Statement of Michael D. Berman, CMB

Chairman
Mortgage Bankers Association

Before the

Committee on Banking, Housing and Urban Affairs
United States Senate

Hearing on

"Public Proposals for the Housing Finance System"

March 29, 2011

Introduction

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA).[1] My name is Michael D. Berman, CMB, and I am the current Chairman of MBA. I have been in the real estate finance industry for over 25 years and am a founder and member of the Board of Managers of CW Financial Services. I also serve as President and Chief Executive Officer of CW Capital. Headquartered in Needham, Massachusetts, CW Capital is one of the top 10 lenders to the multifamily real estate industry, with $3 billion in annual production and over 150 employees in 12 offices throughout the country. My responsibilities include overseeing the strategic planning and operations for all of the company's loan programs, including multifamily programs with Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA). CW Capital has been active in the commercial mortgage-backed securities (CMBS) arena as an investor, lender, primary servicer and issuer of securities. Additionally, CW Capital is a special servicer of approximately 20 percent of the CMBS market.

Today's hearing is on the very important issue of housing finance reform. Exactly one year and six days ago I testified on this very topic before your colleagues on the House Financial Services Committee. Much has changed during those past twelve months.

On the legislative front, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). While it is too early to assess the full impact of this legislation, the financial services industry already has been directing considerable resources toward preparing for the avalanche of new implementing regulations on the horizon. Congress and the administration have voiced a desire for private capital to return to the mortgage market. However, we must be clear that several pending regulatory actions have the potential to increase the cost and decrease the availability of credit to many potential borrowers, as these regulatory actions may drive private capital away from the market, directly contrary to the stated intent.

On the economic front, data in recent months have been stronger than anticipated, with personal consumption expenditures and business spending propelling the current pace of economic recovery. The job market continues to improve, at a disappointing pace, and housing markets remain weak, but we are beginning to turn the corner with respect to mortgage performance.

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

We also note that the Obama Administration recently issued a report to Congress on reforming America's housing finance market. The report, issued by the Departments of Treasury (Treasury) and Housing and Urban Development (HUD), renewed its commitment to affordable rental housing and laid out three potential ways to structure government support in a housing finance market. There are positive aspects of each of the administration's three options, and, in fact, we believe that our proposal is aligned in part with the administration's thinking. I will briefly touch on other key points about the report later in my testimony.

While much has changed in the past year, much remains the same. For example private capital still has not sufficiently returned to the mortgage market, leaving the federal government to backstop some 90 percent of all home mortgage loans. Nearly half of the new home loans for home purchase are guaranteed by the FHA, the Department of Veterans Affairs (VA), or the Department of Agriculture's Rural Housing Services (USDA) programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are in government conservatorship. Fannie Mae and Freddie Mac also now purchase more than half of all multifamily mortgages, loans to owners, and developers of rental residential properties. Because of the current difficulty of attracting investors, only a handful of boutique private label securitization transactions have taken place during the past three years, with ultra-low risk loan characteristics such as very low loan-to-value ratios. The investment community anticipates only three or four more transactions in the year ahead. This situation is as undesirable as it is unsustainable.

MBA continues to identify the key components and optimal structure of a safe, stable and liquid housing finance system for the long-term. I have the privilege of chairing the "Council on Ensuring Mortgage Liquidity" that has been charged by MBA to undertake this initiative. The council's approach has been to examine the issues so that stakeholders can assess options in a measured, thoughtful manner. My fellow council members also are industry practitioners who understand the capital markets and have perspective on what will and will not work. Therefore, the council's recommendations are grounded in pragmatism.

We knew in setting up the council that the policy winds would shift with economic circumstances. Therefore, we continue to refine our recommendations in the context of current events.

Before I go into the specifics of MBA's recommendations, I would like to explain the basic tenets of housing policy that guided the council's work. We believe that housing policy begins with the premise that shelter, like food, is a basic human need. As such, a good and just society ensures that all of its citizens are able to attain at least a minimum standard in terms of their housing, and many families are able to do much more, achieving the American Dream of owning a home. U.S. housing policy, developed over decades, has consistently highlighted these objectives. These include:

- Bringing stability and affordability to the single- and multifamily mortgage finance markets (through Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Bank System);
- Promoting homeownership (through FHA, VA, USDA, the mortgage interest deduction and downpayment assistance programs);
- Providing consumer protections to homebuyers and renters (through fair housing, truth in lending and other regulatory efforts) ;
- Providing subsidies to fill gaps between low-income households' incomes and market rents (through project- and tenant-based Section 8 and other programs); and
- Supporting and promoting the development and preservation of affordable single- and multifamily housing (through HUD and other subsidy and grant programs).

