Written Testimony of

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"Housing Finance Reform: Developing a Plan for a Smooth Transition"

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Chairman Johnson, Ranking Member Crapo, and members of the Committee, my name is David Min and I am an Assistant Professor at the University of California Irvine School of Law, where I teach and research in the area of banking and capital markets regulation. Before coming into academia, I spent over a decade working in financial markets law and policy, both in private practice and in the federal government. Most recently, I served as the Associate Director for Financial Markets Policy for the Center for American Progress, where I was responsible for managing the activities of the Mortgage Finance Working Group organized by CAP. I am here, however, in my individual capacity, and not as a representative of either CAP or the Mortgage Finance Working Group.

For the purposes of my testimony, I will assume that the system of housing finance that we transition into will be some variation of S.1217, the bill proposed by Senators Bob Corker (R-TN) and Mark Warner (D-VA).[1] The Corker-Warner bill envisions a so-called "hybrid" system, in which the federal government provides explicit and priced reinsurance on mortgage-backed securities insured by approved bond guarantors, in a model based loosely on the deposit insurance model of the Federal Deposit Insurance Corporation. As I have noted elsewhere, the federal government has provided, in one way or another, a catastrophic backstop on most residential mortgage funding since the New Deal's banking and housing reforms, and this role has been inextricably linked to a number of key policy objectives, including financial stability, broad and constant liquidity, and the wide availability of the 30-year fixed-rate mortgage that has become the hallmark of U.S. housing finance.[2]

The transition being contemplated would be the largest such undertaking in history, and one that, to the best of my knowledge, has no close precedents. Fannie and Freddie currently hold slightly more than $5 trillion in mortgage-related assets.[3] Since the sudden and steep decline in private mortgage finance that occurred in 2008, the two enterprises have been responsible for more than 60% of the new mortgage originations, about $1.7 trillion each year, an amount equivalent to slightly more than 10% of our nation's annual gross domestic product. The federal government has some experience in resolving failed institutions—recently, the government's interactions with AIG and General Motors come to mind, and before that, we had the experience of the Resolution Trust Company in resolving hundreds of failed thrifts. But I can think of no instance in which we have tried to simultaneously resolve large failed institutions and transition their core economic functions into a newly created set of institutions, certainly not on the scale imagined by Corker-Warner.

The experience of the past decade has shown us that the current housing finance model, which relies predominantly on the mortgage-backed securities issued by the government-

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[1] Housing Finance Reform and Taxpayer Protection Act of 2013, S. 1217, 113th Cong. (2013) (hereinafter "Corker-Warner" or the "Corker-Warner bill").

[2] *See, e.g.*, David Min, *How Government Guarantees in Housing Finance Promote Stability*, 50 HARV. J. LEG. 437 (2013); David Min et al., *The Future of U.S. Housing Finance: Five Points of View*, 17 J. STRUCTURED FIN. 36 (2011). Before Agency securitization evolved to dominate U.S. mortgage markets, federally insured depository institutions were the primary source of residential mortgage funding. In both types of financing, the federal government holds the catastrophic tail risk. Since the 1940s, this government backing has existed for the vast majority of U.S. home loans, typically more than 70%. *Id*.

[3] According to their Form 10-K filings, at the end of 2012, Fannie held $3.064 trillion in mortgage related assets, and Freddie held $2.005 trillion.

sponsored enterprises (GSEs)[4] Fannie Mae and Freddie Mac, well serves a number of critically important policy goals, including offering a broadly available and affordable 30-year fixed-rate mortgage product, meeting the credit needs of underserved populations and product types such as rural areas and multifamily housing, and providing countercyclical liquidity when other sources of housing finance have dried up. Unfortunately, this experience also illustrates a number of serious flaws with the GSE model. Because these enterprises were publicly backed, with private shareholders, they continuously sought to maximize profits by increasing their risk-taking, creating a "heads I win, tails you lose" dynamic between their shareholders and taxpayers. Moreover, protections against taxpayer exposure were clearly insufficient in this framework. In my view, the Corker-Warner bill is a good starting point for thinking about how to keep the parts of the current system that worked, while eliminating the parts that proved problematic.

This same balance needs to be reflected in how we think about transitioning to the future housing finance system outlined in Corker-Warner. Thus, while safety and soundness and taxpayer protection are obviously important policy goal, I believe the most important priority in structuring the transition should be to ensure that there continues to be sufficient liquidity across all market segments. Given the complexity and size of the GSEs' current operations, this is a tremendously complex and multilayered task. Moreover, the stakes could not be higher, as major hiccups would have devastating effects on an already-stagnant economy and financial system.

