Testimony of

Jeff Plagge

On behalf of the

American Bankers Association

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is Jeff Plagge. I am president and CEO of Northwest Financial Corp. of Arnolds Park, Iowa, and Chairman of the American Bankers Association. ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. Northwest Financial Corp is a privately owned, two banking holding company with approximately $1.6 billion in assets. We make between 3,000 and 3,500 mortgage loans per year, virtually all in our direct markets, and with the exception of Des Moines, IA and Omaha, NE, are mostly in rural communities in Iowa. The majority of those loans are sold into the secondary market but we also portfolio loans as well, especially in some of our more rural markets due to loan size or some other issue that makes it difficult to work in the secondary market. It is a big part of our business model and any changes affecting mortgage lending are very important to us, our customers and our communities.

We appreciate the Committee's focus on ensuring that community banks like mine will continue to have access to a federally guaranteed secondary market. Such access is necessary to offer our customers the mortgage credit so vital to the economic health of every community across America. Small banks have always played an important role in mortgage finance. Community banks, with assets under $10 billion, hold over $530 billion (or nearly twenty-three percent of all 1-4 family residential loans held by the industry) and, of course, originate and sell billions of dollars of mortgages, primarily to Fannie Mae and Freddie Mac. These securities issued by Fannie and Freddie are bought by banks and are an important asset class for them, amounting to over $300 billion as of the second quarter of 2013. Perhaps, most importantly, in one out of every five U.S. counties, there is no other physical banking office except those operated by community banks, according to the FDIC Community Banking Study. Without these banks, residents of these communities will find mortgage credit harder to get and more expensive.

Reforming this segment of the mortgage market will be a complex undertaking with far reaching consequences for our economy. It must be undertaken in a thoughtful, orderly manner. We commend the Committee for the serious focus it continues to give these issues, and particularly the leadership of Senators Corker and Warner and the cosponsors of S. 1217 in establishing a framework to build upon to reform the system. We believe that a government guarantee on a limited segment of the market focused on low and moderate income mortgage borrowers is essential. That guarantee must be explicit, fully priced into the cost of each mortgage to which it applies, and, perhaps most importantly, available to all eligible primary market lenders, regardless of their size, charter type, geographic location or number of loans sold into the secondary market. Community banks must remain able to access that guarantee. If these banks' access is curtailed or denied, or their pricing in the market is inequitable, they and the communities they serve will suffer.

As important as this federal government support is, going forward it should be within a mortgage market predominately filled by the private sector. Fostering and encouraging a private market for the vast majority of housing finance must be part and parcel of any federal policy and should be balanced with government support for certain market segments.

We believe that a mutual organization—if structured in an economically viable way and with appropriate governance—may be a promising approach to accomplish the goals of equitable access to secondary market liquidity for community banks—indeed all banks. In fact, in 2011, ABA wrote Treasury Secretary Geithner and HUD Secretary Donovan noting that a possible structure for a transition vehicle (and potential end point) for Fannie Mae and Freddie Mac could include: "a well-regulated and controlled cooperative structure owned by the financing entities or a similarly controlled secondary market public utility that is publically owned." We went on to say that: "Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns and potential taxpayer liability. Activities under the structure will need to be confined to a controlled mission intended, among other things, to foster and accommodate development and expansion of private sector mortgage financing alternatives."

A multiplicity of access points to the federal guarantee is desirable, with the mutual portal being one avenue. For example, many community banks also have existing relationships with larger institutions, through a correspondent or other arrangements, enabling them to sell mortgages that may be placed into a securitization at some point. Community banks should be able to sell into the mutual portal—even for only one loan—or continue to sell through other channels. The key point is that existing relationships and channels should not be harmed by any creation of a new portal to the secondary market.

One of the most important existing relationships, particularly for portfolio mortgage lenders, is the Federal Home Loan Bank System. A principle long held by ABA is that any reform of the secondary mortgage market must recognize the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks or access to advances by their members, particularly for community banks.

