



TESTIMONY OF

Michael F. Petrie, CMB

**President, P/R Mortgage & Investment Corporation
Carmel, Indiana**

**Chairman
Mortgage Bankers Association**

Before the

**United States Senate
Committee on Banking, Housing and Urban Affairs**

April 19, 2005

Thank you for inviting the Mortgage Bankers Association (MBA)¹ to present testimony on the important and timely topic of reform of the oversight of the government-sponsored enterprises (GSEs).

I am chairman of the MBA, chairman of Greensfork Township State Bank, and President of P/R Mortgage and Investment Corporation in Carmel, Indiana. In my official capacity at MBA I have worked with our members on our association's policy on GSE oversight reform. My own company is in the business of multifamily lending and we have been transacting business with both Fannie Mae and Freddie Mac during the last twenty-five years. My company is a member of the Federal Home Loan Bank of Indianapolis.

MBA's members originate and service the vast majority of the loans the GSEs securitize or hold in their portfolios.

I. THE SECONDARY MORTGAGE MARKET: FACTS AND FIGURES

There were approximately \$8.1 trillion in outstanding residential mortgage loans at the end of 2004. This very sizeable amount reflects an increase from \$5.1 trillion at the end of 2000, and \$2.6 trillion outstanding ten years earlier in 1990.

The secondary market is made up of the following players.

- **Fannie Mae and Freddie Mac**, which currently guarantee mortgage-backed securities (MBS) of approximately \$3 trillion. These GSEs also hold whole (unsecuritized) loans in their portfolios. Fannie Mae and Freddie Mac can only buy and securitize residential loans that meet charter act eligibility standards as to loan size and loan-to-value ratio.
- **Private-label MBS issuers**, which are non-GSEs securitizers, such as lenders and dealers. Private label issuers do not guarantee their MBS. The loans backing private label MBS are typically ineligible for GSE purchase. These

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 480,000 people in virtually every community in the country. Headquartered in Washington, D.C., MBA works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies, Wall Street conduits, and others in the mortgage lending field. For additional information, please visit MBA's website at www.mortgagebankers.org.

include loans too big for Fannie Mae and Freddie Mac to purchase (jumbo loans), as well as sub-prime, low documentation, and other non-conforming mortgages.

- **Government National Mortgage Association (Ginnie Mae)**, which securitizes FHA-insured and VA-guaranteed residential mortgage loans. Currently the outstanding balance of these securitizes is approximately \$453 billion.
- **Federal Home Loan Banks**, which hold government loans and conventional, conforming residential loans in the approximate amount of \$114 billion.
- **Whole loan portfolio investors** include thrifts, banks, pension funds, and insurance companies that hold unsecuritized loans, both residential and nonresidential, for their own portfolios. The whole loan market is approximately \$3.4 trillion today.

MBA supports the vital role that Fannie Mae and Freddie Mac play in maintaining and improving liquidity and stability in the secondary mortgage market. These entities generally, and their secondary market activities in particular, are a significant part of America's housing finance system. The structure of Fannie Mae and Freddie Mac combines the advantages of government sponsorship status with the functional organization of a shareholder-owned corporation. The structure, without effective, independent oversight over the GSEs' activities and the use of their special advantages, could lead to a conflict between the GSEs' public purpose goals and their private sector goals of maximizing returns to their shareholders.

For these reasons, MBA has long advocated having a strong and effective GSE regulator. MBA commends the Banking Committee for its efforts to improve GSE regulation. The bill S. 190, introduced by Senators Hagel, Dole, and Sununu, is an excellent measure, and we support it.

II. SAFETY AND SOUNDNESS IS IMPORTANT TO THE MORTGAGE MARKETS

The GSEs must be safe and sound to perform their secondary market function and to meet their affordable housing goals.

America has seen growth in the value of its housing stock, and this is a source of wealth for the 69% of American families who now own homes. As the homeownership rate and our population have grown, the need for responsive housing finance has increased accordingly.

As technology has advanced and as refinancing has become easier, the equity Americans have in their homes has become more liquid. Homeowners' ability to tap their equity has been a major engine for economic growth.