This is particularly true for financing affordable multifamily housing, which is a primary source of rental housing in this country. In the aftermath of the housing crisis, policy makers have generally sought to reduce the emphasis on homeownership and shrink the federal government's role in housing finance, which is reflected in Corker-Warner. But achieving these objectives will naturally mean that affordable rental housing will be much more important, both from a social and economic perspective. Thus, one of the most important elements of the transition will be ensuring that we maintain sufficient liquidity for rental housing, such as multifamily housing.

The guiding principle for legislators and regulators who are structuring our housing finance transition must first and foremost be, "Do no harm." Avoiding the disruption of mortgage liquidity, either systemwide or in individual market segments, should be a paramount concern during this period. A failure to adhere to this principle would be catastrophic for the housing markets and the broader economy.

Assessing the Corker-Warner Transition Plan

The Corker-Warner bill contemplates a transition period of no more than five years following its enactment, during which time Fannie and Freddie would be phased out and the infrastructure for the new system, including the Federal Mortgage Insurance Corporation (FMIC) at the heart of this framework, is established.[5] Upon enactment, Corker-Warner would eliminate

[4] Following the conservatorship of Fannie and Freddie, many have ceased calling these firms "government-sponsored," since they are effectively seen as part of the federal government. Technically, however the conservatorship was structured in a way that kept the enterprises private and lacking an explicit government guarantee, so the term "government-sponsored enterprise" or "GSE" is still accurate.

[5] Corker-Warner §§501-506.

the affordable housing goals currently in place for Fannie and Freddie,[6] and begin to gradually reduce the high cost area loan limits, which currently stand at 150% of the conforming loan limit (now set at $417,000) to 115% of the conforming loan limit within five years.[7] The mortgage assets held in Fannie and Freddie's investment portfolios would be reduced by 15% each year until the FMIC is certified as being operational; at the end of that year, their remaining assets would be used to wind down the enterprises and help cover the costs of any remaining legacy guarantees.[8]

Upon FMIC certification, an event which must occur within five years of enactment, the charters for Fannie and Freddie are repealed and these firms barred from conducting any new business.[9] At this time, outstanding "legacy" debt obligations (bonds and mortgage-backed securities) issued by the GSEs would be explicitly guaranteed with the full faith and credit of the United States.[10]

At a high level, Corker-Warner provides a thoughtful template for long-term mortgage finance reform. But transitioning to the new system that Corker-Warner creates will be a long and difficult process. The Corker-Warner bill provides some broad guidance and mandates on the question of transition, but many issues remain unresolved and need to be addressed before we move on. I discuss some of these below.

Developing a Common Securitization Architecture

Central to the Corker-Warner framework is the development of a new infrastructure for issuing securities with a common government guarantee. Currently, Fannie and Freddie each have their own securitization architectures, but creating a common securitization platform (CSP) is a prerequisite to opening the new system up to a multitude of issuers.[11] Creating the CSP is also important for creating a single security, which many see as a precondition for a successful transition towards the new system, because of the differences in liquidity and pricing that are likely to develop in a system that has more than two issuers.

Even in the current environment, with two virtually identical issuers enjoying the same government guarantee, investors clearly prefer Fannie obligations over Freddie obligations, and as a result, Fannies trade in deeper and more liquid markets and enjoy better pricing.[12] As of June 2012, the spread between 30-year 4.5% Fannie MBS and Freddie MBS was about 48 cents.[13] These spreads are certain to widen with the entry of additional issuers, unless a common security is created. Thus, moving towards a single security seems to be an important part of any

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[6] Corker-Warner §506.
[7] Corker-Warner §504.
[8] Corker-Warner §505.
[9] Corker-Warner §501.
[10] Corker-Warner §501.
[11] *See* Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, *The Conservatorships of Fannie Mae and Freddie Mac*, Remarks before the National Association of Federal Credit Unions Congressional Caucus, Washington, DC (Sept. 13, 2012).
[12] *See* American Securitization Forum, *Discussion of a Proposed Single Agency Security* 1-2, ASF White Paper Series, July 2, 2012.
[13] *Id*. at 3.

transition towards the new system. A single security should also improve liquidity in the important "To Be Announced" (TBA) market, the forward market that is responsible for more than 90% of the trading volume in agency MBS (and which allows borrowers to "lock in" their rates).[14]

In theory, establishing a CSP and single security should not be overly difficult. After all, Ginnie Mae securities have a large number of issuers and a shared government guarantee, and they effectively trade as a single security. Several white papers have been written describing best practices in creating a single security, and they generally share the same recommendations.[15] We need a common platform, such as the CSP, and standardization of terms and contracts, including loan delivery and pooling requirements, remittance requirements, underwriting guidelines, servicing standards, and disclosure policies.