In your invitation letter, Mr. Chairman, you have raised many important questions about possible reforms. In answering these, I would like to frame the discussion under four main themes:

- Any reform of the GSEs must provide fair and equitable access to all primary market lenders selling into the secondary market;

- A mutual organization may be promising but must be economically viable and have the appropriate governance structure to assure fair and equitable access for all lenders—particularly community banks;

- An enhanced role for the FHLBanks holds promise, but must preserve and protectthe system's current vital role; and

- A transition to a new system must ensure that mortgage markets are not destabilized.

I. Any Reform of the GSEs Must Provide Fair And Equitable Access To All Primary Market Lenders Selling Into The Secondary Market

ABA has long maintained that the primary goal of any government involvement in the mortgage markets should be to provide stability and liquidity to facilitate the ability of banks and other primary mortgage lenders to provide home loans for creditworthy borrowers. ***This can only be achieved if there is fair and equitable access by all primary market lenders selling into the secondary market.*** In this regard, ABA commends the Committee for its attention to the concerns of small lenders and their ability to access secondary market funding, which has historically been difficult in some parts of the country. The over-arching goal of reform legislation should be to ensure all eligible lenders—whether small, medium or large—have access to the federal guarantee regardless of the number of loans they seek to sell, their geographic location, or the prevailing economic cycle. As market dynamics change it is not just small lenders who can potentially be disadvantaged and we want to work with you to ensure that banks of all sizes and charter types are able to equitably access the federally backed system that is contemplated.

II. A Mutual Organization Holds Promise But Must be Economically Viable with Governance that Assures Equitable Access for All Banks

S. 1217, legislation introduced by Senators Bob Corker and Mark Warner, and co-sponsored by a number of members of this Committee, contemplates at least two avenues of access to the federal guarantee for smaller lenders—a mutual entity which would be chartered specifically for smaller entities and an expanded role for the Federal Home Loan Banks. While both of these approaches hold certain appeal, both come with risks and potential problems, not the least of which is capitalization. For example, a mutual open only to smaller lenders would be very difficult to sufficiently capitalize, as the potential members have limited available funds to contribute and the cost of capitalizing the mutual, if priced into the mortgages originated by such institutions, may well make them non-competitive with other mortgage providers.

We would recommend that the Committee consider a third alternative, which would be the creation of a mutual entity which would not be limited to only small lenders. Under such a concept, a mutual would be created which would be open to all lenders who would have to buy into the mutual at a sufficient level to capitalize it. By expanding the potential membership, the base of potential capital may be expanded to a large enough degree that capitalization costs are more easily achieved. One key feature that must not be overlooked in developing such an entity is the ability of participants to be able to redeem their capital investment should they choose to leave the system, much like the redemption process allowed to members of the Federal Home Loan Bank system.

If a mutual were to be created as an access point to the federal guarantee, it must be structured to ensure equitable access for all members, regardless of size or charter type. This would involve statutory mandates as to the mission, purpose, and activities of the mutual. It would also require a governance structure that balanced the rights and needs of members of all sizes and types. Under a mutual structure, larger members (and/or those members who engage in the most activity with the mutual) would have the larger investment and thus likely the larger number of shares to vote. This could lead to a “capture” or “dominance” of the mutual by these larger institutions. In order for the mutual to work for all members, it may not be able to function purely as an entity where members vote their shares regardless of size, but would need to have a governance system that balanced the rights and needs of all members. The Federal Home Loan Bank system can serve as one model for such governance. It is a system that is cooperatively owned, but which has complex governance rules which balance the needs and rights of all members.

Whatever structure is ultimately adopted, one feature that it must include is the ability to sell loans individually or in small numbers for cash. Some refer to this as the “cash window”, and it is an essential feature for smaller lenders, or lenders who do not originate or sell large numbers of mortgage loans but still seek access to the secondary market. My bank sells loans via the cash window, as it is not only hard to have sufficient volume to execute our own mortgage-backed securities and the interest rate risk and pipeline management would be too high.

Sellers must also be able to retain servicing or sell it as best meets their needs. Our larger bank does retain servicing rights on many loans and we have built up our secondary market servicing portfolio over the past several years. We now service Freddie Mac loans totaling over $587 million. Our customers always prefer that we service their mortgages, but there are capital limitations for how much we can hold in mortgage services rights within our banks.