All of these efforts are vitally important, and all are necessary to maintain a housing market that provides safe, decent and affordable housing to the American public. In the wake of the recent crisis, policymakers may choose to re-order or change the emphasis of these priorities to some extent. However everyone would agree they are all important. MBA's recommendations are designed to further this policy in a safe, sound and efficient manner.

The MBA Proposal

MBA's recommendations were first issued in September 2009, in a document titled "Recommendations for the Future Government Role in the Core Secondary Mortgage Market." (See www.mortgagebankers.org/advocacy/issuepapers/ceml.htm.) These recommendations established a foundation for the current debate and have been integrated in many of the proposals that have since come forward, including the administration's.

Key Principles and Components

Three principles lie at the heart of MBA's recommendations. First, secondary mortgage market transactions should be funded with private capital. Second, the importance of housing, whether owner-occupied or rental, in the U.S. economic and social fabric warrants a federal government role in promoting liquidity and stability in the mortgage market. This role should be in the form of an explicit credit guarantee on a class of MBS, and the guarantee should be paid for through risk-based fees. Third, taxpayers and the system itself should be protected through limits on the mortgage products covered, limitations on the types of activities undertaken, strong risk-based capital requirements, and actuarially fair payments into a federal insurance fund.

The financial crisis proved that some form of government support is required to keep the mortgage market open during times of distress. The current dearth of activity outside of the existing government-supported liquidity channels exemplifies the risk averse nature of private capital. More importantly, even in good times, investors will remember the experiences of the recent crisis. If they doubt their ability to sell mortgages during a crisis, they will be less apt to buy them outside of a crisis.

However, the size and scope of the U.S. housing market mean that, except in times of extreme duress, the federal government's secondary market role should be to promote liquidity for investor purchases of MBS, not to attempt to provide the capital for or absorb the risks itself.

A guarantee that aims to protect the entire market will be both less effective and less efficient than targeted support for the core of the market, those products that regulators determine should be available to borrowers at all times.

The centerpiece of MBA's recommendation for federal support for the secondary mortgage market is a new line of MBS. Each security will have two components: a) private, loan-level guarantees from privately owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs) which will in turn be backed by b) a security-level, federal government-guarantee (GG) "wrap." The government guarantee will be conceptually similar to that provided by Ginnie Mae by guaranteeing timely interest and principal payments to bondholders and explicitly carrying the full faith and credit of the U.S. government.

Investors in the guaranteed MBS would face no credit risk, but would take on the interest-rate risk from the underlying mortgages. In supporting their loan-level guarantees, the MCGEs would rely on their own capital base as well as risk-retention from originators, issuers and other secondary market entities such as mortgage insurers. Only in the event of a failure of a MCGE would the government guarantee come into play. Before taxpayers were called upon to support the guarantee, a federal insurance fund, capitalized by risk-based fees charged on the supported securities would be next in line. Only in the event that the insurance fund ran dry would there be a call on taxpayer resources. The fund would be capitalized so that this would be an extremely unlikely event, and could likely include provisions to have future MCGEs repay the taxpayers over time as well.

Mortgage Credit Guarantor Entities (MCGEs)
The MCGEs will be privately owned, mono-line institutions focused solely on the mortgage credit guarantee and securitization business. This business encompasses both single-family and multifamily residential mortgages. The loan-level MCGE guarantee would be backed by private capital held by the MCGEs which would be overseen by a strong regulator.

The MCGEs will be required to manage their credit risk by using risk-based pricing, originator retention of risk (such as reps and warrants backed by sufficient capital to support them), private mortgage insurance (PMI) and risk transfer mechanisms including other risk-sharing arrangements, to ensure that there is a strong capital buffer before the GG and insurance fund would come into play. Loans would not be included in a GG security unless they were guaranteed by a MCGE.

In most cases the MCGEs will own the loans underlying the GG securities they issue, and in the event of foreclosure could own the real estate collateral. The MCGEs will have standard corporate powers to raise debt and equity. Other than access to the related GG security they could issue, none of the corporate debt or equity the MCGEs issue would be guaranteed, either explicitly or implicitly, by the federal government. The MCGEs must be sufficiently capitalized to weather all but the most extreme credit events, and should report regularly to the satisfaction of the GG, Treasury and the MCGEs' regulator.