But in reality, moving towards a common platform and single security may be quite difficult. The technical challenges alone are likely to be very challenging. Fannie and Freddie each created and perfected their securitization infrastructures over many years. Integrating these systems together into an open securitization platform that can be utilized by any approved issuer will be a painstaking task. But as recent history teaches us, developing a complex technology infrastructure can be much more difficult than originally anticipated. It took Wells Fargo three years to integrate its data systems with those of Wachovia, following its acquisition of the Charlotte-based bank holding company. Bank of America did not finish integrating its data systems with those of Merrill Lynch until September of this year, nearly five years after Merrill was acquired.[16]

Indeed, it is worth noting that the Federal Housing Finance Agency's progress towards creating the CSP is proceeding exceedingly slowly. At this point, more than 18 months after the common securitization platform was first publicly announced by the FHFA,[17] the only public announced progress towards creating this CSP has been the filing of a certificate of formation for a limited liability company and the signing of a lease for office space.[18] The slow pace of CSP development does not bode well for the relatively aggressive timeline envisioned by Corker-Warner, which calls for the FMIC to be certified as operational within five years.

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[14] *See generally* James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of NY Economic Policy Review, May 2013.

[15] *See, e.g.*, *id*.; Mortgage Bankers Association, "Ensuring Liquidity Through a Common, Fungible GSE Security," *in Key Steps on the Road to GSE Reform*, Sept. 11, 2013; American Securitization Forum, *Discussion of a Proposed Single Agency Security*, *supra* note 12; Richard Johns, Executive Director, Structured Finance Industry Group, *Essential Elements of Housing Finance Reform*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Sept. 12, 2013).

[16] *See Bank of America Merrill Lynch Completes Transaction Data Repository*, Press Release, Sept. 16, 2013, *available at* http://newsroom.bankofamerica.com/press-releases/commercial-and-middle-market-banking/bank-america-merrill-lynch-completes-transaction.

[17] *See* Federal Housing Finance Agency, A Progress Report on the Common Securitization Infrastructure (Apr. 30, 2013), *available at* http://www.fhfa.gov/webfiles/25144/WhitePaperProgressReport43013.pdf. The idea for creating a common securitization platform was first announced in February 2012 by FHFA, which followed up with a detailed proposal that was released to the public in October 2012.

[18] *See* Federal Housing Finance Agency, *FHFA Announces Significant Steps in Organization of Joint Venture to Establish Common Securitization Platform*, News Release (Oct. 7, 2013).

Achieving Liquidity for the New MBS

Another important transition issue that must be considered is how to best scale up liquidity for the new securities guaranteed by the FMIC in the Corker-Warner framework. Corker-Warner essentially envisions an on/off progression, in which the GSEs are shut down at the same time that the FMIC opens for business. Once the FMIC is certified as operational, the GSEs lose their charters and are barred from conducting any new business. The concern with this approach, of course, is that when this handoff occurs, there is a lack of demand for the new securities, due to any number of factors (such as a reluctance by investors to be early adopters). If that were to occur, the sudden drop in liquidity could be quite problematic for the housing markets.

Responsibly Reducing High Cost Area Loan Limits

Corker-Warner calls for scaling back the size of the federal government's footprint, with so-called "high cost" loan limits being, at least in the transition phase, the primary focus of this reduction. But it is not clear how much private non-guaranteed liquidity is currently available to fill the vacuum that will be created. Some have suggested that depository institutions should play a greater role in financing home loans, reprising the role they once played in originating and holding mortgages to term (as opposed to simply originating mortgages with the intent to sell these to secondary market actors, which has increasingly displaced originate-to-hold lending). But the fact is that bank deposits are simply not a large enough source of funding at this time to replace much of the activity that Fannie and Freddie currently do. As Figure 1 illustrates, the *total* amount of U.S. bank deposits is barely sufficient to meet U.S. housing finance needs. Moreover, as my fellow witness Jim Millstein has noted, we have been experiencing a net decline in real estate loans held by commercial banks, suggesting that traditional bank balance sheets are an unlikely source of increased housing finance in the near future.[19]