Our housing finance system, made up of both GSEs and private companies, requires access to liquid funds day in and day out from both American and international capital sources. The housing GSEs are major links between the capital market and the housing market.

Regulating the safety and soundness of two firms as big and as complex as Fannie Mae and Freddie Mac is extremely challenging. For this reason, MBA believes the safety and soundness regulator should have all the tools necessary for the task. The regulator needs general regulatory authority, which the Office of Federal Housing Enterprise Oversight (OFHEO) currently lacks. The regulator should have enforcement authority like that of the banking agencies. For example, the regulator should have authority to issue a cease and desist order to halt an unsafe and unsound practice. Banking agencies have this authority but OFHEO does not.

Further, we believe the GSE regulator's budget should be funded through assessments on the regulated entities outside the appropriations process, as the bank regulators are funded. An insufficient budget, pressured by the constraints of appropriations, has been a serious impediment to Fannie Mae's and Freddie Mac's regulators over the years.

III. CHARTER COMPLIANCE IS IMPORTANT TO THE MORTGAGE MARKETS

An important part of regulating Fannie Mae and Freddie Mac is monitoring their adherence to their secondary market role. The Department of Housing and Urban Development (HUD) is today primarily charged with that task, but, like OFHEO, it lacks some of the most basic tools for its task.

HUD lacks, for example, regulatory definitions of key charter act terms, leaving uncertainty about which GSE activities are within the bounds of their charter acts. HUD is also constrained in its review of new programs by a rigid statutory process. HUD has a fixed amount of time to review new programs – the same amount of time no matter how simple or how complex the program. HUD cannot reject a program application on safety and soundness grounds. Also, HUD's budget is woefully inadequate for the complicated job of regulating two large companies. We support the improvements that S. 190 would make to address these current constraints.

America has two different residential mortgage markets – the primary and secondary markets

America has two different residential mortgage markets. One is the "primary" market. In the primary market, retail consumers consult lenders and brokers to learn about the types of loans available, decide which type meets their needs, and apply for loans. The lender counsels the consumer, takes and processes the loan application and obtains supporting information, such as a property appraisal and credit history. If approved, the lender agrees to make a loan to the consumer, funds it, and closes the loan. This process, from the consumer's first interest in a loan through and including funding and closing the consumer's loan, is called loan origination. Loan origination and its related activities are the work of the primary market.

The other market is the “secondary” market, and it is quite different from the primary market. One very significant difference is that the secondary market does not involve mortgage consumers, only investors and mortgage lenders. Another very significant difference is that there is no loan origination in the secondary market. That is because the secondary market is where investors buy and sell loans that were already originated in the primary market.

Both markets are necessary. The reasons we need the primary market are plain – consumers need mortgage loans. The reasons we need the secondary market may not be as obvious, but are just as important. Lenders use cash to originate loans, and they need to sell closed loans to replenish their cash supply so they can continue to originate loans. A lender’s ability to sell loans increases the lender’s ability to originate loans. The secondary market functions very well because it is liquid; institutional investors can readily buy and sell loans.

Fannie Mae and Freddie Mac are very large players in the secondary market. They purchased or securitized approximately 73.4% of the prime conforming mortgage loans in the United States from 2001 through 2003.

Both Fannie Mae and Freddie Mac securitize loans. To securitize them, they bundle, or pool, loans together and use the loans as collateral to back mortgage-backed securities, or MBS. The GSEs sell the MBS to investors. As consumers across America make payments on their mortgages, those payments pass through to the MBS investors. In exchange for a fee that lenders pay, Fannie Mae and Freddie Mac guarantee to MBS investors that the investors will be paid, even if consumers default on their loans.

While individual mortgage loans are illiquid, MBS are a particularly liquid mortgage investment. From a cash flow standpoint, investing in MBS is roughly equivalent to investing in mortgage loans directly. But the MBS investor buys a share in a pool of loans, and does not buy interests in the loans directly. This allows MBS investors to diversify their risks across a pool of loans so that individual problem loans have less impact on the investor.

