——or a replacement for——

Senator SCHUMER. I agree——

Secretary DONOVAN. ——for whatever system might——

Senator SCHUMER. ——and I see Secretary Geithner agreeing. But you, too, support the basic concept and think we ought to explore it?

Secretary DONOVAN. Absolutely.

Senator SCHUMER. OK. A final question for Secretary Geithner on a topical issue. It is about Japan. They are our second largest creditor after China, an issue you and I have talked a lot about—not Japan, but China. Do you think there is any risk that in order to respond to the disaster and support their economy in the aftermath, that the Japanese will have to resort to selling some of their Treasury holdings to raise cash? Do you see this having any impact on Treasury prices and U.S. interest rates?

Secretary GEITHNER. I do not.

Senator SCHUMER. Could you explain why?

Secretary GEITHNER. Japan is a—I should say, Senator, that I extend and we should all extend our thoughts and concerns to what Japan is going through.

Senator SCHUMER. Absolutely.

Secretary GEITHNER. I think it is an extraordinary challenge for them and I think—but Japan is a very rich country, very high savings rate, and it has the capacity to help deal with not just the humanitarian challenge, but the reconstruction challenge they face ahead.

Senator SCHUMER. Thank you, and thank you, Mr. Chairman.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much. Thank you, both Secretaries, for joining us today.

Short of overall GSE reform, what steps could we take today short of that 2-year period that Secretary Geithner mentions that would encourage capital formation, the return of the private sector into the housing market?

Secretary GEITHNER. Well, Senator, we begin in our report by highlighting the fact that there are some things we can do to help gradually phaseout the Government's role, and we have to get these rules in place for banks and investors and the securitization market so there is clarity about the rules of the game in this context, you know, better underwriting standards, clearer capital requirements, better disclosure requirements, better servicing standards, things like that. So those two conditions are very important for getting private capital to come in and we think we can begin that process right now.

Senator MORAN. In the instances that you describe, that would be an administrative action as compared to a Congressional action?

Secretary GEITHNER. Those sets of reforms we laid out to wind down the Government's role and to put in place clearer rules of the game for the private markets, most of those things we can do within authority Congress has already given the executive branch.

Senator MORAN. Secretary——

Secretary DONOVAN. There is also, I would add, a number of levers that we point to in the report that we have already begun to take action on, as well. FHA has grown from its historic share of the market of 10 to 15 percent to close to 30 percent, in the purchase markets, over 50 percent. And with authority that this Committee worked to give us last year, we just announced an increase in our premiums of 25 basis points, that in addition to helping to rebuild our reserves can help to begin to step back our role.

I would also point to the loan limits, which we advocate Congress allowing to step back to the HERA limits on October 1, and we would want to engage in further conversations, particularly around FHA, about what lower loan limits we might want to pursue for FHA, as well as the GSEs going forward. So those are a number of other steps we have begun to take.

Senator MORAN. Thank you both. Hometown Kansas bankers continue to talk to me about the regulatory environment in which they operate, and particularly small community banks. I have had conversations with bankers who say they no longer are making real estate loans as a result of the concern about the regulatory examination environment. I think it would be a very sad day for particularly rural America, but for America in general when your hometown banker is not willing or capable of making home loans. Are both of you aware of those concerns and are there steps being taken to either dissuade the bankers from having that concern or to reduce the reason that they do have the concern?

Secretary GEITHNER. Senator, you are absolutely right, and, of course, we hear the same thing from banks across the country. Part of this, of course, is, in some sense, the natural consequence of the natural response of regulators who, in some sense, were a little too—how should I say—too loose in the boom and they tend to overcorrect——

Senator MORAN. Overreact?

Secretary GEITHNER. ——in the crash. And so I think that you are still seeing banks report a lot of concern about the change in the basic environment from examiners.

The bank supervisors in the country with responsibility for this are aware of this concern. They have issued a series of guidance to examiners and clarifications about treatment of commercial real estate loans, for example, to try to respond to this concern, and I know that Chairman Bernanke and Chairman Bair and the Acting Comptroller of the Currency, John Walsh, are aware of this and are continuing to try to look for ways they can try to make sure their examiners bring the appropriate degree of balance to these judgments and do not overcorrect.

Senator MORAN. Another point I would make, though, Senator, is well, is one of the consequences that we have seen in the—through this crisis has been an increasing concentration of lending. Today, the top five banks account for about 60 percent of all originations, and we have heard—I have heard very directly from FHA-approved lenders in many communities, particularly rural communities, that FHA's presence, along with VA and USDA, is absolutely critical to ensuring that they can continue to be a source of safe, affordable home loans in their communities. And, in fact, one of the points that we make in the report is that a risk of option one, in particular, could be that we would have less—more concentration and less——

Senator MORAN. In the origination.

Secretary GEITHNER. ——availability for community banks in others to be able to continue lending in those communities.

Senator MORAN. Before I lose my last 9 seconds, let me ask a broad question. I think there is a—as you all are aware, the topic of conversation, the discussion, the point that Congress and the Administration are in deals with the fiscal house of the United States. In my view, we are bankrupt or nearly bankrupt fiscally, and I think there is a tendency in this country to see this as a typical Republican versus Democrat, liberal, conservative, whatever the labels are, something that is an academic or philosophical battle going on in Washington, DC.

In my view, there are significant consequences to everyday Americans' standard of living, interest rates, and I would think that if we continue to have a goal in this country of having home ownership, I hope that you would agree with me that there is a significant consequence to the failure of Congress in addressing the fiscal issues that we face today with rising interest rates. I would like your reaction as to tell Americans that what we are discussing here are the outcome of the debate and the votes that occur in the House and Senate, approved by the President, have direct consequences upon our country's and its citizens' ability to enjoy a higher standard of living and to enjoy home ownership. Am I missing something in the magnitude of what we face today?

Secretary GEITHNER. No, I agree completely. It is a bipartisan imperative that we find a way to put in place long-term reforms to reduce our long-term deficits. Of course, we have to do that in a way that does not hurt the recovery or leave us without the capacity to finance things that are critical to our capacity to grow as a country going forward. But our growth prospects will be in jeopardy, short-term and long-term, if we cannot find a way on a bipartisan basis to lock in reforms that will bring those deficits down over time, not least because of the potential risk you see higher interest rates in the future, higher interest rates that would be bad for the economy generally, not just make home ownership more expensive.

Secretary DONOVAN. I would also add that within the direct area of housing finance, important steps have been taken by the conservator of the GSEs to improve their lending. Their current lending has begun not only to improve the housing crisis more broadly, but also to allow them to make good on their commitments to repay the American taxpayer through the agreements they have with Treasury.

And on the FHA side, we have taken a broad set of steps to improve our finances to the point where we will actually contribute to the taxpayer in the range of $10 billion this year because of the improvements that we have made in risk management and a range of other areas.

So these are critical areas where we can get our own fiscal house in order by responsibly managing, again, on a bipartisan basis, just as you have said, to improve Government in the way that the

President laid out in his State of the Union Address and has consistently said. We have to improve the performance of Government, and that means an important part of getting our fiscal house in order.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman.

Secretary Geithner, the Administration's report to Congress refers to Basel III, and Basel III will require banks to hold more capital—[inaudible]—and this should improve the ability of banks to withstand downturns and home price declines, and importantly, it would increase the stability of our financial system and create incentives to, obviously, underwrite good mortgages, and I would expect that, as the guarantees provided by Fannie Mae and Freddie Mac are wound down——

Chairman JOHNSON. Could the Senator turn on her microphone?

Senator HAGAN. Sorry about that. Is it on now? Thank you.

I would expect as the guarantees provided by Fannie Mae and Freddie Mac are wound down and the Government involvement in the mortgage market is removed, that mortgages will be viewed as riskier for purposes of capital standards.

How would you expect mortgages and mortgage-related securities to be viewed for risk weighting and capital adequacy standards under Basel in each of the three options outlined in the Administration's report?

Secretary GEITHNER. I think my own view is that the capital you ask, you require banks to hold against risk should be the same under all those three options. I would not alter them based on the options that Congress ultimately comes to. And again, that is because of the simple proposition that whatever risks banks hold, in mortgages or elsewhere, you want to make sure they are required to hold more capital against those risks. So those standards should apply regardless of the options Congress chooses.

Senator HAGAN. Well, with the higher capital requirements in place, what do you believe the comparative cost to consumers will be for a 30-year fixed-rate mortgage under these plans?

Secretary GEITHNER. I think under any of these plans, it is important to recognize that the cost of mortgages will rise for the American people. It will rise modestly, we believe, but they would be different under those three options, and I think any reasonable person looking at those options would conclude that the cost of mortgage finance and particularly for a 30-year fixed mortgage would be higher in option one and in option two than in option three.

Senator HAGAN. Higher in option one?

Secretary GEITHNER. Highest in one——

Senator HAGAN. OK.

Secretary GEITHNER. ——less high in two, and less high in three.

Secretary DONOVAN. Also, Senator, obviously, the interaction of the qualified residential mortgage, as you know, as one of the sponsors of that provision, will be critical here, as well. And so how we set those standards, as Secretary Geithner said, not changing the risk weighting, but obviously QRM will be a critical part of how we set those standards more broadly, and as we release that rule for comment, we should continue to have that discussion about how we set those standards to ensure adequate capital, but also not pricing that would put fixed-rate financing out of reach for most consumers.

Senator HAGAN. That is what I am very concerned about. What would the impact be on U.S. banks that hold mortgage-related securities relative to their competitors abroad, and would our banks be required to hold comparatively more capital?

Secretary GEITHNER. Under the framework of capital reforms that we have supported, there would be a level playing field across global markets and institutions. So the design of these standards are—the objective is to make sure that banks in the United States are required to hold the same level against risk as would be banks in the United Kingdom or in Canada or in Germany, and that is for obvious reasons, because you want there to be a level playing field across institutions. Now, of course, that is a challenge to achieve in practice, but it is very important we try to do that.

Senator HAGAN. Well, as we have been talking about, there have been calls for down payment requirements of as much as 20 percent, and just some examples right now. Middle-class families in the U.S., I do not think are able to always satisfy that high down payment requirement. Median single-family homes cost, on average, about $170,000 in 2009, and median household income was approximately $55,000. So it would seem that under such circumstances, if the family earned that median income, it would take them a great deal of time to save $34,000 to put toward a home, and when you consider instances where the same family has, for instance, unreimbursed medical expenses or is saving college education for several children, how do we help and ensure that families that fit this middle class definition and this profile could ultimately obtain a home?

Secretary DONOVAN. So I think, first of all, as a bedrock principle, this is one of the reasons we focus on having FHA continue to be a source of affordable, safe mortgages for low- and some moderate-income borrowers. So that is an important bedrock to ensure that that continues.