Similarly, it is improbable that private-label securitization, which accounted for so much volume during the housing boom years of 2002-07, will be able to replace much of the vacuum left by a reduced government footprint in the near future. Since 2008, private-label securitization of mortgages has essentially been non-existent. Figure 2 lists the underwriting characteristics for all of the private-label mortgage securitization deals that have taken place since the 2008 financial crisis. The credit characteristics are extremely high, and the volume is still very low. As Georgetown Law professor Adam Levitin has described, the PLS market is currently a "market for lemons" and is likely to stay that way for some time, until investors regain confidence in the integrity of the highly informationally asymmetric PLS process.[20] At the same time, the implementation of the "Qualified Mortgage" (QM) standard, which provides safe harbor for mortgage originators, and the "Qualified Residential Mortgage" (QRM) standard, which provides an exemption from the risk retention requirements of Dodd-Frank, are likely to have

[19] Jim Millstein, Chairman & Chief Executive Officer, Millstein & Co., *A Blueprint for Finance Reform in America*, Remarks Before the Woodrow Wilson International Center for Scholars, May 22, 2012.

[20] Adam J. Levitin, Professor of Law, Georgetown University Law Center, *Housing Finance Reform: Fundamentals of a Functioning Private-Label Mortgage Backed Securities Market*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Oct. 1, 2013).

some impact on the availability of private, non-guaranteed mortgage finance, but it is too early to tell what this impact might be.

In the near term, aggressively lowering loan limits may lead to a gap in the availability of mortgages in high-cost areas, which could adversely affect the housing markets in those regions.

Ensuring the Continued Flow of Mortgage Finance for Underserved Market Segments

Historically, the GSEs have played an important role in providing mortgage credit to underserved market segments, such as rural housing and housing for lower-income households. They have played a particularly important role in providing financing for affordable multifamily rental housing, with roughly two-thirds of the multifamily units they finance being affordable to households earning less than 80% of area median income.[21] GSE financing for affordable multifamily rental housing has come from both their guarantee activities and purchases for their investment portfolios, and has been motivated at least in part by their affordable housing goals. The GSEs' footprint in multifamily housing finance has generally been much more variable than their single family market share, shrinking down to about 25% of the market when market conditions are good and increasing to fill the vacuum when market conditions deteriorate (70% at the height of the crisis).[22]

Corker-Warner calls for an aggressive reduction in the GSE portfolios over a period of five years, and for the elimination of the affordable housing goals. Replacing these mechanisms would be a separate set of entities that have been collectively described as the "Market Access Fund," which would be funded by a small levy, between 5 to 10 basis points of outstanding mortgage guarantees.[23] The Market Access Fund would, as my fellow witness Mark Zandi has described, attempt to provide both direct subsidies and explicit credit enhancement to foster greater access to securitization in underserved market segments, particularly in affordable multifamily housing.[24] The existing multifamily guarantee business would be transferred to the FMIC, as Corker-Warner currently stands,[25] although as Dr. Zandi has noted, this is likely a placeholder, as it is difficult to imagine a regulator running a business.[26]

[21] *See* Ethan Handelman, Vice President for Policy and Advocacy, National Housing Conference, *Housing Finance Reform: Essential Elements to Provide Affordable Options for Housing*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Nov. 7, 2013). As Mr. Handelman outlines, one key reason why the GSEs play such a dominant role in affordable multifamily is that, unlike purely private sources of mortgage capital (such as insurance funds or pension funds), they offer long-term products, which are critical for many of the specific needs of developing and maintaining affordable multifamily deals.

[22] *See* Shekar Narasimhan, Managing Partner, Beekman Advisors, Inc., *Housing Finance Reform: Essential Elements of the Multifamily Housing Finance System*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Oct. 9, 2013).

[23] This includes the National Housing Trust Fund and Capital Magnet Fund that were established but not implemented under the Housing and Economic Recovery Act of 2008, as well as other funds meant to provide targeted credit support meant to facilitate securitization of niche products. *See* Corker-Warner, §§401-403; Ellen Seidman, Phillip Swagel, Sarah Wartell, and Mark Zandi, *A Pragmatic Plan for Housing Finance Reform*, June 19, 2013, *available at* http://www.urban.org/uploadedpdf/412845-Housing-Finance-Reform.pdf.