Because the key mission of the MCGEs will be to guarantee and securitize mortgages through the program described, their portfolio holdings of mortgage assets would be limited to *de minimis* levels. Their portfolios would only be used to a) aggregate allowable mortgages for securitization, b) hold REO properties prior to disposition, and manage loss mitigation through foreclosure, modifications and other activities, c) incubate mortgages that may need seasoning prior to securitization, d) develop new mortgage products through a strictly limited level of research and development prior to the development of a full-fledged securitization market, and e) fund highly structured multifamily mortgages that are not conducive to securitization.

The number of MCGEs should be based on the goals of a) competition, b) strong and effective regulatory oversight, c) efficiency and scale, d) standardization, e) security volume and liquidity, f) ensuring no one MCGE becomes "too big to fail," and g) the transition from the current government sponsored entity (GSE) framework. Initially, we would expect the number of MCGEs to be two or three. The regulator would have the ability to increase that number, through the granting of charters, as the market develops. Intense competition along a number of dimensions would benefit borrowers and the market as a whole. The market would also benefit from standardization of the mortgage-backed security (MBS) structure so that investors can easily compare security offerings across MCGEs.

The existing system extended an implied federal backing to all the activities of Fannie Mae and Freddie Mac, including not only their mortgage guarantees, but also their portfolio investments, derivative counterparties and corporate bondholders. Some of those activities were clearly allocated insufficient capital, underpriced and under-supervised. In our proposal, the extent of federal backing would be greatly constrained, making explicit what is guaranteed and what is not, and establishing mechanisms to properly capitalize, price and supervise those activities.

It is important to reiterate that while the MBS in this model would be guaranteed by the government, the MCGEs as institutions would not be. The corporate debt and equity issued by the MCGEs would be purely private. As with other firms, investors in MCGE equity and debt would accept the potential risk of failure and loss. For this reason, the MBA proposal recommends regulators charter enough MCGEs to establish a truly competitive secondary market, and to overcome issues associated with "too big to fail."

Government Guaranteed "Wrap"
The government guaranteed MBS issued by the MCGEs would carry a guarantee of timely interest and principal payments, would explicitly carry the full faith and credit of the U.S. government and would be supported by a federal insurance fund, funded by risk-based fees charged for the securities at issuance and on an ongoing basis. Due to similarities in responsibilities and likely structure, Ginnie Mae could potentially take on the responsibilities of the GG.

The GG would be responsible for standardization of mortgage products, indentures and mortgage documentation for the core mortgage market. Minimum regulated fees would be established for ongoing servicing, surveillance and reporting. This would ensure standardization and liquidity throughout the core market. Each MCGE would individually issue GG securities under this standardized regime. These securities would carry the GG security-level guarantee backed by the MCGE loan-level guarantee; accordingly, the MCGEs will have approved and insured the underlying collateral.

The mission of any federally related mortgage securitization and guarantee program should be explicitly limited to ensuring liquidity in the core mortgage market through the issuance and guarantee of MBS. This important mission should not be distorted by additional public or social housing policy goals. To the degree additional objectives and housing policies are desired, they should be pursued through FHA, VA, USDA, Ginnie Mae and direct federal tax and spending programs, which should be adequately funded and supported to meet these important objectives. Potentially, a surcharge could be placed on the insurance premiums to accumulate an affordable housing fund. This surcharge should be tracked separately to ensure that the insurance fund is actuarially sound.

While the full faith and credit of the U.S. government should mean there will not be a need for a liquidity backstop, in times of extreme market distress liquidity could be provided to the GG securities market through Treasury and/or Federal Reserve purchases of GG mortgage securities. As a result, there would be no need for the MCGEs' portfolios to take on the role of "liquidity providers of last resort."

Reform Recommendations of the Administration
As was mentioned above, the housing finance reforms issued by Treasury and HUD included three possible restructuring options. The administration's first option would limit the government's role almost exclusively to the existing targeted assistance initiatives of FHA, VA, and USDA. 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.

Compared to the first and second options, the third option creates a broader role for the government in ensuring 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 the MCGEs a premium to cover future claims and would not pay claims until private guarantors are wiped out.