Second of all, a clear commitment through a dedicated, transparent stream of funding that would allow us to continue to support, for example, down payment assistance that would allow homeowners who can achieve home ownership to be able to buy a home that they can afford and to remain a homeowner in a sustainable way.

But I do think that there are implications beyond those two bedrock principles that we lay out in any of the three options that we need to look at the differences between the various options, particularly around the availability—and the pricing, as Secretary Geithner said earlier—of the 30-year mortgage in those different options. It would be different and there clearly would be less availability of a fixed-rate 30-year mortgage and higher pricing on that in option one relative to option three.

Secretary GEITHNER. I agree with what the Secretary said, and I want to underscore how important it is, the point you made. And again, it is not just the impact on the homeowner, but we have a great tradition in this country of thousands of small businesses started because people were able to borrow against the value of their home. So we want to make sure we get this balance right.

So we do not know exactly where the right balance is, but I do think it is important to recognize that whatever we do, it is important that we get the incentives better for people to hold more equity in their house over time. Not all Americans, necessarily, but we do want to save for the bulk of the mortgage market. You want the system to rely on a thicker equity cushion, not just greater capital requirements by banks but by homeowners. I think that is very important, and we have lots of ways, not just through FHA, but we propose in the report a number of other ways to try to make sure that we give people some help to buy that first home, to be able to afford that first home, and I think we can get a better balance than we have in our current system.

Senator HAGAN. And then the financing structure, the actual cost, the interest rates, too, I think, is that——

Secretary GEITHNER. Exactly right, and——

Senator HAGAN. ——impact that greatly.

Secretary GEITHNER. And that is one reason why we have emphasized so—and this is very important, that as we proceed, we have to proceed with a lot of care because it would be irresponsible for the Government of the United States to embrace policies today that would raise the cost of mortgage financing significantly and add to the still very substantial burdens, fragility of the current housing finance system. So we want to proceed carefully, but, of course, in terms of the ultimate end state, we also want to be careful that we do not go too far the other direction.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thank you both for being here and for your work.

I want to go back to Senator Moran's concerns about the overall fiscal situation. Do you think Congress and the President can put off to beyond the next election some major approach to get us on a different long-term fiscal path without the risk of serious negative consequences in the meantime.

Secretary GEITHNER. Well, I would say it this way. It would be better for the country for Congress and the Administration to come together sooner and agree on a set of reforms you can lock in today that would restore gravity to our fiscal position. If you do it now, with a multiyear set of reforms, you give people more time to adjust. You give individuals and investors more time to adjust, businesses more time to adjust, and you leave the world more confident that we are not going to put this off forever, and it is easier to solve if you start these kinds of things early. Better to move now if you can and you can find a way to do it sensibly.

Secretary DONOVAN. And just to add to that, Senator, I would say critical steps that we are taking, the freeze that the President proposed over 5 years, reductions we are proposing for 2012, I would say, in our own budget at HUD, almost a 3-percent reduction relative to 2010, all of those steps would bring domestic discretionary spending to the lowest level since President Eisenhower. So those are critical steps. As I think we have recognized, Secretary Geithner has recognized, we need to move beyond just domestic discretionary spending, but we clearly have proposed a budget that puts us on that course.

Senator VITTER. Well, at least my next question, because I guess I just fundamentally disagree with that, my next question was going to be when will the President and the Administration lead on changing our fiscal course, because I truly believe what has been announced so far has gotten completely panned in terms of the markets, which are ultimately the most important and most objective judge, and that is going to impact what consequences we face down the line.

Secretary GEITHNER. Well, Senator, of course, you do not expect me to agree with that, and I do not agree with that. What the President proposed in his budget is a series of detailed changes to our resources and our commitments that would reduce our deficits from 10 percent of GDP to around 3 percent of GDP, which is primary balance. That is the level at which you stop our overall debt burden from growing as a share of our economy. That is a necessary condition for fiscal sustainability. It does not solve the problem for the succeeding decades, but it is the minimum thing we need to do, and when we frame this, we frame this as proposed, is we frame it as a first step, as a down payment. And if Congress were to legislate constraints on itself that was consistent with that deficit reduction path, that would be enormously helpful to sustaining the confidence in the United States and around the world that we are going to go back to living within our means.

Now, we will still—even if we achieve that, we will still have to figure out how to come together and make deeper reforms in health care spending over time, because ultimately, over the succeeding decades, that is what drives our long-term deficits. But we have to find a way to get from 10 percent of GDP, which is an unsustainable near-term fiscal position, to at least primary balance in a 3- to 5-year period so that we can stop the overall debt burden from growing as a share of the economy, and that is what we propose.

Now, under our Constitution, the President proposes but Congress has to legislate in that context, and I actually would be more encouraging than I think you were in the sense that I think if you listen carefully to what is happening across the Congress today, there is a lot of interest across the aisle, Democrats and Republicans, to try to come together now in a bipartisan framework that will lock in some long-term reforms.

Senator VITTER. I agree with the last statement and I encourage everyone, including the Administration, to latch on to that and to lead in that.

My second main topic is about risk retention. There are proposals to exempt GSE loans from risk retention. Do either of you support that?

Secretary DONOVAN. I actually do not think that there are discussions about exemptions. I think that the key question is if we are setting standards for risk retention, that should cover the market broadly, and the question is how do we ensure, whether it is the GSEs or any other kind of financial institution, that they are holding adequate capital? I think everything that we have said in the discussion today about reform of the GSEs would suggest that we are very much in favor, the Administration is, of ensuring that the GSEs are holding adequate capital against their commitments, and that is, I think, what you will see not only when the draft rule for QRM gets released, but also in the further discussions that we have about the future of the GSEs.

Secretary GEITHNER. Well, one quick thing, Senator.

Senator VITTER. Sure.

Secretary GEITHNER. Again, our overall objective, and this has to be our shared objective, is to have the private markets, banks and investors, bear more of the risk in housing finance, not less of the risk. So absolutely, we want to make sure as we design these draft regulations that we are meeting that basic objective. We do not want to be working against that basic objective. And as I said, we expect to go out with a draft rule reasonably soon and that will be just a draft rule. We will have a chance for people to comment on that so we can adjust it, if necessary, to make sure we are consistent with that objective.

Senator VITTER. So under the framework you are describing, would GSE loans in terms of down payments, risk retention, *et cetera,* be treated like other loans?

Secretary GEITHNER. Senator, I do not think it is appropriate for either of us to comment on the details of these proposals yet because, again, we want to make sure that the people responsible do that carefully and they will come out for public comment soon in draft form. But again, our overall objective should be to make sure that we create a system where private investors, private banks, private individuals are holding more of the risk in housing finance, not less of the risk relative to the Government agencies in this context.

Senator VITTER. OK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you both for testifying and working on this very important challenge.

I wanted to focus on option three and get a little better sense of some of the pieces. Perhaps those have not been laid out in detail, but at least a little bit of a sense of what you are thinking are thinking.

In terms of a piece of the guarantee fund fee being pulled off for the Government's catastrophic guarantee fund, first, would that portion that would go to the Government's catastrophic guarantee, would that be adjustable in kind of an FDIC style, where it could be set and changed from year to year as the size of the fund grew and the risks seemed higher or lower?

Secretary DONOVAN. Senator, I think that is something, obviously, that could be designed in the details. But I think one of the principles that we have as we laid out these options was that providing the ability to respond to market conditions, particularly as you enter a financial or a housing crisis, there is a need to ensure that that pricing can be adjusted, whether it is to grow those reserves more rapidly or to ensure that there is adequate capital available, adequate liquidity during that crisis. So I think some form of flexibility would be important.

Senator MERKLEY. And my impression is, this catastrophic guarantee fund is designed as a last resort after private mortgage guarantee companies, I assume, fail, if you will. And so would that kick in after the stockholders have lost their value? Would it kick in after the bond holders have lost the value of their investment?

Secretary DONOVAN. I think one of the primary areas that we focused on the report is to ensure that we are creating a system where there is real private capital at risk ahead of any guarantee. Were there to be that system, we would want to ensure that equity would be at risk and therefore would be wiped out, if you will, before there would be access to a guarantee in that——

Senator MERKLEY. Including bond holders as well as stock?

Secretary DONOVAN. Well, it depends who—if you are talking about the bond holders on securities, obviously, the protection would be for the bond holders on the securities. If those are bond holders to capital that goes to that institution, then yes, that would be at risk.

Senator MERKLEY. I was speaking to the latter. So next, one of the concerns about Fannie and Freddie is they became so large, so systemically significant. Would there be a limit on the size of these private mortgage guarantee companies?

Secretary GEITHNER. I think the most important thing to do would be to make sure that you regulate them for capital and that they are required to be subject to a set of comprehensive oversight supervision with capital requirements to do that. That would be the necessary test for this. I think the only way to limit the real risk to the system ultimately and the risk to the taxpayer in this context, beyond just requiring them to hold enough capital, is to make sure that if the Government is exposed to any risk of loss, there is, as Secretary Donovan said, there is a lot of capital ahead of the Government in that context.

Secretary DONOVAN. I think the other important point here, as well, would be that independent of the size of the individual institutions, a fundamental premise of option three was that the footprint overall of that guarantee be limited relative to, as Secretary Geithner referred to it, the sort of nationalization option or continuing the current place where we are, where over 90 percent of new mortgages are guaranteed.

So it is not just the individual size of the institutions but the overall size of any guarantee being limited to ensure that the primary risk in the market is borne by the private sector.

Senator MERKLEY. You know, one of the things that we talked about under the Volcker Rule structure—actually, it was outside the Volcker Rule but was in Merkley-Levin—was that the companies that were private investment banks, as they became larger and more systemically significant, that the regulators could raise the capital requirements so as to recognize that additional risk of a particular single house going down. Could something like that be used in this incident to not necessarily completely put an upper limit on the size of companies, but to kind of encourage multiple smaller companies?

Secretary GEITHNER. I think that perhaps I could start on that, Senator. I think it is very important generally, as you look across the system, that we recognize there is a level of concentration or consolidation that would be against our broad interests in this context, and we very much want to create a set of incentives in the system where we are preserving the very strong role played in that today by regional banks, by small community banks in this context. And one important thing to do in looking at these options is to make sure that we do not alter that balance in a way that would work against the objective of a very diversified, rich mix of institutions, small and large, in our current banking system.

Now, in terms of capital requirements, I am personally very supportive of, and I welcome very much the recognition in legislation of this, of trying to make sure that for the largest institutions in the country that create the greatest potential risk in the context of stress, that they be held to higher capital standards than other banks, and that is the approach we have brought to these broad capital reforms around the world.

Again, the basic principle should be not just that banks hold enough capital against risks, they could absorb a shock without having to turn to the Government or taxpayer, but for large institutions whose failure or whose mistakes would cause broader damage to the innocent or to the more prudent, you want to make sure that they are held to higher standards, as a whole. So I very much welcome that basic principle.