Any access point or points must ensure both the cash and servicing features are available and ensure that smaller lenders (or those lenders only selling small numbers of loans) are not disadvantaged through pricing on the loans themselves or the sale of the servicing. One of the actions taken by the Federal Housing Finance Agency as conservator of Fannie Mae and Freddie Mac was to eliminate volume pricing by the GSEs. This is an approach that must be continued in whatever new access points are established going forward. We encourage consultation with FHFA on their experiences in managing this outcome during conservatorship.

In your invitation letter, Mr. Chairman, you asked about a duty to serve underserved populations or geographies included in any new guarantee housing finance system. Banks already have such a mandate to serve all segments of their community through the Community Reinvestment Act. Similarly, their mortgage lending activity is tracked through the Home Mortgage Disclosure Act and banks are examined for compliance with both acts on a regular basis. No further duty to serve is needed for banks. Other lenders, be they credit unions or mortgage banks or other entities which are not currently required to meet similar mandates, should be subject to specific duties to serve in order to place all mortgage lenders seeking a federal guarantee on a more equal lending footing and to help ensure more equitable lending choices for all borrowers.

III. An Enhanced Role for FHLBanks Must Preserve Its Current Vital Role

S. 1217 also contemplates an expanded role for the Federal Home Loan Banks. While this should be considered, there are many issues that must be addressed. FHLBanks, as member-owned cooperatives, serve their large and small members very well, and are self-capitalized entities (and are in the process of increasing their reserves). However, this is capital which is already fully deployed and cannot be repurposed for new activities, absent the consent and direction of the members/owners of the System, or diluted in its capacity to absorb FHLB losses. In order to fully function as an alternative option to Fannie Mae and Freddie Mac—including taking on credit enhancement and securitization activities—the Federal Home Loan Banks would have to seek substantial additional capital from their members. Again, these institutions are unlikely to have the funds necessary to provide such capital, and if the cost of raising such capital were priced into mortgage originations, the mortgages may be unaffordable and non-competitive.

Expanding the role of the FHLBanks in this fashion also leads to a number of other potential problems, including the fact that FHLB membership is not available as an option for all potential lenders (such as mortgage banks or brokers), and opening the system to these non-depositories would pose great and untenable risks to the existing owners-members of the system. Another problem is that the added risks associated with the new activities envisioned may be unappealing to a significant portion of the FHLB membership, which may resist expanding into these new lines of business, even if sufficient capital were available.

A more limited expansion of the role of the Federal Home Loan Banks may be more feasible. For example, you asked in your invitation letter about the feasibility of FHLBanks as aggregators of mortgages or security issuers. It is possible that the FHLBs' role as aggregators of loans originated by their members could be expanded, including the ability to hold such loans on their balance sheets for a period of time to facilitate the efficient aggregation and sale to investors (and to promote the cash sale of individual loans bymembers). It may be possible to authorize the FHLBs to issue securities as well, which is a position supported by some of the individual Banks in the System. Such a change must take care to ensure that securitization authority comes with sufficient oversight to ensure that it does not pose undue risk to an individual Federal Home Loan Bank or its counterparts, given the joint and several nature of FHLBank debt.

Another serious concern relates to the regulatory oversight of the FHLBanks. ABA is concerned with the approach taken in S.1217 which would transfer the supervisory and regulatory functions over the Federal Home Loan Banks from the Federal Housing Finance Agency to a newly created Federal Mortgage Insurance Corporation (FMIC). We are concerned that doing so creates a conflict of interest, whereby the FMIC is both a regulator of and to some degree a competitor to the Federal Home Loan Bank system. Both the FHLBs and FMIC would have a mission of supplying liquidity to the mortgage finance system. The FMIC, as currently envisioned, would likely grow to support a larger segment of the overall market than the FHLBs in their current form. Placing regulation of the FHLBs with the FMIC is likely to lead, at best, to neglect of the System and, at worst, to regulatory policies that may disadvantage the System and its owners/users.