MBA believes there are positive aspects of each of the administration's options. For example, as in option one we place a high value on having private capital bear most of the risk. As in option two we think the MCGE channel will naturally decline during good times, and expand during crises. In terms of form and function, option three closely resembles MBA's recommendations.

Other Liquidity Channels

No formula for restructuring the housing finance system is complete unless other private and public liquidity channels are factored into the equation. In MBA's recommendation, there would continue to be key roles for the fully private market, as well as for FHA, VA, USDA and Ginnie Mae and the Federal Home Loan Banks, particularly as such roles evolve in support of public or social housing policy goals and objectives. MBA's MCGE framework is not intended to be the entire market. It is meant to focus on a narrowly defined set of core mortgage products that should be available in all market conditions.

We also believe it is appropriate to consider additional means of 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.

Loan Characteristics

One issue that arises frequently during the housing finance reform debate is the question of the availability and pricing of long-term, fixed-rate financing. For decades, the 30-year, fixed-rate mortgage has allowed families to budget their finances and safely build wealth. In evaluating the options for a future housing finance system, we should consider carefully the implications of such options on the availability and pricing of those mortgages.

Homeowners in the U.S. have come to view the 30-year, fixed-rate, self-amortizing, prepayable mortgage as the product standard. Payments are predictable and borrowers are protected from fluctuations in interest rates. From the borrower's perspective, it is the simplest mortgage product available. If rates rise, payments are unchanged. If rates decline, borrowers typically have the option to refinance at no explicit cost.

Although thought of as consumer friendly, from the standpoint of an investor, the 30-year, fixed-rate, self-amortizing, prepayable mortgage is actually a very complex product. Borrowers refinance when rates drop, transforming a loan with a nominal 30-year maturity to a short-term instrument. When rates increase, refinances disappear, extending the expected life of the loan. Banks and thrifts that fund themselves with deposits are not natural holders of 30-year, fixed-rate, prepayable loans, because they would inevitably be borrowing short and lending long. With the beginning of the U.S. MBS market in the early 1970s, it was discovered that investors were willing to bear the prepayment risk associated with these loans, so long as they were protected from the credit risk. From that point to today, with a few exceptions, most investors either did not have the capacity or the willingness to take on the credit risk, particularly given the uncertainty involved with systemic credit events such as the one we just lived through.

The appeal of the 30 year fixed-rate mortgage in the U.S. is also a result of the role the GSEs play in the “To-Be-Announced” (TBA) market. As the name suggests, the defining feature of a TBA trade is that the the underlying mortgage loans have not been identified and may not even have been originated on the trade date. Instead, participants agree only on a defined set of parameters of the securities to be delivered. This contrasts sharply with private-label MBS, whose loans must be originated before trading. The TBA market also significantly lowers the transaction costs associated with originating, servicing, and refinancing a mortgage. In addition, the TBA market provides an efficient way for lenders to hedge the interest rate risk involved in offering borrowers the ability to lock-in a rate for 30 days while closing on a mortgage. TBA prices, which are publicly observable, also serve as the basis for pricing and hedging a variety of mortgages that are not TBA-eligible, such as high-balance (i.e. “jumbo”) loans not eligible to be purchased by the GSEs. TBA trading is thus a key link between the primary and secondary mortgage market and constitutes a major difference from non-agency or private-label MBS.

It is also notable that long-term fixed-rate mortgages are unusual elsewhere in the world. A key reason for the distinctions in products between countries is differences in funding. Deposit funding dominates in most countries, while the U.S. is unique in terms of the importance of securitization. Over 60 percent of U.S. residential mortgages have been securitized. The next closest countries are Canada, Spain and the United Kingdom with 24 to 28 percent securitized. Therefore, in order to maintain the availability and affordability of the 30-year, fixed-rate mortgage, the U.S. needs a vibrant secondary market where investors can focus on and manage interest rate and prepayment risks, while being shielded from the uncertainties surrounding mortgage credit risk.

MBA’s recommendations take care to ensure that capital is available to creditworthy borrowers in all communities. We believe formal establishment of the core residential mortgage market will set a benchmark for consumers, underwriters, investors and others. For consumers, the presence of well-defined core mortgage products will provide a standard against which other products can be assessed. The core market will also provide considerable stability, ensuring that mortgage products of a known type will be available in all market conditions. For underwriters, the characteristics of the "well-documented, well-understood" mortgages of the core market will provide a known base for modeling and pricing risk. Variations would be considered a part of the non-core market and would operate outside of any taxpayer backstop. For investors, the core market will establish performance and pricing standards for use in GG MBS investing, and against which other investment options can be judged.