Senator MERKLEY. And finally, under the description of option three, the Government would set standards for mortgages that could be in the pools, guaranteed by the private guarantee companies. Would those be different than the QRM standards, and what would guide those standards?

Secretary GEITHNER. I hope not, just on the grounds that I think we would want to have a simple, uniform, tougher, more conservative set of standards for these things. You would want to try to improve the odds that you have got one framework for differentiating. But that depends a little bit on how these options are designed.

Secretary DONOVAN. Just to echo Secretary Geithner's point, one of the clear problems that led us into this crisis in the first place was sort of a patchwork of various standards, or lack of standards, that applied across different types of mortgages. One of the important elements of the QRM is that it would hopefully level that playing field rather than continuing the patchwork that we saw before.

Senator MERKLEY. Thank you.

Chairman JOHNSON. Senator Kirk.

Senator KIRK. Thank you, Mr. Chairman.

Just picking up on everyone else's thought, and even the Secretary talking about increased risk retained by the private sector, I think one of the key problems is for the American people to best understand it the way I think about it is the movie, "It's A Wonderful Life." The Bailey Building and Loan retained its mortgages and, therefore, expects to be repaid. I think it was Long Beach Savings which pioneered becoming just a loan origination house and they never expected to be repaid. And so they just skimmed the percentage and off-loaded loans onto the Government. So the Government actually was the problem because it turned banks and savings and loans into loan origination houses that never expected to be repaid, and, therefore, quality was not retained.

What about a rule, if we look at other than option one, which required the originating bank to re-own out of 100 loans it made the bottom ten? And so if the Government found that out of 100 loans, these bottom ten were not performing, you have to re-own them. And so the garbage that you passed on to the Government needs to be recaptured by the loan, therefore sinking the bank that originated this terrible paper.

Secretary GEITHNER. Senator, you have got the challenge exactly right and the problem exactly right and that may be one way to do that. Again, for this to work, you have to do two things, or maybe many more than two things. You need to make sure that you get the underwriting standards right and people who originate are required to be exposed to some of the risk in that judgment. But you also have to require that they hold capital against the risk, because as you said, in our system, we let people not just originate these things and well them——

Senator KIRK. Right.

Secretary GEITHNER. ——and they have legal liability there, but if they did not have capital, you did not have that protection in that context, and the people who bought those have no recourse against them, so——

Senator KIRK. Right. Yes.

Secretary DONOVAN. Senator, I would just add, and this connects back to the discussion we just had with Senator Merkley, by the nature of the design that we discussed for option three, they would be at risk not just for the ten worst mortgages, but, in fact, all 100 of those mortgages in the pool to the extent of the capital they are holding as well as the equity, whatever assets were held at that institution. And so I think we fundamentally agree with the nature of your comment.

Senator KIRK. Right. A totally separate subject, because it is a hot issue. We now see Japanese equities have fallen 17 percent, Chinese equities 1.4, Hong Kong 2.9, Taiwan 3.4, and Australia 2.1. Do you see a systemic risk forming here, because the assumption, you know, housing in general will always rise was a fundamental assumption that created a systemic risk in our system. Another problem may be Asia is strong, and therefore, actually, that assumption is incorrect, creating a systemic risk. I would guess that you could probably give me a better—that U.S. pensions and other holdings are probably, what, 1 to 3 percent held in Asian equities, which are now falling fairly rapidly. Could you describe if you see a systemic risk in the fall of Asian equities?

Secretary GEITHNER. I do not, Senator, in this context. Again, I would focus much more on just the basic humanitarian reconstruction challenge and containing the risks and repairing the damage caused by the catastrophe there, and I think that is something that Japan, with assistance from the world community, can do, can achieve.

Now, I do think it is important to recognize that we come into this period of challenge in the world economy in a much stronger position than we have been and you see much more confidence—and I think it is justified—here and around the world in the resilience of the process of repair and expansion you see underway. Now, of course, we want to make sure that we do everything we can to help sustain that. We do not want to jeopardize that. And I think that should be our focus and attention.

Senator KIRK. I am concerned, though, because we see Toshiba and Toyota stopping production and it looks like we have a systemic shortage of power in Japan that will cripple large publicly traded companies in being able to maintain production.

Secretary GEITHNER. Well, Senator, again, there are a lot of things to be concerned about in the world and I think that it is very important that we watch this carefully, and it is very hard to judge at this stage, again, what is going to be the magnitude of the short-term cost of production and output there. Again, our focus and attention is going to be on trying to help them make sure they can help meet the humanitarian challenge and the reconstruction challenge and I think we can be reasonably confident they are going to be able to do that.

Senator KIRK. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you, Secretaries, for being here today.

I actually want to go all the way back to the very beginning and the Ranking Member's conversation with you, Secretary Geithner, about taking the politics out of this, which I am all for. And one of the things that worries me in reading the three options and all the discussions that have been had is that even though we will not make an explicit guarantee, even though we will do everything that we are going to try to do to mitigate the private actors from believing that the Government is going to show up and rescue the markets, there is a nagging concern that they will always believe that we will be because of the sheer scale of housing, the importance of it to our economy, and I wonder if you could talk a little bit more about whether you see that as a risk and what it is we could do to try to mitigate it, that moral hazard.

Secretary GEITHNER. I do see it as a risk, and I think you are right to highlight it, but I do not think it is beyond our capacity to make a substantial improvement in mitigating that risk. The options we proposed, in each of those options, any guarantee the Government provided would be explicit, carefully qualified, priced to the extent we can cover any risk or loss to the taxpayer, and a very important principle.

Now, you could say, even if we achieve that, would we still be left as in all financial system with some risk that banks operate with the hope and expectation, or investors operate with the hope and expectation the Government would step in in the future, as we have in the past. That is a very important concern, and I think that the only way credibly we know to reduce that risk is to make sure we deliver the reforms that were put in place in legislation last year. And again, what those reforms do is require banks to hold much more capital—not just banks, but entities that operate as banks hold much more capital against losses, that the Government cannot step in to save them from their mistakes.

The only thing the Government can do is step in to dismember them safely with less risk of collateral damage to the innocent, and if we do those two things along with improving the incentives in the mortgage market so that not just banks but homeowners have more equity in their homes as a whole, I think we can make a very substantial difference in creating a system that is less vulnerable to crisis and less vulnerable to the moral hazard risk that pervades all financial systems.

Secretary DONOVAN. Let me go back to sort of the premise of your question, which I think is important, as well, that part of this debate is to look at other countries around the world that have different housing finance systems and to say, well, they do not have mechanisms that protect against crisis in the same way that we do. But I think, in fact, if you look closely at those systems, there are—in almost every case, there is a recognition, exactly as you have said, that in the midst of a major financial crisis, the impacts on housing, on household savings, on a whole range of problems—labor mobility, for example—are so deep that, in fact, there is a system, whether explicit or not, that would step in, whether it is banking guarantees or some other form that exists, and a broad recognition that there needs to be a system that exists.

And so we try, I think, in the report to be very explicit about that and to lay out options. And in each case, whether it is FHA alone or FHA plus some other form of backstop in crisis, in options two and three, recognize that we will need to step in. In fact, if you look at Mark Zandi's recent analysis of this, he says that had we not stepped in, the crisis would have been much deeper on the housing front.

But I think as Secretary Geithner has laid out, designing that in the most clear, transparent way possible, putting private capital at risk in front of it as much as possible so that we minimize the chances, which are always there, of mispricing the guarantee or of having moral hazard, other effects, are minimized.

Senator BENNET. And I was going to actually ask you to talk a little bit about the differences between what we saw with FHA, what we saw with Fannie and Freddie, but in the interest of—and I think it is important for people to focus on that—in the interest of time, I am going to skip that, because I do not want to get in trouble with the Chairman, and ask you another question.

The White Paper notes that, quote, "Fannie Mae and Freddie Mac were allowed to behave like Government-backed hedge funds, managing large investment portfolios for the profit of their shareholders with the risk ultimately falling largely on taxpayers." If we create something like the Administration's third option, should the private successors to Fannie and Freddie be allowed to maintain investment portfolios or should they be allowed to maintain them with certain restrictions on the investments?

Secretary DONOVAN. I think there is no question that any portfolio activities should be dramatically different from what was there before. I think there are some minimal functions that, for example, if you are talking about multifamily housing in rural communities or in other underserved communities where there might be some need to accumulate loans for some short period of time prior to securitization, there are some relatively small activities that we might consider. But fundamentally, the scale of the portfolios, the lack of restrictions on the portfolios were fundamental problems. And, I think perhaps most importantly, ensuring that any guarantee that was provided did not backstop those portfolios, I think, are critical pieces of what we are proposing, fundamentally different from what was true at Fannie Mae and Freddie Mac.

Senator BENNET. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

Senator BENNET. Thank you for your testimony.

Chairman JOHNSON. We will have a second round of very brief questioning.

Secretary Donovan, the Administration's report cautions against a hasty transition from Fannie Mae and Freddie Mac in the current economy, but it also recommends increasing the enterprise guarantee fees. Last week, we heard from the realtors and home builders that increasing these fees discourages potential home buyers. Some industry groups argue that these fees may drive borrowers to FHA-insured loans. By increasing these fees, are we moving more mortgages away from the private market and toward FHA?

Secretary DONOVAN. Senator, first of all, I would say, and I want to echo Secretary Geithner's comments earlier, that we do, under any of the options, have to recognize that there will be some increased cost for mortgages. I think if you look back at the system that we had, there is no question that we underpriced risk and took on risks at the interest rates we provided that we were not prepared for. And so I think that is one recognition we have to make in the system going forward.

I also think it is important that as we take steps with the GSEs, we also within FHA take prudent steps to ensure that we are not expanding risk through FHA and increasing our portfolio beyond its current footprint. And, in fact, our recent announcement of a 25-basis point increase in our premiums will help to do that, and I think sets the stage for private capital to begin to return. So I do think we are taking steps recognizing that through FHA.

And one important point I would make, FHA's guarantees are 100 percent guarantees, and so we take that risk very seriously and we have to ensure as we look at Fannie Mae and Freddie Mac that we are also doing things, whether it is looking at options like risk sharing or other legislative changes to FHA, that would ensure FHA is better prepared in the future to step in in this kind of role.

Chairman JOHNSON. Would this be more likely in one of the options in the report rather than others?

Secretary DONOVAN. I do think that if FHA is the sole guarantor, with VA and USDA playing a somewhat smaller role, but if the Federal Government in total through those three entities are the sole guarantors, particularly in the wake of a crisis, then I think there is certainly a risk that we take on a much larger footprint, if you will, in the market than would happen under options two or three.