Fannie Mae and Freddie Mac have a Congressionally mandated role

Congress created Fannie Mae and Freddie Mac because America needs a liquid secondary mortgage market to assure continuous availability of mortgage financing throughout the country. Before Fannie Mae and Freddie Mac existed, for example, mortgages were more available in some regions than others, and there were regional cost imbalances, because there was no effective mechanism to move funds between geographic areas. Liquidity was lacking, and homeownership suffered.

Congress chartered Fannie Mae and Freddie Mac directly. This is unusual, as most companies, banks, thrifts, and other lenders are chartered or created by a federal or state authority, not by Congress itself.

Having a Congressional charter affects the market in a number of ways. For example, Fannie Mae and Freddie Mac are the only Congressionally chartered companies that securitize residential mortgage loans. They are therefore free of direct competition.

Another is that Fannie Mae and Freddie Mac are subject to Congressional oversight. They must perform the secondary mortgage market functions Congress created them to perform, and they may not deviate from their Congressional charters.

Fannie Mae and Freddie Mac must also meet affordable housing goals that Congress mandated in 1992. In establishing these affordable housing goals, Congress did not expand or alter the GSEs' secondary market role. Rather, Congress clarified the GSEs' obligation to purchase, in the secondary market, their fair share of mortgage loans made to finance homes for lower income families and in underserved areas.

In their charter acts, Congress expressly prohibits both Fannie Mae and Freddie Mac from originating mortgage loans. Loan origination, because it is in the primary market, is inconsistent with the GSEs' secondary market purpose. Similarly, their charter acts clearly restrict the GSEs to the secondary mortgage market. But the charter acts do not define where the primary market ends and the secondary market begins. This longstanding lack of clarity has led to the call for a "bright line" to establish what are permissible and impermissible GSE actions under the charter acts. MBA has advocated the need for this clarity for years. This is why MBA supports the "mission clarification" provisions in S. 190. S. 190 would, for example, require the regulator to define what the charter acts mean when they prohibit GSE loan origination. This mission clarification provisions would, for the first time, add certainty to the housing finance markets in the important area of Fannie Mae's and Freddie Mac's business activities and investments.

S. 190 would not, as some have suggested, eliminate the GSEs' mortgage loan underwriting technology. The markets today are very dependent on this GSE technology. Rather, S. 190 would permit the regulator to introduce competition into that technology market. The regulator would need to be reasonable in approach and sensitive to market orderliness. Because S. 190 would introduce competition, and because competition spurs innovation and lowers prices, MBA supports this approach.

Fannie Mae and Freddie Mac are the largest mortgage buyers in the secondary market because the GSEs do not have direct competitors, and because they have a lower funding cost than other secondary market investors, among other reasons. The GSEs have a lower funding cost than others because markets believe the United States government stands behind the GSEs' debt. The GSEs have used their prominence to encroach upon the primary market, to the detriment of competitors and competition. HUD, for example, recently required Fannie Mae to cease its real estate owned management and disposition activities because those activities are beyond the GSE's charter. Those activities interfered with primary market competitors who offer the same

services. In this way, the GSEs' incursion into the primary market detracts the GSEs' attention from their purpose, and is harmful to competition and, ultimately, to consumers.

MBA believes the GSEs should not use their special advantages to compete in the primary market or to expand into markets that are already well served. Having a clear boundary separating the primary and secondary markets would provide more than mere clarity. It would retain competition in the primary market. MBA strongly supports competition because competition, more effectively than anything else, spurs innovation and lowers prices to consumers.

For these reasons, MBA urges this Committee to define a clear boundary between the primary and secondary mortgage markets. There are a number of ways to accomplish this, but we believe that a clearer definition of loan origination and of the secondary mortgage market, as S. 190 would provide, would enable the regulator to police the boundary.

IV. AFFORDABLE HOUSING GOALS

Fannie Mae's and Freddie Mac's affordable housing goals are an important part of the GSEs' role in the secondary mortgage market. MBA wholly supports the GSEs' efforts to help finance affordable housing. MBA believes the goals should be high enough to cause the GSEs to stretch their reach into underserved markets, but that the goals should be reasonable, to avoid market distortions or other adverse unintended consequences. Congress should not give the regulator authority to set an unlimited number of goals and subgoals.

MBA believes that Congress should retain the existing housing goals, but should amend them to provide greater focus on low-income households.