It also must be remembered that the mortgage market and the GSEs support the financing of both single-family and multifamily properties, and that both serve important roles in housing our nation. MBA's recommendations are geared to both parts of the market. The same structure, rationales and tenets apply to the federal role in the core single-family and multifamily secondary mortgage markets. Even though the multifamily market had much lower default rates and stronger performance than the single-family ownership market during the recent downturn, it is also subject to liquidity crises.

Transition

Both MBA and the administration's recommendations recognize the importance of careful execution during the transition from the current to the future state of the housing finance system. The administration's report included actions that can be taken now to reduce the government's role and taxpayer exposure in the market. For example, they advocate for gradually increasing guarantee pricing at Fannie Mae and Freddie Mac, reducing conforming loan limits, and increasing down payment requirements. The administration also plans to continue winding down Fannie Mae and Freddie Mac's investment portfolios.

While these actions may prove to be effective levers for adjusting the mixture of private capital and government support, it is very important that any action take place in a careful and deliberate manner. Ignoring the consequences of interim actions and the pace of economic recovery could shock a still-fragile housing market, severely constrain mortgage credit for American families, and expose taxpayers to unnecessary losses on loans the institutions already guarantee. 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.

While a gradual transition to the new housing finance may be desirable, there are strong reasons to lay out a clearly defined future for mortgage finance as soon as possible. The uncertainty over the future policy environment is likely deterring the recovery by inhibiting the ability of businesses and investors to plan and move forward.

The longer the uncertainty persists, the more difficult it becomes to retain and/or recruit personnel with the necessary skill sets to execute financing. Both the multifamily and single-family markets are vulnerable in this regard.

Regulators also should proceed with caution as they continue to implement the Dodd-Frank Act. One of our concerns is that the magnitude and scope of reforms poses challenges from a coordination standpoint. The scope of the Dodd-Frank Act's new consumer protections, underwriting provisions, risk retention requirements, disclosure, liability and operational requirements is profound. Adding secondary mortgage market reforms to this equation will require the highest degree of care and coordination.

One aspect of Dodd-Frank in particular that merits attention is the risk retention provision, including its exemption for qualified residential mortgages (QRM) and framework for commercial real estate MBS. The QRM is likely to shape housing finance for the foreseeable future and may even serve as a precursor for what the future GSE is likely to be eligible to securitize. An overly restrictive QRM definitiion that does not heed the Congressional intent will displace a large portion of potential homebuyers, which in turn will slow economic growth and hamper job creation.

MBA believes Congress can play a role in the transition by encouraging regulators to formulate a strategic theme to guide their actions going forward. For example, before attempting to attract private capital back to the housing finance market by increasing Fannie Mae and Freddie Mac's guarantee fee, regulators should consider the extent to which risk retention rules may drive private capital away from the market.

A narrowly defined government role of guaranteeing credit risk at an actuarially fair price promotes liquidity and limits volatility in the secondary mortgage market, which makes it easier for homebuyers to obtain mortgages during normal economic times and mitigates the risk and consequences of volatility in the housing market and financial markets. This assumes that the government can accurately assess what is an actuarially fair price. Mispricing the wrap premium by either over- or under-charging for the wrap has costs.

Pricing risk is difficult for both the private sector and the government. However, it is less difficult now than it was 5 years ago. At that time rating agencies and investors looked to "stress events" for which there were incomplete data and different market practices. Having just experienced the worst real estate downturn since the Depression, we now have vast amounts of data that can provide the basis for more robust and accurate risk pricing models.

Experience has also shown that governments intervene to protect depositors and prevent housing market collapses. Knowing this, MBA believes taxpayers are better served by clearly defining the boundaries of such intervention and collecting revenues upfront rather than paying a lump sum ex post facto.

Conclusion

It is time to commit to a future housing finance system for the United States. The administration, Congress and the private sector share a responsibility to work together to build a stronger and more balanced system of housing finance. MBA looks forward to working closely with the Committee on this issue in the weeks and months ahead. Thank you again for the opportunity to appear before the Committee today. As MBA's deliberations on these topics continue, we would welcome the opportunity to come back and update you on our work.