So clearly, that is something as we consider the various options we need to be aware of, and I think to work collaboratively with the Committee to ensure that FHA is prepared and that we continue to make changes for FHA to take on a larger footprint in crisis, as we have done in this one. There are many issues, systems issues around procurement and other things where ensuring we have the ability to operate effectively and efficiently as we step up in a crisis, those are things that I think ought to be a central part of what we are looking at as we consider reform to the GSEs.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Secretary Donovan, to quote in your words, the Administration is fully committed to exploring other measures to make sure that secondary market participants are providing capital to all communities. Then Secretary Geithner said, Government-supported incentives for housing that distorted the market. On the one hand, you say the Administration is fully committed to exploring Government incentives that will distort the market and are good to distort the market. What are some of the ways that the Administration is considering meeting these seemingly contradictory goals? Are you considering Government-mandated lending quotas or an expansion of the CRA, Community Reinvestment Act, and how do you achieve some of these goals without politicizing lending decisions?

Secretary DONOVAN. I think we have, Senator, talking about the risks of the politicization of any of these issues——

Senator SHELBY. And there are big risks there, are there not?

Secretary DONOVAN. No question there are risks, but I would go back to something you said earlier in the hearing, which is that transparency can be a powerful tool to ensure that markets are working effectively——

Senator SHELBY. Absolutely.

Secretary DONOVAN. ——and one of the things that we have seen is as we have provided transparency in the primary market through mechanisms like the Home Mortgage Disclosure Act, for example, we have seen that transparency be a powerful force to ensure that where you have homeowners that can be successful homeowners, that have the capacity to take on loans, that credit is provided in those communities.

So I think there is a lot that we can do with transparency as well as making sure that we do not have an unlevel playing field between primary market and secondary market factors. So those are a couple of ideas I would point out.

Senator SHELBY. Secretary Geithner, your joint report states that the Obama administration's reform plan is designed, quote, "to target the Government's vital support for affordable housing in a more effective manner." Numerous studies, including those conducted by the Congressional Budget Office and the Federal Reserve, have concluded that the Federal Government's implicit guarantee of Fannie and Freddie securities yielded a small benefit to borrowers. Most of the benefit went to Fannie and Freddie's shareholders and executives. Do you agree with the results of those studies?

Secretary GEITHNER. I do.

Senator SHELBY. So has the value of Government guarantees for mortgage-backed securities been overstated by some, and probably me here, trying to push home ownership?

Secretary GEITHNER. I think that in the context of Fannie and Freddie and the support the Government provided implicitly to those institutions for housing finance, you are right to say that most of the benefits of those guarantees did not go to the purported beneficiaries, and that would be something that you would want to make sure you avoided in the future if you were going to preserve any role for a guarantee, and again, I think there are ways to do that, Senator, that are not beyond our capacity to get right.

Senator SHELBY. I hope we can, because if you are socializing the risk, putting it on the taxpayer, and privatizing the profits to the shareholders, we have got a bad situation.

Secretary GEITHNER. Exactly. And I would—we would not support, even if this Committee were inclined to, we would not support re-creating a system in which private shareholders were able to benefit from a guarantee designed to help make sure that homeowners have access to more affordable housing, and that an economy like ours is able to withstand shocks like this with less collateral damage.

Senator SHELBY. Would it be the position of both of you not to replicate another Fannie Mae and Freddie Mac?

Secretary GEITHNER. Absolutely.

Secretary DONOVAN. Absolutely.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Thanks again to Secretary Geithner and Secretary Donovan for being here today.

It is essential that we create a stable, sustainable housing market for American families. The Administration's White Paper is a good starting point for our discussions about how to do that. I look forward to continuing those discussions as we further explore the options presented today.

This hearing is adjourned.

[Whereupon, at 11:51 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JACK REED

I want to welcome both of our distinguished witnesses.

We are here this morning to discuss the Administration's report to Congress on several possible pathways forward for reforming the housing finance market.

To start off, let me say I am particularly pleased that the report focuses on achieving a better balance in the U.S. housing market to provide for a wider range of housing choices. This includes access to home ownership for those in a position to take on mortgages and a more robust and affordable rental housing sector, which would include something similar to a national Housing Trust Fund, which I created to support and develop affordable rental housing for more Americans.

There is bipartisan agreement that we need to restructure Fannie and Freddie and limit the Government's role in the mortgage market. But we have to be careful and get this right, and not rush towards a solution that might not be the right one just for the sake of acting quickly.

Changing the home financing landscape is going to have a major impact on consumers, construction workers, and taxpayers.

If we act precipitously, as some have suggested, the already fragile housing market and the overall economy could be severely affected. The solution, at the end of the day, must be right and actually solve problems, instead of creating more problems.

The proposals we will discuss today outline options to properly target and limit the Government's involvement in the mortgage business.

However, we need to clearly remember that the Federal Government became involved in the housing finance system because of a series of major failures in this sector.

In the 1930s, liquidity risk was born by the borrowers. Back then, a borrower took out a 5-year interest only loan and put 50 percent of the value of the home down as a down payment. At the end of the loan, the outstanding balance had to be paid or the loan had to be renegotiated, or rolled over.

During the Great Depression, so many banks went under and borrowers lost so much value in their homes that these loans could not be refinanced or rolled over. As a result, we had a liquidity crisis, and there were massive numbers of foreclosures.

In response, the Federal Government created the Federal Housing Administration, Fannie Mae, and the Federal Home Loan Banks to help provide liquidity for housing loans.

FHA also standardized a new concept at the time—20-year mortgages where the loan would be repaid in full at the end with the FHA insuring lender repayment. Eventually, over time, this lead to the standardization of the 30-year mortgage.

The next housing crisis requiring Government intervention was the savings and loan (S&L) crisis.

As interest rates went up to 15 percent, S&Ls found themselves paying 15 percent in financing costs, but were only receiving 7 percent on home loans. This severe mismatch caused many to fail, and the S&L crisis was really an interest rate crisis, which also precipitated a Government response.

Fast forward to 2008, to our most recent housing crisis—which many believe was caused by the failure to properly underwrite loans. In other words it was caused by underwriting risk. Lenders improperly believed they had found a way to sufficiently diversify risk through the securitization process that they no longer had to focus as much on the basic and fundamental tasks of ensuring that borrowers could repay the loan at the end of the day. We addressed some of these underwriting issues in Dodd-Frank by, for example, requiring lenders to ensure a borrower's ability to repay and requiring lenders to disclose the maximum a consumer could pay on a variable rate mortgage, with a warning that payments will vary based on interest rate changes.

So, some key questions I will have for our witnesses this morning are: What have we learned from these various housing sector crises? And how can we preserve some of the strengths of our existing system—such as the 30-year fixed rate mortgage, a deep and liquid national mortgage market, and the standardization of mortgage products that has made them attractive for private sector investment—while making our system less subject to such crises in the future?

I am pleased that Chairman Johnson is planning on holding a robust set of hearings on these issues in the months ahead, as we work towards how to best reform our housing finance system and provide access to decent, safe, and affordable housing for all Americans.

PREPARED STATEMENT OF SENATOR MICHAEL F. BENNET

Mr. Chairman, thank you for holding this important hearing.

With this hearing, we start the difficult process of reforming our housing finance system and reducing the Government's role in the secondary mortgage market.

As we start our work, it's critical that we remember that families across the country continue to struggle in this difficult economy. In Colorado, one property out of forty had some form of a foreclosure filing making the State 10th in the Nation when it comes to foreclosure problems. Between foreclosure sales and vacant homes, there are reminders across Colorado of how the failure in our housing market has fundamentally changed our lives.

Problems with Fannie Mae and Freddie Mac are emblematic of a financial system that had spun completely out of control. As the subprime lending boom escalated, Fannie and Freddie sought to maximize their profits by entering this unstable market. By doing so, they undermined their financial integrity and exposed taxpayers to billions of dollars in risk.

Moving forward, we need to ensure that the American taxpayer will not be subject to such exposure again. We also need to reduce the Government's involvement in the secondary mortgage market. Finally, these reforms must ensure that middle-income families can still attain the American dream of home ownership.

I look forward to this challenge. Thank you Mr. Chairman.

PREPARED STATEMENT OF SENATOR JERRY MORAN

Thank you Chairman Johnson and thank you Secretary Geithner and Secretary Donovan for appearing before the Committee to discuss the critical need for reform of our Nation's housing market. The white paper submitted to Congress by your Administration is a foundation to the discussions we will be having over the coming months. It is lacking in specific detail and in recommendations, but does give my colleagues and me some food for thought.

There is no doubt that our housing markets are fragile and will likely remain so for some time. Nine out of every ten mortgages being made today are supported by the Federal Government. Any fundamental reform of Fannie Mae, Freddie Mac, and FHA must take this current fragility into account. That being said, the housing market's heavy reliance on the GSEs must not serve as an excuse to delay the debate. Taxpayers have pumped tens of billions into the failed giants Fannie Mae and Freddie Mac and it is highly unlikely that they will be made whole.

However we choose to reform the system, whether it is one of the three options that the Administration has presented or something else entirely, we must make sure that taxpayers are protected and that the private markets are not disadvantaged. There are some who may believe that we have time on our side and that this is a discussion that can begin somewhere down the road. I am not one who is willing to postpone this debate. I stand willing to begin the necessary work with my colleagues and with the Administration so that we can reach a point where taxpayers are protected and responsible home ownership remains an option for Kansans.

Thank you both for appearing before us today and I look forward to your testimony.

PREPARED STATEMENT OF TIMOTHY GEITHNER

SECRETARY, DEPARTMENT OF THE TREASURY

MARCH 15, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify this morning.

Last month, we released a report outlining our vision of the next steps for reforming the housing finance market. My testimony today summarizes the content of that report.

There is little dispute that the financial crisis was partly the result of fundamental flaws in the housing finance market. The consequences of those flaws, and the losses Fannie Mae and Freddie Mac have inflicted on taxpayers, make clear that we must build a healthier, more stable market that will work better for American families and our Nation's economy.

For decades, the Government supported incentives for housing that distorted the market, created significant moral hazard, and ultimately left taxpayers responsible for much of the risk incurred by a poorly supervised housing finance market. In more recent years, we allowed an enormous amount of the mortgage market to shift to where there was little regulation and oversight. We allowed underwriting standards to erode and left consumers vulnerable to predatory practices. We allowed the market to increasingly rely on a securitization chain that lacked transparency and accountability. And we allowed the financial system as a whole to take on too much risk and leverage.

These were avoidable mistakes. Their convergence, as we all know, resulted in a financial system vulnerable to bubbles, panic, and failure. Reforming our country's housing finance market is an essential part of our broader efforts to help ensure Americans will never again suffer the consequences of a preventable economic crisis.

Our proposal for reform breaks sharply from the past to fundamentally transform the role of Government in the housing market.

We believe the Government's primary role should be limited to several key responsibilities: consumer protection and robust oversight; targeted assistance for low- and moderate-income homeowners and renters; and a targeted capacity to support market stability and crisis response.

The Administration is committed to a system in which the private market—subject to strong oversight and strong consumer and investor protections—is the primary source of mortgage credit.

