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

Hearing on

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

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

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

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

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

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

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

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

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

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

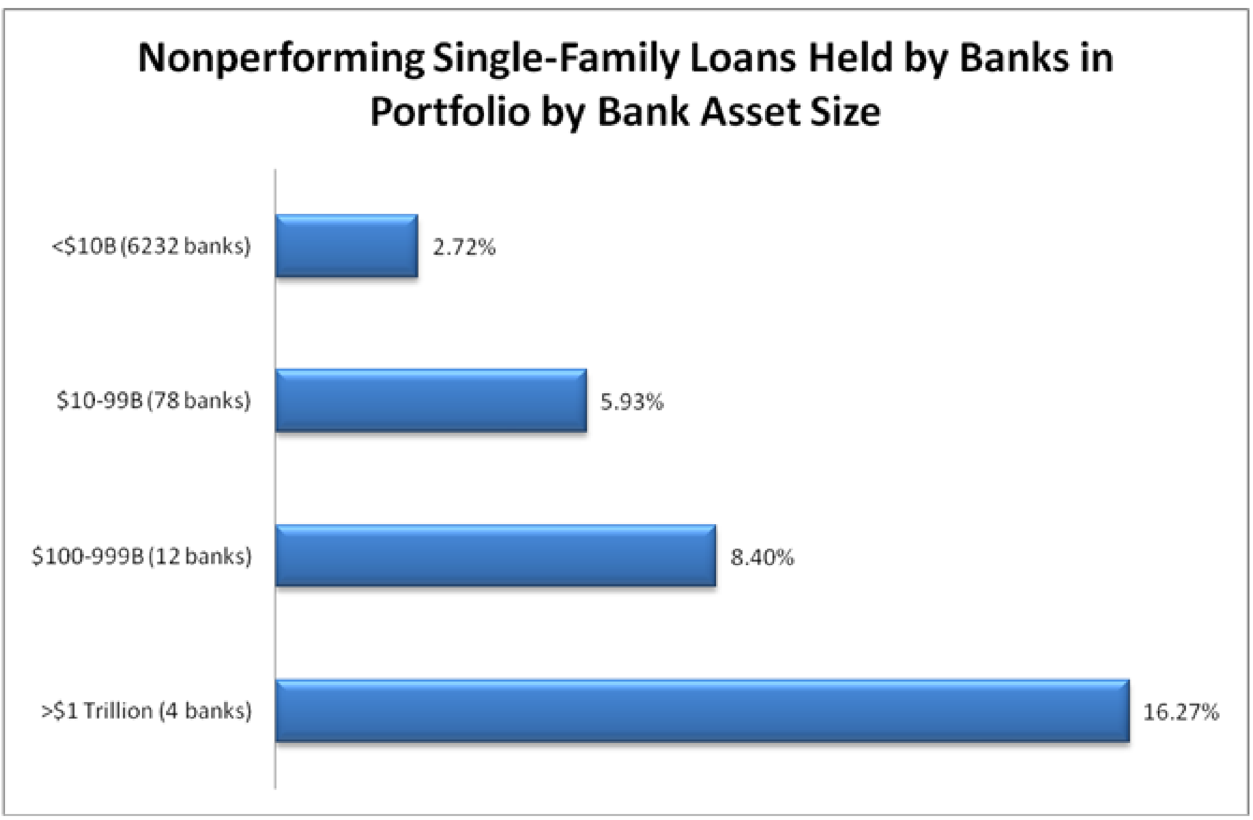
Countrywide and other large customers also benefited from looser underwriting standards, many undertaken in order to meet affordable housing goals. In 1995 Fannie was frank about the risks and why it was willing to take them:

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

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

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

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



[1] Source: bankregdata.com.

Virtually all community banks have less than $10 billion in assets. The 6232 banks with assets of less than $10 billion had a 2.72% nonperforming loan rate. Compare that to a rate of 16.27% for the 4 banks with assets over $1 trillion. I believe that if a similar analysis were done on the basis of loans sold to the GSEs the relative results would be substantially the same.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Appendix 1: Definition of a Prime Loan

A prospective prime borrower needs to be qualified based on a demonstrated ability to repay the loan, a demonstrated willingness to meet his or her obligations, and sufficient equity to reduce the likelihood of default to a reasonable level.

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

- Conventional loans on properties occupied as a primary or secondary residence.
- Home purchase loans with an LTV of 90 percent or less commencing on January 1, 2016. During the five-year GSE wind down and private-market transition period we recommend, an LTV limit of 95 percent would be permitted until December 31, 2012, and an LTV limit of 92.5 percent would be permitted until December 31, 2015.
- Rate and term refinances with an LTV of 80 percent or less with a maximum loan term of twenty-five years.
- Cash-out refinances with an LTV of 75 percent or less with a maximum loan term of twenty years.
- As noted, research shows that loans with an LTV of 60 percent or less sustain virtually no losses. Therefore, any loan with an LTV greater than 60 percent could be insured by mortgage guaranty insurance down to 60 percent; however, a fully amortizing loan with a term of fifteen years or less and an LTV greater than 80 percent could be insured by mortgage guaranty insurance down to 70 percent.
- Loans to borrowers with a demonstrated willingness to meet their obligations as represented by a FICO credit score of 660.
- No second mortgage at loan origination and prohibited by the mortgage documents for a period of six months after origination. The mortgage documents also grant the mortgage holder and mortgage insurer (if any) the right of prior approval with respect to any second mortgage taken out after six months.
- The mortgage note and mortgage shall:
    - Require the borrower to declare his or her intent regarding owner occupancy;
    - Require the borrower to acknowledge that if the intent to occupy changes within twelve months of the date of the loan, the borrower has an affirmative obligation to notify the lender;
    - Advise the borrower that upon receipt of such notice, the lender has the right to increase the interest rate on the loan by a stipulated percentage; and
    - Provide that if the borrower fails to notify the lender, the lender may call the loan and require its immediate repayment, and such loan, if not already recourse to the borrower, becomes recourse and not dischargeable in bankruptcy.
- Housing and total debt-to-income ratios of less than 33 percent and 38 percent, respectively (28 percent and 33 percent on 95 percent and 92.5 percent loans during the five-year transition period).
- Underwritten based upon verified income, assets, and credit.
- If an adjustable-rate mortgage or balloon, an initial fixed rate for seven years or more, with the borrower qualified at the maximum rate permitted during the first seven years.
- If a prepayment fee is charged, it may not provide for a fee in excess of 3 percent of principal for the first year, 2 percent for the second, and 1 percent for the third, and the

originating lender must offer the applicant the option of a similar loan with no prepayment fee.

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

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

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

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

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

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

coverage or guaranty of securities (new provision). MI companies are limited to covering individual loans rather than pools of loans.

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

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