Instead, we urge a different approach to the regulatory structure than that envisioned in S. 1217. The FMIC should not serve as both a guarantor and a regulator, and with specific regard to FHLBanks, the traditional advance business should not be regulated by the new guarantor. Any expanded powers and activities granted to the FHLBank3s which would permit them to engage in new activities (such as aggregation and securitization) under the new system, could potentially be regulated by the new regulator over the FMIC (as describedabove) on a functional basis, with the traditional advance activities of the Federal Home Loan Banks regulated by a separate agency devoted to only their regulation.

Finally, it is important to note that the Federal Home Loan Banks have functioned very successfully for 80 years in serving the liquidity needs of their member/owners and the communities and borrowers those lenders serve. ***No action taken by Congress should serve to destabilize or otherwise threaten that liquidity function.***

IV. A Transition to a New System Must Not Destabilize Mortgage Markets

ABA has long held that any transition to a new system must be undertaken carefully over a number of years to ensure that the mortgage markets are not destabilized.

Many details of a transition will be dictated by the ultimate new structure determined for the guarantor and the roles ultimately to be played by the private market in the new system. It is possible for a phased transition whereby some of the functions currently performed by Fannie and Freddie are slowly devolved to the private sector, such as aggregation and issuance of securities, with the role of Fannieand Freddie shrinking over time until they were only providing the guarantee function, which could ultimately be switched to the new guarantor. It will be essential that existing securities issued by Fannie and Freddie remain guaranteed going forward. Given the risk sharing exercises recently undertaken by Fannie Mae, it is possible that a transition could include a ramp up of such activities tailored to provide the framework for the first loss position desired under a new system.

Assets of the GSEs, including the automated underwriting systems and the single securitization platform, will have value to entities involved in a new system, and this relative value should be considered when determining how to best allocate them. If the Committee adopts the mutual open to all eligible primary market lenders as we have recommended above, we believe that there is merit in transferring these systems and the platform to this mutual. My bank, like many community banks, utilizes one of the GSEs' automated underwriting systems as it provides significant benefits, such as faster loan approvals, reduced closing costs, less documentation, and approval of loan applications that in the past were denied. We find Freddie Mac's automated system to be a valuable tool to aid in decision-making. The automated underwriting systems cannot fully evaluate a file like a live underwriter can especially in the areas of character and collateral. We place a lot of importance on consistent evaluation and strong guidance on loan files to ensure equitable decision making.

Going forward, we also believe that the door should remain open to other underwriting systems beyond those owned by the GSEs for determining eligibility for the federal guarantee going forward. Doing so encourages innovation. Any privately developed systems would have to be carefully evaluated and tested to ensure that they provide the same or better underwriting determinations as the existing systems. Additionally, transparency in any underwriting system should be encouraged, including in the existing systems or any evolution of them.

Conclusion

ABA believes that a government guarantee on a limited segment of the market focused on low and moderate income mortgage borrowers is essential. This is best accomplished by developing a sustainable, rational and limited role for the federal government in supporting and regulating mortgage markets so that there will always be credit available to qualified homebuyers not only during economic upswings but most importantly during downturns. Importantly, the government guarantee must be explicit, fully priced into the cost of each mortgage to which it applies, and available to all eligible primary market lenderson an equitable basis regardless of size, charter type, geographic location or number of loans sold into the secondary market. If community banks' access to that guarantee is curtailed or denied, or their pricing in the market is inequitable, they and the communities they serve will suffer.

We believe that S. 1217 offers a good starting point for reform, but further work and detail is required. We hope that our comments, particularly with regard to the proposed mutual concept and the possible expansion of the activities of the Federal Home Loan Banks are helpful.

We have been pleased to work with the Committee and to provide feedback to your questions and stand ready to assist further. The current conservatorship status of Fannie Mae and Freddie Mac is unsustainable over the long term, as is a return to "business as usual" without significant reform of the government's role in the secondary mortgage market. ABA and our members are committed to working with you to achieve a sustainable, durable, and equitable system.