We are committed to a system in which the private market—not American taxpayers—bears the burden for losses.

And while we believe that all Americans should have access to affordable, quality housing, our goal is not for every American to become a homeowner. We should provide targeted and effective support to families who have the financial capacity to own a home but are underserved by the private market, as well as a range of options for Americans who rent.

As the housing market recovers and the economy heals, the Administration and Congress have a responsibility to look forward, reconsider the role Government has played in the past, and work together to build a stronger and more balanced system of housing finance.

Reducing the Government's Role in the Mortgage Market

In the wake of the financial crisis, private capital has not sufficiently returned to the mortgage market, leaving Fannie Mae, Freddie Mac, FHA, and Ginnie Mae to insure or guarantee more than nine out of every ten new mortgages. Under normal market conditions, the essential components of housing finance—buying houses, lending money, determining how best to invest capital, and bearing credit risk—should be private sector activities.

We will work closely with the Federal Housing Finance Agency to determine the best way to responsibly reduce Fannie Mae and Freddie Mac's role in the market and ultimately wind down both institutions. This objective can be accomplished by gradually increasing guarantee pricing at Fannie Mae and Freddie Mac, as if they were held to the same capital standards as private institutions; reducing conforming loan limits by allowing the temporary increases enacted in 2008 to expire as scheduled on October 1, 2011; and gradually increasing the amount of private capital that risks loss ahead of taxpayers through credit loss protections from private entities and gradually increased down payment requirements. We also support the continued wind down of Fannie Mae and Freddie Mac's investment portfolios at a rate of no less than 10 percent annually.

I want to emphasize that it is very important that we wind down Fannie Mae and Freddie Mac at a careful and deliberate pace. Closing the doors at Fannie Mae and Freddie Mac without consideration for the pace of economic recovery could shock an already-fragile housing market, severely constrain mortgage credit for American families, and expose taxpayers to unnecessary losses on loans the institutions already guarantee. It is ultimately in the best interest of the economy and the country to wind down Fannie Mae and Freddie Mac in a responsible and prudent manner.

Treasury estimates show that the net cost of our support for Fannie and Freddie will total approximately $73 billion through 2021, 44 percent lower than the $134 billion in net investments requested or drawn to date. This estimate is consistent with the FHFA's stress tests, which have proven to be appropriately conservative. Costs have already begun to decline; in the third and fourth quarter of 2010, the combined net costs to the taxpayers of Fannie Mae and Freddie Mac decreased by approximately $2 billion largely as a result of the recovering housing market and reforms instituted by FHFA as conservator. Minimizing loss to the taxpayer will continue to be a priority during the reform process, and many of the steps we lay out in our plan are likely to help us further reduce the ultimate cost.

The Administration is fully committed to ensuring Fannie Mae and Freddie Mac have sufficient capital to perform under any guarantees issued now or in the future, as well as the ability to meet any of their debt obligations. Ensuring these institutions have the financial capacity to meet their obligations is essential to maintaining stability in the housing finance market and the broader economy. During the transition, it is also important that the operations of Fannie Mae and Freddie Mac continue to serve the market and the American people, including retaining the human capital necessary to effectively run both institutions.

As we decrease Fannie Mae and Freddie Mac's presence in the market, we will also scale back FHA to its more traditionally targeted role. We support decreasing the maximum loan size that qualifies for FHA insurance—first by allowing the present increase in those limits to expire as scheduled on October 1, 2011, and then by reviewing whether those limits should be further decreased going forward.

We will also increase the pricing of FHA mortgage insurance. FHA has already raised premiums twice since the beginning of this Administration, and an additional 25 basis point increase in the annual mortgage insurance premium is included in the President's 2012 Budget and will be levied on all new loans insured by FHA as of mid-April 2011. This will continue ongoing efforts to strengthen the capital reserve account of FHA and align its pricing structure in a more appropriate relationship with the private sector, putting the program in a better position to gradually return to its traditional and more targeted role in the market.

The Administration also supports reforms at the Federal Home Loan Banks (FHLBs) to strengthen the FHLB system, which provides an important source of liquidity for small- and medium-sized financial institutions. These reforms include instituting single district membership, capping the level of advances for any institution, and reducing the FHLBs' investment portfolios.

We also believe it is appropriate to consider additional means of advance funding for mortgage credit as a part of the broader reform process, including potentially developing a legislative framework for a covered bond market. We will work with Congress to explore opportunities in this area.

Addressing Fundamental Flaws in the Mortgage Market

Winding down Fannie Mae and Freddie Mac and implementing reforms at FHA and the FHLBs, however, is only one side of the coin. These steps alone will not give rise to a housing finance market that meets the needs of families and communities, nor will it guarantee that private markets can effectively play a predominant role. We must also pursue reforms that restore confidence in the mortgage market among borrowers, lenders, and investors.

The Administration supports the strong implementation of reforms to help address precrisis flaws and rebuild trust and integrity in the mortgage market. Taken together, these reforms will improve consumer protection, support the creation of safe, high-quality mortgage products with strong underwriting standards, restore the integrity of the securitization market, restructure the servicing industry, and establish clear and consolidated regulatory oversight. The Dodd-Frank Act laid the groundwork for many of these reforms. We will implement its provisions in a thoughtful manner to protect borrowers and promote stability across the housing finance markets.

Treasury is currently coordinating critical reforms to the securitization market that will require originators and securitizers to retain risk, including coordinating an interagency process to determine the parameters for Qualified Residential Mortgages (QRM) under the Dodd-Frank Act. This summer, the Consumer Financial Protection Bureau will assume authority to set new rules to curb abusive practices, promote choice and clarity for consumers, and set stronger underwriting standards. Federal regulators will require banks to increase capital standards, including maintaining larger capital buffers against higher-risk mortgages that have a greater risk of default.

Treasury is also actively participating in interagency efforts to design and implement near-term reforms that will help correct chronic problems in the servicing industry, which has proven especially ill-equipped to deal fairly and efficiently with the sharp increase in the number of families facing foreclosure. Right now, we are working together to design national servicing standards that better align incentives and provide clarity and consistency to borrowers and investors regarding their treatment by servicers, especially in the event of delinquency. Our work includes identifying ways to reduce conflicts of interest between holders of first and second mortgages and improving incentives for servicers to work with troubled borrowers to avoid foreclosure.

Alongside these efforts, Treasury, the Department of Housing and Urban Development, and the Department of Justice are coordinating the Administration's interagency foreclosure task force, which is comprised of eleven Federal agencies and also works closely with the State Attorneys General. In light of reports of misconduct in the servicing industry, the task force is currently reviewing foreclosure processing, loss mitigation, and disclosure requirements at the country's largest mortgage servicers. Those that have acted improperly will be held accountable.

Providing Targeted and Transparent Support for Access and Affordability

Low-and moderate-income families and communities account for a large proportion of all home purchase mortgages, and 100 million Americans are renters. The Administration stands strongly behind our obligation to support an adequate range of affordable housing options and access to fairly priced, sustainable mortgage credit for all communities and families—including those in rural and economically distressed areas, and those with low- or moderate-incomes.

Although home ownership is not the best option for everyone, affordable opportunities should be available to Americans with the financial capacity to own a home. Part of our efforts to reform the housing finance system will focus on helping ensure FHA is a sustainable, efficient resource for creditworthy first-time homebuyers and families of modest incomes. We are working expeditiously with the FHA to plan and carry out reforms so its programs are more efficient and responsive to changing market conditions. To improve and streamline other Government initiatives, the Departments of Housing and Urban Development, Agriculture, and Veterans Affairs—which all operate targeted housing finance programs—will establish a task force to explore ways to better coordinate or consolidate their efforts.

We will also consider measures to help ensure secondary market participants—securitizers and mortgage guarantors—provide capital to all communities in ways that reflect activity in the primary market consistent with safety and soundness. In addition, we will focus on making sure all mortgage market participants comply with antidiscrimination laws, and work with Congress to require greater transparency for data that tracks where and to whom mortgage credit is flowing.

Our approach should also encourage greater balance between home ownership and rental opportunities. That means improving support to the one-third of Americans who rent their homes, and especially to low- and moderate-income families. In the near term, the Administration will begin work to strengthen and expand FHA's capacity to support both lending to the multifamily market and adequate financing for affordable properties that private credit markets generally underserve. As part of our efforts, we will explore innovative ways to finance smaller multifamily properties, which contain a third of all multifamily rental units but the housing finance system has not adequately served.

Addressing long-standing problems in housing finance, like rental supply shortages for the lowest income families, will require a dedicated commitment, but it is one that can be made in a budget neutral way. We look forward to working with Congress and other stakeholders to discuss this and other avenues for improving access and affordability in a targeted, transparent way.

Options for the Long-Term Structure of Housing Finance

In the paper the Administration released last month, we laid out three potential ways to structure Government support in a housing finance market where the private sector is the predominant provider of mortgage credit.

In each option, Government support would be transparent, explicit, and limited. Each would make private markets the primary source of mortgage credit and the primary bearer of mortgage losses. Each would preserve FHA assistance and similar Government initiatives that assist targeted groups, such as low- and moderate-income families, farmers, and veterans.

The first option would limit the Government's role almost exclusively to these targeted assistance initiatives. The overwhelming majority of mortgages would be financed by lenders and investors and would not benefit from a Government guarantee.

In the second option, targeted assistance through FHA and other initiatives would be complemented by a Government backstop designed only to promote stability and access to mortgage credit in times of market stress. The Government backstop would have a minimal presence in the market under normal economic conditions, but would scale up to help fund mortgages if private capital became unavailable in times of crisis.

The third option broadens access for creditworthy Americans and helps ensure stability in times of market stress. Alongside the FHA and targeted assistance initiatives, the Government would provide reinsurance for certain securities that would be backed by high-quality mortgages. These securities would be guaranteed by closely regulated private companies under stringent capital standards and strict oversight, and reinsured by the Government. The Government would charge a premium to cover future claims and would not pay claims until private guarantors are wiped out.

The report we released last month discusses the advantages and disadvantages of each approach in additional detail, and also encourages Congress and the public to evaluate each option in light of four common criteria: access to mortgage credit, including the future role of the 30-year fixed-rate mortgage; incentives for private investment in the housing sector; taxpayer protection; and financial and economic stability.

Part of our intention in providing this narrow set of options and key criteria by which they should be judged is to encourage an honest conversation about the merits and drawbacks of each approach among the Administration, Congress, and stakeholders. We are faced with difficult choices that will involve real trade-offs. The challenge before us is to strike the right balance between providing access to mortgages for American families and communities, managing the risk to taxpayers, and maintaining a stable and healthy mortgage market.

In choosing among these options, care must be given to designing a system that maximizes the benefits we are seeking from Government involvement in the mortgage market, while minimizing the costs. We should also be sure to consider how to utilize the existing systems and assets in our housing finance system, including those at Fannie Mae and Freddie Mac, as best as possible for the benefit of the taxpayer and the American people.