Some have suggested that, in addition to retaining the affordable housing goals, Congress should require the GSEs to contribute to a fund, or to funds, to assist lower income families in obtaining affordable housing. While some have proposed that a housing fund contribution be calculated as a percentage of the GSEs' income, MBA believes that any contribution should be calculated as a percentage of outstanding GSE debt. This would make it more difficult for the GSEs to pass the cost of their contribution on to mortgage lenders and consumers. It would also tie a benefit of government sponsorship, the lower capital cost, to the GSEs' affordable housing contributions. The same amount of contribution can be required by either calculation method.

To assure that the funds actually go toward meeting the affordable housing needs they are intended for, the GSEs' regulator should have authority to determine by regulation how the funds may be used, and the regulator should monitor the administration of the funds. We also believe that an advisory board of industry practitioners should be

central to setting criteria for use of any funds, and for monitoring the funds' administration.

V. CAPITAL REGULATION

It is important that Fannie Mae and Freddie Mac maintain capital levels that support liquidity for the residential mortgage markets but that are also consistent with safety and soundness, stability for the overall market, and minimum exposure to the American taxpayer. MBA believes the regulator should have flexibility in setting the appropriate risk-based and minimum standards.

VI. ENFORCEMENT AUTHORITY

The GSE regulator should have the same enforcement tools the banking agencies have. Among these is cease and desist authority. Cease and desist authority is one of the most fundamental, effective, flexible, and important tools a financial regulator can have. Regulators can narrowly tailor cease and desist orders to resolve the precise problems, without otherwise limiting or interfering with the institution's operations. Flexibility in cease and desist orders makes them effective.

Some have proposed, as in S. 1508 as reported out last year by this Committee, that the regulator's capital authority should permit the regulator to require capital increases only in a narrow set of circumstances. Today, Freddie Mac's capital surcharge is required through OFHEO's cease and desist authority, not its capital authority. OFHEO's cease and desist authority is flexible and can address many problems, not just capital deficiencies. If the regulator's capital authority permits capital surcharges only in limited circumstances, it is possible that some might construe that capital authority as limiting the regulator's cease and desist authority. Congress should not inadvertently limit the regulator's cease and desist authority.

VII. RECEIVERSHIP

Congress has debated whether to include in a bill provisions that would permit a regulator to appoint a receiver if either Fannie Mae or Freddie Mac were to become financially distressed. MBA's view is that, in the unlikely event of distress at either company, it is important to maintain the operations of mortgage finance markets. We believe this should be the fundamental principle behind any receivership policy and law.

We believe that the regulator should not appoint a receiver or conservator lightly. Rather, the regulator should only be able to appoint a conservator or receiver when there is a serious capital deficiency, a serious threat to liquidity, or a real possibility of market disruption.

When a regulator does need to intervene, it should be able to operate the enterprise to restore it to health if that would best protect the housing markets. If necessary, the regulator should be able to maintain the operations of the mortgage securitization business, which is critical to the markets, while winding down the portfolio operation in an orderly manner. Because it may be necessary for the GSE in receivership to issue

debt to ensure an orderly wind down of the portfolio business, the receiver should have authority to cause the GSE to issue debt to ensure that orderliness.

Only Congress, not the regulator, should be able to rescind a GSE's charter.

To ensure certainty in the markets today, before there is a problem, Congress should specify a priority of claims in the event either Fannie Mae or Freddie Mac is in receivership. Congress should specify that holders of MBS that the GSE had issued have a prior claim to the mortgages backing the MBS, as well as to the flow of revenue the GSE continues to receive as guarantee fees. That guarantee fee revenue would be necessary for the securitization business to continue. The securitization business is critical to market function, and Congress should ensure its continuation even if Fannie Mae or Freddie Mac were in receivership. This would help maintain the operations of the mortgage finance markets, which should be the underlying policy for any Congressional action in this matter.

VIII. PORTFOLIO RESTRICTIONS

There have been suggestions that Congress should place strict limits on the size of Fannie Mae's and Freddie Mac's portfolios of mortgage loans and MBS due to systemic risks arising from the portfolios. MBA is keenly concerned about risks in financial markets, as are other participants in those markets. MBA certainly does not want undue systemic risks, and is supportive of Congressional efforts to protect against any such risks.