[24] Mark Zandi, Chief Economist and Co-Founder, Moody's Analytics, *Essential Elements of Housing Finance Reform*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Sept. 12, 2013).

[25] Corker-Warner §601.

[26] Mark Zandi and Cristian deRitis, *Evaluating Corker-Warner*, Moody's Analytics Report (Sept. 2013).

One concern with the proposed transition is that it may wind down key aspects of the current system that have provided financing for these underserved segments—the investment portfolios and the affordable housing goals—without having fully established the Market Access Fund. Given economic and demographic trends, we have already seen a sharp increase in the demand for affordable rental housing. As policy makers seek to deemphasize homeownership and reduce the federal government's footprint in single-family housing finance, we should expect to see this demand increase. Thus, it is imperative that we avoid leaving vacuums in the availability of mortgage credit, which would be devastating for renters, rural homeowners, lower income families, and many others who are vulnerable and struggling to make ends meet during a period of economic stagnation.

Attracting Sufficient and Appropriately Priced Capital Into the New System

Another important concern is bringing in sufficient capital to fund the new private MBS issuers that are central to the hybrid system envisioned by Corker-Warner. While some have raised concerns about the availability of private capital willing to serve as equity in this new system,[27] I am optimistic that there is a large pool of capital to draw upon, and I think that last week's proposal from Fairholme Capital Management gives us some evidence of that. The question, of course, is on what terms this capital is available.

The core economics of this business are strong, as Figure 3 indicates. Since their conservatorship, the GSEs have been steadily improving their performance, as the impaired loans guaranteed during the 2003 to 2007 period are written off and the new books of business from 2008 and onward grow to become a larger proportion of their balance sheets. That being said, there are a number of variables that will affect how much capital is available and on what terms. These include capital requirements,[28] expected market size and share (which is affected by, among other things, loan limits and barriers to entry), and the pricing of the government guarantee.

Corker-Warner requires that private capital representing no less than 10% of the guaranteed MBS be placed in a first loss position,[29] although as former Treasury official Phillip Swagel has noted, Corker-Warner contemplates that this private capital may be tranched, which would lower its costs.[30] Some have argued that this capital level is too high, and will thus lead to both a dearth of private capital and a sharp increase in mortgage rates. For example, Laurie Goodman and Jun Zhu conduct an empirical analysis and conclude that 4-5 percent capital would

[27] Mark Zandi and Cristian deRitis, *The Road to Reform* 5-7, Moody's Analytics Report (Sept. 2013).
[28] While it is generally thought that equity investors prefer higher leverage, so as to maximize their potential returns, there is some evidence that lower leverage (such as created by higher capital requirements) leads to higher returns over time. *See generally* Malcolm Baker and Jeffrey Wergler, *Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation and the Low Risk Anomaly*, NBER Working Paper No. 19018 (2013).
[29] Corker-Warner §202.
[30] Phillip Swagel, *Housing Finance Reform: Essential Elements of a Government Guarantee for Mortgage-Backed Securities*, Testimony Before the U.S. Senate Committee on Banking, Housing & Urban Affairs (Oct. 31, 2013).

have covered all of the GSEs' losses coming out of the 2007-08 mortgage crisis.[31] Taking into account the proposed Mortgage Insurance Fund, which is required to reach a reserve level of 2.5 percent of outstanding principal balance within 10 years (1.25% within 5 years), Corker-Warner effectively contemplates a 12.5% buffer against taxpayer loss,[32] on top of any improvements to mortgage loss rates that may accrue as a result of QM and QRM. This compares to the current system, in which Fannie and Freddie had minimum capital requirements of 2.5% of assets plus 0.45% of adjusted off-balance sheet obligations (including guaranteed mortgage-backed securities).[33]

Maintaining Sources of Countercyclical Liquidity

A longer-term transition goal should be to preserve sources of countercyclical liquidity. The unfortunate fact about private bank capital is that it is highly procyclical, chasing profits during credit booms and becoming overly risk averse during credit contractions. As a result, the government is typically the only game in town when it comes to countercyclical liquidity. We need only look to our current mortgage markets to see this phenomenon on display. Since the credit contraction began in 2007, Agency securitization has been responsible for virtually all housing finance, accounting for over 90% of residential mortgage originations. Without this countercyclical liquidity, it is certain that the housing bust would have been far worse, with extremely negative effects on the broader economy. Before this most recent housing crisis, the last great housing crisis we had occurred in the 1930s, when we did not have in place any sources of countercyclical liquidity. The result was a 50% national delinquency rate and a 10% foreclosure rate.[34]