Each of the longer-term reform options we have outlined will require legislation from Congress, and we hope to work together with you and your colleagues to pass comprehensive legislation within the next 2 years. Failing to act would exacerbate market uncertainty and risk leaving many of the flaws in the market that brought us to this point in the first place unaddressed. We look forward to continuing the dialogue with consumer and community organizations, market participants, and academic experts as we work together to build a housing finance market that is stronger and more stable than it was in the past.

I want to conclude with one important point. Housing is a critical part of our economy and we will proceed with our plan for reform with great care. Our objective, after all, is a healthier, more stable housing finance system. While we are confident that the steps we have laid out follow the right path, haste would be counterproductive—possibly destabilizing the housing finance market or even disrupting the broader recovery.

I'd be happy to take your questions now and, again, thank you for the opportunity to be here today.

PREPARED STATEMENT OF SHAUN DONOVAN

SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

MARCH 15, 2011

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Obama administration's efforts to reform and strengthen America's system of housing finance.

I appear before you today at a time when our housing market and underlying economy continue to recover from the worst crisis since the Great Depression, while still mindful that this recovery remains fragile. We have made remarkable progress these past 2 years, which I will describe in greater detail below. But we must also look to the future to ensure that such a crisis never happens again—and our recent proposal for reform, Reforming America's Housing Finance Market, sets the stage for a robust public discussion of how we can do that. At the end of the day, the housing finance system must work for all American families, whether they are high or low income, owners or renters.

Before discussing the report itself, I would like to say a few words about the steps that we have taken to stabilize a fragile housing market. I will then focus on three key elements in the report. First and foremost is the Administration's commitment to housing affordability and access to mortgage credit. Second is the critical role the Administration proposes for the FHA going forward, and third is how the Administration and Congress must work together to ensure housing finance advances opportunity in every community.

Administration Efforts To Stabilize the Housing Market

Mr. Chairman, immediately upon taking office, President Obama and this Administration quickly took several steps to confront the economic crisis, including steps to stabilize a housing market that was declining rapidly with seemingly no bottom. House prices were in freefall—having fallen every month for 30 straight months before the inauguration. Home equity had been slashed in half—losing $6 trillion total—which wiped out wealth for many families. And we were losing an average of 753,000 jobs every month and were in the middle of 22 consecutive months of job losses.

With the housing market continuing to collapse and private capital in full retreat, the Administration had no choice but to take action.

Federal Reserve and Treasury Department mortgage-backed securities purchase programs helped keep mortgage interest rates at record lows, enabling many American families with equity in their homes to refinance into sustainable mortgage products at significant monthly savings. Indeed, refinancing a mortgage amortized over 30 years from 6 percent down to 4 percent cuts monthly payments by 20 percent. These savings can then be applied to other household budget needs or put away for a rainy day, a college fund, to start a new business, or for retirement.

To ensure mortgages were available at those low rates, the Administration provided critical support for Fannie Mae and Freddie Mac, which had been put into conservatorship under the Administration of George W. Bush, and FHA and Ginnie Mae stepped in to play a larger role in the home purchase and refinancing markets. As reported in the Obama Administration's February Housing Scorecard, since April 2009, more than 9.5 million homeowners have been able to refinance their mortgages to benefit from lower interest rates, saving each household an average of $140 per month or, collectively, $18.1 billion annually.

It should be noted moreover that the vast majority of losses the GSEs have incurred are from loans made prior to conservatorship. Indeed, since Fannie Mae and Freddie Mac were placed into conservatorship by the previous Administration, the FHFA has strengthened underwriting standards and adjusted pricing to better reflect risk, and key indicators show that the quality of loans they are making has improved substantially—allowing the GSEs to play an important role supporting our housing market over the last 2 years.

And collectively, the FHA's loss mitigation policies and the Administration's Home Affordable Modification Program (HAMP) set an example for mortgage modification efforts that the private market took too long to adopt but has finally begun to incorporate into their servicing practices. More than 4.2 million distressed borrowers have received mortgage assistance since April 2009—including HAMP modifications, FHA loss mitigation activities, and voluntary private efforts as part of the HOPE NOW alliance—more than twice the number of foreclosures completed during that time. Monthly foreclosure starts are down more than 25,000 per month from this same time 1 year ago. While some of this decline may be attributed to servicer process reviews that are taking place in response to the recent discovery of widespread foreclosure processing issues, we are seeing encouraging signs that fewer families are entering delinquency.

In short, our efforts are helping struggling families, their communities, and the economy. Foreclosure starts are down, and, most importantly, we have seen 12 straight months of job growth in the private sector.

The Need for Reform

For all of the efforts to date, though, there is much more to do. We must continue to take steps to facilitate the return of private capital to the housing finance system in a responsible way. Last summer, Congress passed, and the President signed, sweeping financial reform legislation. Crucially, the Dodd-Frank Wall Street and Consumer Protection Act, provides vital protections for consumers and investors that will help end abusive practices in the mortgage market and improve the stability of the overall housing finance market.

In keeping with our obligations under Dodd-Frank, the Obama Administration recently delivered a report to Congress, Reforming America's Housing Finance Market, which provides a path forward for reforming our Nation's housing finance system. The report outlines steps that will be taken to wind down Fannie Mae and Freddie Mac and help bring private capital back to the market in a first loss position. Moreover, it describes how to fix fundamental flaws in the mortgage markets and better target the Government's support for a full range of housing that is affordable for its occupants, and lays out choices for longer-term reforms.

The President believes that an integral part of reforming the housing finance system must be ensuring that Americans have access to quality housing they can afford. This involves supporting a range of affordable options. For the millions of Americans who rent, this means designing a system that can consistently provide necessary financing to appropriately maintain those rental properties and support development of affordable housing opportunities in communities that provide access to decent jobs and good schools. For current and aspiring homeowners, we reaffirm our commitment to promoting sustainable home ownership predicated on safe mortgages. We continue to believe that every American who has the credit history, the financial capacity and the desire to own a home should have the opportunity to take that step—and that the private sector will continue to play a crucial role in providing fairly priced access to mortgages in all communities.

Although some have suggested Fannie and Freddie's affordability goals were solely responsible for their failure, they were not. Indeed, the vast majority of mistakes that were made—poor underwriting standards, underpriced risk, and insufficient capital with inadequate regulatory or investor oversight—mirrored those made in the private label securities market where affordability goals were simply not a factor. It was these flaws that drove the GSEs and the broader market to failure, not the affordability goals.

Nevertheless, we must recognize that the GSEs' affordable housing goals, while well intended, were not well designed. They didn't respond effectively to the needs of underserved communities and they were decidedly misaligned with mortgage origination by primary market actors. Worst of all, they failed to prevent the kind of high-cost, predatory loans which devastated countless communities and were one of the roots of the crisis.

In reforming the housing finance system, we have before us an opportunity to ensure that our efforts to provide access to mortgage credit and promote housing affordability are more effective than in the past. Those efforts must be better targeted, more transparent, and more focused on providing support that is financially sustainable for families and communities alike. We must remain cognizant that secondary market activities are a significant driver of liquidity in the primary market and variations in access to mortgage finance across communities is substantively impacted by them.

The Importance of a Robust and Responsible Private Mortgage Market

FHA and the GSEs have stepped into the void left when private capital for mortgage finance dried up early in the housing crisis. They have played, and continue to play, this critical countercyclical role. But as we return to normal market function, we are committed to shrinking Government's oversized footprint in the mortgage market. The Government-backed share of the current mortgage market is well in excess of 90 percent, which is far higher than we would like in normal times.

Similarly, FHA alone accounts for more than 20 percent of the market—almost twice its historical norms and about seven times bigger than its share leading up to the crisis, when typical FHA borrowers were frequently convinced to take on unsustainable and often predatory products flowing through effectively unregulated channels. FHA's countercyclical activities have been critical in providing mortgage financing during the crisis. By facilitating the availability of vital liquidity through a variety of approved community banks, credit unions, and national lenders, FHA has helped over 2 million families buy a home since President Obama took office—80 percent of whom were first-time buyers. FHA has also helped nearly 1.5 million existing homeowners refinance into stable, affordable products, with monthly savings exceeding $100 on average.

FHA, along with VA and USDA, are not alone in providing liquidity for mortgages during this crisis. Nearly all non-Ginnie Mae residential mortgage-backed securities issued since the crisis began have come from the GSEs. Without them playing this role, the availability of credit for families purchasing homes during these times of economic stress would have been dramatically restricted, leading to an even more strain on the housing market.

But this level of Government exposure isn't sustainable—and the time has come to begin to bring private capital back. The options we laid out in the report help us get there.

Towards a New System of Housing Finance

Bringing private capital back into the housing finance system does not mean eliminating all Government involvement in housing finance. We believe that a Government role, targeted correctly, and with the right protections for taxpayers, should remain an important component of any future system. That is why all three of the reform options we lay out in the white paper include a strong, resilient FHA and solid consumer and investor protections.

To that end, reforming and strengthening FHA is the first of four primary areas of reform to achieve broader mortgage access and housing affordability. The other crucial components of reform are a commitment to affordable rental housing, a flexible and transparent funding source for access and affordability initiatives, and strong measures to ensure that ensure that capital is available to creditworthy borrowers in all communities, including rural areas, economically distressed regions, and low-income communities.

A Reformed and Strengthened FHA

Within the existing authorities granted to us by Congress, we have already begun the necessary process of making changes to FHA to ensure that it will be able continue its mission. FHA has already made the most sweeping combination of reforms to credit policy, risk management, lender enforcement, and consumer protection in its history. These reforms have strengthened our financial condition and minimized risk to taxpayers, while allowing us to continue fulfilling our mission of providing responsible access to home ownership for first-time homebuyers and in underserved markets.

In the near term, we look to Congress to pass FHA reform legislation that enhances FHA's lender enforcement capabilities and risk management efforts critical to our ability to monitor lender performance and ensure compliance, among other things. Indeed, last year the House of Representatives passed an FHA reform bill, H.R. 5072, containing an array of changes along these lines, and, while similar legislation was introduced in the Senate, action on the bill was not completed. We look forward to working with both chambers of Congress to enact these proposals into law.

Longer term, we also hope to work with Congress to give FHA additional flexibility to respond to stress in the housing market and to manage its risk more effectively. This will mean giving FHA flexibility to adjust fees and programmatic parameters more nimbly than it can today. FHA should also have the technology and talent needed to run a world-class financial institution.

Strengthening and reforming FHA in a way that is healthy for its long term finances and ensures that FHA is able to continue its mission of providing access to mortgages for low- and moderate-income families is a central component of broader systemic reforms. While FHA has already changed policy to require that borrowers with lower FICO scores make larger down payments, FHA will consider other options, such as lowering the maximum loan-to-value ratio for qualifying mortgages more broadly. In considering how to apply such options, FHA will continue to balance the need to manage prudently the risk to FHA and the borrower with its efforts to ensure access to affordable loans for lower- and middle-income Americans, including providing access to home ownership for first-time homebuyers and underserved markets.