At the same time, MBA does not believe that a Congressionally mandated dollar cap or limit would be the most appropriate method of protecting against systemic risks. The mortgage and financial markets fluctuate and evolve. In 2004, for example, while the mortgage market overall grew 14%, the GSEs' portfolios grew only about 1%, at least in part due to changing market conditions, and in response to increasing regulatory capital requirements. A rigid dollar cap on the GSEs' portfolios could be disruptive because it would not adjust to changing circumstances. Any portfolio limits should be structured to account for those circumstances when financial markets need or do not need the portfolios' support.

The GSEs' portfolios can provide liquidity and stability in times of market turmoil. For example, in 1998 when many financial markets were in turmoil due to the Russian debt crisis combined with the collapse of Long Term Capital Management, the GSEs' ability to rapidly expand their portfolios helped maintain stability in the mortgage market. A portfolio limitation could interfere with this important function.

The portfolios do help the GSEs meet their affordable housing goals. Many lower income families need special loan structures to be able to purchase homes. Also, financing affordable apartments often requires innovative approaches. Both Fannie Mae and Freddie Mac purchase a significant number of the single-family and multifamily

loans that are not easily securitized and that make a critical contribution to the GSEs' ability to meet their affordable housing goals.

For example, some multifamily loans are difficult to securitize because they have unique characteristics. Similarly, single-family reverse mortgages for the elderly are difficult to pool and securitize. Because of the securitization difficulties, the GSEs routinely hold these loans in their portfolios. A portfolio limitation could interfere with this important source of financing affordable homes for lower income or other underserved Americans.

By financing their portfolios, the GSEs have attracted significant foreign capital to the American mortgage markets, allowing our housing market to grow. This function should be preserved.

While the portfolios in these ways can serve to support the GSEs' housing and affordable housing responsibilities, providing secondary market liquidity does not require that the portfolios need to grow unchecked.

We believe that Congress should create a strong, effective regulator for the GSEs. A strong regulator could make an expert assessment of the risks inherent in each of the GSE's portfolios. Based on its expertise, and using its discretion, the regulator should be authorized to design an appropriate method for regulating the riskiness of the portfolios that takes into consideration all the ever-moving facets of the financial markets. The regulator's ability to adjust capital requirements is an important part of this equation.

IX. IMPROVEMENT FOR THE FEDERAL HOME LOAN BANKS

The Federal Home Loan Banks (Banks) have a distinctive structure and an important housing role, which MBA strongly supports. Our members are keenly interested in the safety and soundness of the Banks. For many MBA members who are also members of the Banks, their single largest investment is the stock they own in their Federal Home Loan Bank.

MBA believes that Congress must preserve the cooperative nature and the mission of the Federal Home Loan Bank System in the course of reforming its regulatory structure. We support the concept of a single regulator for all three housing GSEs, but we also believe that a separate division within that regulator focusing on the Banks is sound policy.

The Distinctive Nature of the Federal Home Loan Bank System

The Banks have a strong housing function, but they accomplish it in a different way and they are structured differently from Fannie Mae and Freddie Mac in many important respects.

Ownership structure. The Banks have a different ownership structure from the other housing GSEs.

- Each Bank is cooperatively owned by member institutions. The member institutions must meet statutory eligibility criteria, and are required to hold stock in their Bank. In exchange, the members benefit from the Banks' advances, which are low cost loans from the Banks to their members. Members also benefit from optional participation in their Banks' mortgage purchase and affordable housing programs.
- Fannie Mae and Freddie Mac are shareholder-owned, publicly traded companies.

The Banks' return on equity has been flat in recent years at about 8%, while Fannie Mae and Freddie Mac have returned profits at double-digit rates above 20%.

Debt structure. All three GSEs borrow in the capital markets.

- The Banks raise debt collectively, and are jointly and severally liable for each others' debt. This is an important aspect of the Banks' cooperative design. It permits the Banks to borrow at about the same cost as Fannie Mae and Freddie Mac. Banks use their debt proceeds to make low-cost loans, or advances, to their members. Advances are collateralized largely by residential mortgage loans. Advances provide significant funding to Bank members.
- Fannie Mae and Freddie Mac borrow independently of each other, and are each liable for their own debt. Fannie Mae and Freddie Mac do not make advances to financial institutions.