And similar to the Administration's broader reform of the U.S. housing finance system, FHA will take any steps for reform carefully to ensure that they do not undermine the broader recovery of the housing market. Similarly, as we consider changes in such areas as down payments and LTV ratios, we will make sure to retain the flexibility to respond to changing market conditions, so that we are able to manage risk, and maintain access, as effectively as possible.

Some have expressed concerns that the increases to the monthly premium set to go into effect next month—on the order of $30 per month for the average borrower—and any increase in down payment requirements have the potential to excessively restrict access to credit or perpetuate a dual credit market. We believe that the benefit to the financial health of FHA of the relatively modest premium increase is appropriately balanced with the need to maintain access, as the change remains affordable for almost all homebuyers who would qualify for a new loan. Similarly, we will only pursue increases in down payment where the impact on access is not prohibitive.

A Commitment to Affordable Rental Housing

With half of all renters spending more than a third of their income on housing—and a quarter spending more than half their income—this Administration believes that as part of a balanced housing policy there should be a range of affordable options for the millions of Americans who rent. Reducing Government's role in the single family market makes this commitment even more critical.

Private credit markets have generally underserved multifamily rental properties that offer affordable rents, preferring to invest in high-end developments. By contrast, Fannie Mae and Freddie Mac developed expertise in profitably providing financing to the middle of the rental market, where housing is generally affordable to moderate-income families. As we wind down Fannie Mae and Freddie Mac, it will be critical to find ways to maintain funding to this segment of the market.

One option would be to expand FHA's capacity to support lending to the multifamily market. Utilizing existing multifamily expertise so that FHA and other entities continue the industry's current best practices and retain valuable human capital would help achieve this objective.

We will also consider a range of reforms, such as risk-sharing with private lenders to reduce the risk to FHA and the taxpayer, and developing programs dedicated to hard to reach property segments, including the smaller properties that contain one-third of all rental apartments.

Dedicated Funds for Targeted Home Ownership and Rental Affordability

Support for affordable housing requires consistent, flexible, and transparent funding. Although FHA and other Federal affordable housing policies do a great deal to provide access and affordability, we recognize that a more balanced system will require additional resources to address clear gaps. That was the goal of the National Housing Trust Fund, which was authorized by Congress in 2008, but which has yet to receive funding. And with the largest increase in worst case housing needs in the quarter-century history of the survey—the necessity for strong support of affordable housing has never been more clear.

That is why the Administration will work with Congress on developing a new dedicated financing mechanism to support affordable home ownership and rental housing that current policies cannot adequately address. This funding stream would support the development and preservation of more affordable rental housing for the lowest-income families to address serious supply shortages. On the ownership side, it would support down payment assistance, counseling, or other mechanisms to help qualified low and moderate-income homebuyers, in a form that does not expose them or financial institutions to excessive risk or cost.

The funds could be used to scale up support for proven nonprofit partnerships for affordable housing production and preservation that can attract much larger amounts of private capital. This is the purpose of the Capital Magnet Fund, also enacted in 2008 and funded in FY2010 as a pilot demonstration administered by the Treasury Department's Community Development Financial Institutions Fund. And funding would help to overcome market failures that make it hard to develop a secondary market for targeted affordable housing mortgages, such as that for small rental properties.

These components target specific needs in flexible ways that can engage a range of partners and respond to local priorities and opportunities. We will work with Congress to ensure that funding will be transparent and targeted to clearly defined objectives and programs.

Ensuring That Capital Is Available to Creditworthy Borrowers in All Communities

Last, housing finance reform must include measures to ensure that capital is available to creditworthy borrowers in all communities, including rural areas, economically distressed regions, and low-income communities. Our plan calls for greater transparency that requires secondary market actors to disclose information on the credit, geographic, and demographic characteristics of the loans they package into securities. In addition to benefits for investors, greater transparency allows us know who is abiding by fair lending and equal credit obligations—and who's not.

A key lesson from this crisis is that decisions made in the secondary market very clearly drive lending practices in the primary market—and the potential for disparate impact in the availability and quality of mortgages in underserved communities is very real.

To that end the Administration is fully committed to exploring other measures to make sure that secondary market participants are providing capital to all communities in ways that reflect activity in the private market, consistent with their obligations of safety and soundness.

Long-term Options

Beyond the key foundations of a new, reformed housing finance system based on the principles discussed above, the extent of any Government guarantee in the system has yet to be determined—and our report presents three options. While I would refer the Committee to the report itself for a detailed discussion of the advantages and drawbacks of each, I would note that the issue most likely to impact American families is the question of the availability and pricing of long-term, fixed-rate financing under each of the options. For decades, the 30-year, fixed rate mortgage has allowed families to safely build wealth and climb the ladder to the middle-class. So as we consider the options for a future housing finance system, I believe we should consider carefully the implications of these choices on the availability and pricing of those mortgages.

In all of these options, however, a reformed and strengthened FHA remains an important participant in the market. This Administration believes there continues to be an important role for Government in ensuring access to mortgage credit and housing affordability—one that incorporates lessons learned from the past. We will continue to ensure that creditworthy low- and moderate-income borrowers have access to affordable mortgages.

Winning the Future Starts at Home

Ultimately, Mr. Chairman, this plan is about bringing private capital back into a healthier housing finance system and providing a balanced national housing policy that offers all Americans the choices in housing that make sense for them and for their families. Whether it is rental options near good schools and good jobs, access to credit for those in a position for sustainable home ownership, or assistance for those who feel the strain of high housing costs, the housing finance system must meet their needs, and we look forward to working with Congress to make it happen.

The more the American people can participate in this debate, expanding beyond necessary discussions of capital markets, G-fees, risk-based capital, and mortgage-backed securities to express equally necessary consideration of how essential the system is to the futures of their own families and communities—the better system we'll build, the stronger our country will be, and the more opportunity we'll be able to provide every American. Thank you.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) support housing finance reform to ensure appropriate Government oversight to meet the mortgage finance needs of the multifamily rental housing industry. We commend Congressional efforts to address the future of the housing finance system and respectfully submit this statement regarding the reform of the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac.

NMHC and NAA represent the Nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management, and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of State and local apartment associations. NAA is a federation of 170 State and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes.

The bursting of the housing bubble exposed serious flaws in our Nation's housing finance system. As policy makers craft solutions to fix the single-family housing problems, they should be mindful not to do so at the expense of the much smaller and less understood, but vital, multifamily sector.

Apartments are a critical component of the Nation's housing market, but history has made it clear repeatedly that the private market simply cannot meet a majority of the industry's capital needs. A federally backed secondary market is absolutely critical to the sector's health and our ability to continue to meet the Nation's growing demand for rental housing.

Fortunately, to date meeting that need has posed little to no risk to the taxpayer. In stark contrast to the single-family sector, the apartment industry did not overbuild during the housing boom. Even more importantly for the issue at hand, the GSEs' multifamily programs did not contribute to the housing meltdown.

Overall loan performance in the $2 trillion multifamily sector remains relatively healthy, and the strongest performance has been recorded by the debt provided by the GSEs. Their multifamily delinquency and default rates remain below 1 percent—a tenth of the size of the delinquency/default rates plaguing single-family.

Through careful underwriting, the GSEs' multifamily models have met the test. They have attracted enormous amounts of private capital; helped finance millions of units of market-rate workforce housing without Federal appropriations; sustained liquidity in all economic climates; and ensured safety and soundness in their multifamily business. As a result of the liquidity provided by the GSEs, the United States has the best and most stable rental housing sector in the world.

As you consider policy to alter the Government's role in mortgage financing for our housing system we ask that you consider the following factors affecting the financing needs for multifamily housing.

Private Capital Is Necessary, But Not Sufficient

We are encouraged by the thawing in the private capital markets and support a return to a marketplace dominated by private capital. But lawmakers need to understand that even in healthy economic times, history has made it clear that the private market simply cannot meet a majority of the rental housing industry's capital needs.

Banks are limited by capital requirements and have never been a source of long-term financing. Life insurance companies have typically been less than 10 percent of the market, lend primarily only to newer, luxury high-end properties and enter and leave the multifamily market based on their investment needs and economic conditions. The private-label CMBS market is unlikely to return to the volume and market share it reached a few years ago, and the FHA has exceeded its capacity to meet the sector's capital demands. While covered bonds might provide some additional liquidity to apartment borrowers, they are unlikely to provide the capacity, flexibility, and pricing superiority necessary to adequately replace traditional sources of multifamily mortgage credit, including the GSEs.

Growing Importance of Rental Housing, Experts Forecast Supply Shortage

The United States is on the cusp of a fundamental change in our housing dynamics. Changing demographics are causing a surge in rental demand that will continue long after the economic recovery. This includes 78 million echo boomers entering the housing market, baby boomers downsizing, and a dramatic decrease in the number of married couples with children to less than 22 percent of households.

Between 2008 and 2015, nearly two-thirds of new households formed will be renters. That's six million new renter households. University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 will have to be rental units. Yet, private capital for new apartment construction all but disappeared during the crisis, virtually halting new development activity for nearly 2 years.

New multifamily construction set an all-time post-1963 low in 2010 at 97,000 new starts. We need to be building an estimated 300,000 units a year to meet expected demand. Yet most forecasts suggest we'll start fewer than half that many in 2011. That's not even enough to replace the units lost every year to demolition, obsolescence and other losses.

Without Government credit support of multifamily mortgages or mortgage-backed securities to ensure a steady and sufficient source of capital going forward, the apartment industry will not be able to meet the Nation's housing needs and Americans will pay more for workforce housing. A federally backed secondary market is critical not only for the long-term health of the industry but also to help refinance the estimated $300–$400 billion in multifamily mortgages that will mature by 2015.

Workforce Housing Without Federal Subsidies

Policy makers should understand that nearly ALL of the multifamily funding provided by the existing GSEs helped create workforce housing (not just the capital they provided to properties designated "affordable"). Fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to families at or below the median income for their community. This includes an overwhelming number of market-rate apartments with no Federal appropriations, produced with virtually no risk to the taxpayer.

Key Principles for GSE Reform

The apartment industry urges you to consider the following key points for inclusion in any reform measure:

1. Do No Harm: Preserve Multifamily Lending Programs

The multifamily sector produces the vast majority of this Nation's affordable, workforce housing. Therefore there is an appropriate public mission for the Government to provide an effective financing system to ensure the Nation's housing needs are met. In addition, the multifamily sector, and more specifically the GSEs' multifamily programs, did not contribute to the housing meltdown. Therefore, as policy makers "fix" the problems in the single-family sector, they should not do so at the detriment of the multifamily industry.

2. Protect the Taxpayer: Look to Proven Multifamily Models

The taxpayer is footing the bill for the breakdown of the single-family housing sector and that should never happen again. The GSEs' multifamily programs can serve as a model for a reformed housing finance system. They have performed extraordinarily well and have less than a 1-percent delinquency rate. Historically, they have been well capitalized, have covered all their losses through the loss reserves they collected and have earned a profit. Even during conservatorship, the GSEs' multifamily programs have earned net revenues of $2 billion. [1] Their success is the result of strong business models that use retained risk and stringent underwriting criteria.

To protect the taxpayer going forward, these models should be carefully studied for a broader application within the larger housing finance system. Specifically, the Government must ensure strong regulatory oversight. It should consider implementing some level of retained risk by mortgage originators and servicers and adequate capital standards to fund loan-loss reserves. These steps would preserve the strong mortgage loan performance and track record seen in the multifamily sector and protect the taxpayer.

3. Federal Government Involvement Necessary and Should Be Appropriately Priced

Even after we transition to a new housing finance system, there will be an ongoing need for an explicit Federal Government guarantee on multifamily mortgage securities and portfolio-held loans. Over the past 40 years, there have been numerous occasions when the private sector has been unable or unwilling to finance multi-

[1] Source: GSE SEC filings. This does not include writedowns of Low-Income Housing Tax Credit holdings that the firms have been prohibited from selling and liquidating.

family loans. There is a legitimate concern that the private sector cannot be counted on, from both reliability and capacity stand-points, to consistently finance the majority of multifamily borrowers' needs. Hence it is hard to envision a reformed housing finance system without some form of Federal credit enhancement. However, that credit should be priced at an appropriate level that reflects the mortgage risk and the value of the Government's credit enhancement and in such a way that it complements, but does not unfairly compete with, private debt capital.

4. Liquidity Support Should Be Broad and Available at All Times, Not Just "Stop-Gap" or Emergency

Any Federal credit facility should be available to the entire apartment sector and not be restricted to specific housing types or specific renter populations. Narrowing any future credit source would remove a tremendously important source of capital to a large portion of our industry, namely market-rate developers who actually provide a large volume of unsubsidized workforce housing. Such a facility should also be available at all times to ensure constancy in the U.S. housing market throughout all business cycles. It would be impossible to turn on and off a government-backed facility without seriously jeopardizing capital flows.

5. Mission Should Focus on Liquidity, Not Mandates

The public mission of a federally supported secondary market should be clearly defined and focused primarily on using a Government guarantee to provide liquidity and not specific affordable housing mandates. Such mandates create conflicts within the secondary market and are partially responsible for the housing crisis because of the distortions the mandates introduced into the GSEs' business practices. Instead of mandates, the new housing finance system should provide incentives to support the production and preservation of affordable multifamily housing. Absent incentives, the Government should redirect the affordability mission to HUD/FHA and the Low-Income Housing Tax Credit program.

6. Retain Portfolio Lending While Expanding Securitization

Securitization must be used to attract private capital for multifamily mortgage capital. However, unlike single-family loans, multifamily loans are not easily "commoditized." Without the ability to hold some loans in portfolio, multifamily lending activities will be significantly curtailed. In addition, securitizing multifamily loans is not always the best way to manage credit risk. Portfolio capacity is also required to aggregate mortgages for a structured securities sale.

7. Create Certainty and Retain Existing Resources/Capacity During the Transition

To avoid market disruption, it is important that policy makers clearly define the role of the Government in a reformed system and the timeline for transition. Without that certainty, private capital providers (*e.g.,* warehouse lenders and institutional investors) are likely to limit their exposure to the market, which could cause a serious capital shortfall to rental housing. In addition, during the transition years, we believe it is critical to retain many of the resources and capacity of the existing GSEs. The two firms have extensive personnel and technology expertise as well as established third-party relationships with lenders, mortgage servicers, appraisers, engineers and other service providers that are critical to a well-functioning secondary market.

We appreciate the opportunity to present the views of the apartment industry and look forward to working with you to build a world-class housing finance system that meets the Nation's changing housing needs while also protecting the taxpayers.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 15, 2011

The Honorable Spencer Bachus
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Bachus:

I am writing in response to your March 9th letter about the ongoing discussions toward a comprehensive settlement with mortgage servicers. Your letter raises concerns about the efforts underway to address serious deficiencies in documentation, internal controls and processing identified in regulatory and enforcement agency reviews of mortgage servicers. The Department of Justice, in its capacity as chair of the Financial Fraud Enforcement Task Force, has been leading those discussions among federal agencies and communicating with State Attorneys General and certain financial institutions about this matter. Discussions are ongoing and there is not yet agreement on a settlement.

Your letter raises a question about the role of the new Consumer Financial Protection Bureau ("CFPB") in these discussions. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFPB does not currently have authority to administer penalties, and will, therefore, not be a party to any formal settlement with mortgage servicers. Under that same law, the CFPB will obtain significant authority to set standards for the mortgage servicing industry on July 21, 2011 – the date when consumer financial protection functions of other agencies transfer to the CFPB. For this reason, the CFPB has been invited to advise the other agencies on how to design appropriate servicing standards for the mortgage servicing industry.

Sincerely,

Timothy F. Geithner

Identical letters to:
The Honorable Scott Garrett
The Honorable Patrick McHenry
The Honorable Randy Neugebauer
The Honorable Pete Sessions

cc: The Honorable Tim Johnson
The Honorable Richard Shelby

NAFCU

National Association of Federal Credit Unions
3138 10th Street North • Arlington, Virginia • 22201-2149
703-522-4770 • 800-336-4644 • Fax 703-522-2734

Fred R. Becker, Jr.
President and CEO

March 14, 2011

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

Dear Chairman Johnson and Ranking Member ~~Shelby:~~ Chairman Johnson

I write today on behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association exclusively representing the interests of our nation's federal credit unions, with respect to tomorrow's hearing "The Administration's Report to Congress: Reforming America's Housing Finance Market." The future of housing finance reform is of great importance to our nation's credit unions, and NAFCU commends the commitment of Department of Treasury in developing its proposal and of the Senate Banking Committee in ensuring that all proposals are carefully reviewed moving forward.

As potential options for reform begin to take shape, NAFCU would like to stress the importance of retaining a system that provides credit unions with the liquidity necessary to serve the mortgage needs of their 92 million members. NAFCU would like to share with the Committee on Banking, Housing and Urban Affairs, a core set of principles that must be considered to ensure that credit unions are treated fairly during any housing finance reform process:

- A healthy and viable secondary mortgage market must be maintained. A secondary mortgage market, where mortgage loans are pooled and sold to investors, is essential in providing the liquidity necessary for credit unions to create new mortgages for their members.
- There should be at least two Government Sponsored Enterprises (GSEs). To effectuate competition in the secondary market and to ensure equitable access for

credit unions, NAFCU supports the creation or existence of multiple GSEs that would perform the essential functions currently performed by Fannie Mae and Freddie Mac. These entities should have the ability to purchase loans and convert them into mortgage backed securities (MBSs), each of these functions serves to facilitate mortgage lending.

- The U.S. government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in the MBSs and facilitate the flow of liquidity.

- Fannie Mae and Freddie Mac have been crucial partners for credit unions and have served an important function in the mortgage lending industry. Both have been valuable entities to the nation, particularly to the nation's economy. It is important that during any transition to a new system (whether or not current GSEs are to be part of it) credit unions have uninterrupted access to the GSEs, and in turn, the secondary market.

- We could support a model for the GSEs that is consistent with a cooperative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards. The GSEs should also meet other appropriate regulatory standards to limit their ability to take on risk while ensuring safety and soundness. Rigorous oversight for safety and soundness is also paramount.

- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.

- While a central role for the U.S. government in the secondary mortgage market is pivotal, the GSEs should be self-funded, without any dedicated government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans. Credit union loans provide the quality necessary to improve the salability of agency securities.

- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay substantially all their current government debts. <u>Legislation to reform the GSEs should ensure that taxpayer losses are not locked in, but should allow for time for the GSEs to make taxpayers whole</u>.

- NAFCU does not support full privatization of the GSEs at this time because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.

- The Federal Home Loan Banks (FHLBs) serve an important function in the U.S. mortgage market. Most importantly, they provide their credit union members with a reliable source of funding and liquidity. Throughout the financial crisis, despite experiencing financial stress, the FHLBs continue to be a strong partner for credit unions. Reform of the nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs. Importantly, access to FHLBs for small lenders should not be impeded in any way.

We have concerns about the Administration's report on the future of housing finance and the proposals contained therein. We applaud the Administration for their efforts in crafting this report, however, as the report recognizes, the cost of mortgage credit "would likely increase" under each of the options for unwinding the GSEs. We agree, and we would add that this outcome could lead to the further disintegration of the American dream of owning a home.

Furthermore, we believe that the approaches outlined in the report could open the door for a handful of large banking institutions to dominate the secondary market, creating a situation that could limit options for smaller community financial institutions, such as credit unions, or even drive some out of the mortgage business entirely. As such, we would urge the Senate to reject the Administration's options as proposed and seek a solution that addresses these concerns while following the principles outlined above.

We also have concerns about the report's treatment of the FHLBs. As stated in the report, the administration recognizes the vital role FHLBs have played in helping smaller financial institution access liquidity. Still, concerned that the FHLBs have developed significant weakness, the report proposes reforms of these entities. Notably, the administration proposes that "each financial institution to be an active member in only one single FHLB Bank."

NAFCU does not believe that limiting active membership to only one FHLB is either advisable or warranted. First, such limitation raises the potential of increased concentration risk. Secondly, it should be left for each credit union to determine, both based on cost and other business factors, whether obtaining different services from different FHLBs is best for their institution. We see no reason why, for example, a credit union should not be able to obtain liquidity services from one FHLB because it best suits its operations while seeking risk management services from another because it provides it the best option.

In summary, NAFCU strongly believes that any reforms must not disrupt the fragile housing finance system that is slowly beginning to recover. We do not believe that the options as proposed by the Administration would do that. As you know, any such disruption could trigger a "double-dip" recession and such an occurrence will have a devastating impact on our country's economy as well as the global finance system. In addition, we believe it is critical that the essential functions of Fannie Mae and Freddie Mac are retained until taxpayer capital that the federal government injected into the GSEs is recovered. The essential functions include, but are not limited to, purchasing and guaranteeing mortgages originated by credit unions.

We thank you for this opportunity to provide our input on this crucial issue and NAFCU would welcome the opportunity to provide additional views on housing finance reform as the legislative process moves forward. If my colleagues or I can be of assistance to you, or if you have any questions regarding this issue, please feel free to contact myself, or NAFCU's Vice President of Legislative Affairs, Brad Thaler, at (703) 842-2204.

Sincerely,

Fred R. Becker, Jr.
President/CEO

cc: Members of the Committee on Banking, Housing and Urban Affairs