Mortgage purchases

Fannie Mae, Freddie Mac, and the Banks all purchase mortgage loans in the secondary market, but the Banks have a unique and innovative approach. The Banks purchase loans through programs called Mortgage Purchase Program (MPP) and Mortgage Partnership Finance (MPF).

- The MPP and MPF programs give lenders the option of retaining servicing rights on loans they sell. Loan servicing is the process of collecting, posting, and transmitting monthly mortgage payments from borrowers. Servicers collect a fee, and servicing can be profitable. Loan servicing is a marketable asset. A lender that retains the servicing on its loans can stay in touch with the borrowers in its community. Fannie Mae and Freddie Mac often do not permit small lenders to retain servicing.
- Under the MPP and MPF programs, the Banks pay lenders a fee for sharing in credit risk. (Credit risk is the risk of loss due to borrower default.) Fannie Mae and Freddie Mac, on the other hand, charge lenders a guarantee fee and take

the credit risk, although Fannie Mae and Freddie Mac sometimes do require lenders to absorb credit losses.

Scope of Mission.

- Fannie Mae and Freddie Mac are solely dedicated to residential mortgages.
- While the Banks focus heavily on housing, they also support economic development, including commercial, industrial, manufacturing, social service, and other projects.

Banks' Support for the Residential Mortgage Market

The Banks' members range from very large institutions to small and medium sized institutions, some in underserved rural and urban communities. Without access to their Bank's low cost advances, many of the smaller institutions would not be viable. Advances provide Bank members liquidity to be able to continue to remain competitive. There are currently \$581 billion in advances outstanding.

In addition to supporting community institutions by providing low-cost advances, the Banks' advancing program supports housing. This support comes from the requirement that advances be collateralized, and almost all that collateral is residential, single-family mortgage loans. Thus, the advancing program creates significant demand for residential mortgage loans.

The Banks support housing in other ways as well. For example, they hold approximately \$107 billion in Fannie Mae and Freddie Mac MBS. The Banks also hold \$26.5 billion in debt of Fannie Mae, Freddie Mac, and state and local housing agencies. Finally, the Banks hold approximately \$114 billion in residential mortgages through their MPP and MPF programs.

The Banks' combined assets of \$896 billion, as of June 2004, include over \$828 billion in mortgages, mortgage securities products, and advances collateralized by residential mortgage loans. This is substantial support for housing in America.

How Securitization Helps the Mortgage Markets

Under the MPP and MPF programs, lenders have an option of selling mortgage loans to a Bank. This option benefits lenders because it provides some competition for Fannie Mae and Freddie Mac. Competition benefits both mortgage lenders and consumers.

The MPP and MPF programs are very small compared to Fannie Mae and Freddie Mac, however. The Banks' loan purchases are constrained because the Banks hold on their balance sheets the loans they purchase. Holding loans on-balance sheet presents two constraints – the Banks must hold capital against the loan assets, and holding mortgages involves assuming some degree of interest rate risk.

A better approach would be for the Banks to securitize the loans they acquire. By securitizing loans, the Banks would acquire loans from lenders, pool them into MBS, then guarantee and sell the MBS. In this way, the Banks would not incur interest rate risk because the loans would not be on their balance sheets. Because securitization would permit the Banks to transfer interest rate risk to ready, willing, and able investors, it would enhance the Banks' safety and soundness.

Because securitizing loans is safer than holding them, the banks would be able to securitize far more loans than they can buy and hold. Through securitization, then, the Banks could provide the benefits of increased secondary market competition for loans. This competition would put downward pressure on the cost of homeownership.

MBA recommends that Congress explicitly affirm that the Federal Home Loan Banks may securitize loans. The Banks would be subject to regulatory oversight in this activity, as they are in their other activities.

X. CONCLUSION

The Mortgage Bankers Association appreciates the opportunity to present its views on these important issues. S. 190 is an excellent beginning for achieving a more secure and more vibrant housing market. We look forward to working with the Committee as you move forward on GSE legislation.