Of course, in winding down Fannie and Freddie, Corker-Warner eliminates the two largest sources of countercyclical mortgage liquidity. Corker-Warner recognizes the need for such a function, however, and thus, in the presence of "unusual and exigent" circumstances, allows for the issuance of securities that do not have 10% private capital in a first loss position. In the event that we have another mortgage crisis, this exigency clause may not be sufficient to

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[31] Laurie S. Goodman and Jun Zhu, *The GSE Reform Debate: How Much Capital is Enough?*, Urban Institute, Oct. 24, 2013.

[32] There are two other layers of protection against taxpayer loss that Corker-Warner increases. Private mortgage insurance currently covers a little less than 15% of mortgages securitized by the GSEs and takes a first loss position between 6% and 35%. *See* Fannie Mae 2013 Third Quarter Credit Supplement; Freddie Mac October 2013 Investor Presentation. Under Corker-Warner, PMI is left in place, covering loans with an LTV over 80, but its coverage amounts are increased. Corker-Warner §2. Homeowner equity is also likely to be increased, by virtue of the 5% down payment requirement created in Corker-Warner. Corker-Warner §2. Fannie Mae's current average loan-to-value ratio on all single-family loans they have guaranteed is 67.1%. *See* Fannie Mae 2013 Third Quarter Credit Supplement. Freddie Mac's average loan-to-value ratio on its single-family conventional guaranty book of business is 73%. *See* Freddie Mac October 2013 Investor Presentation.

[33] *See* Office of Federal Housing Enterprise Oversight, *Mortgage Market Note: Fannie Mae and Freddie Mac Capital*, July 17, 2008. Fannie and Freddie were also subject to risk-based capital requirements, based on a 10 year stress test model. *Id*. The two enterprises were actually subject to surplus capital requirements due to alleged accounting improprieties and other issues, from 2004 until the time of their conservatorship. *See* Federal Housing Finance Agency, *Capital Prior to Conservatorship*, *available* at http://www.fhfa.gov/Default.aspx?Page=146. Following their conservatorship, FHFA has suspended capital classifications and announcements. *See* Federal Housing Finance Agency, *Capital Under Conservatorship*, *available* at http://www.fhfa.gov/Default.aspx?Page=78.

[34] *See* David Min, *How Government Guarantees in Housing Finance Promote Stability*, *supra* note 2.

meet the liquidity needs of the market. Based on observations of the current experience, in which Fannie and Freddie have been responsible for roughly two-thirds of all mortgage originations, it may be the case that greater emergency powers are appropriate.

Recommendations for Transition

Given the issues with the transition contemplated by Corker-Warner, what should we do next? I lay out some recommendations below.

Delegate more responsibility to regulators and remove arbitrary timetables

In a number of different ways, Corker-Warner looks to micromanage the transition process. The GSEs are given specific timelines for lowering their loan limits and winding down their portfolios, and the FMIC is provided with very specific capital requirements as well as a specific schedule for implementing the CSP and ending the activities of the GSEs. But as the above analysis demonstrates, these are highly technical issues that would benefit greatly from dedicated expertise and data. Is 10% the right level of capital? Will winding down the GSE portfolios by 15% a year have an adverse effect on the housing markets (particularly underserved and vulnerable areas)? Will private sources of mortgage finance come into the market if the GSEs lower their loan limits each year? What if we shut down the GSEs, the CSP opens for business and liquidity is lacking? All of these are questions that are best answered by regulators making decisions based on data analysis, rather than by legislation making choices based on assumptions that may or may not turn out to be correct.

Regulators should be given greater discretion and encouraged to respond to developments on the ground, with broad principles guiding their actions rather than detailed and specific rules. Timetables should not be dictated ex ante, but rather should be developed in response to data-driven analysis. It may be useful to compare the roles of the FHFA and FMIC with those of federal banking regulators, who enjoy very broad discretion and expansive powers to promulgate and enforce regulations based on their regulatory goals. Given the complexity of the transition we are anticipating, giving regulators more flexibility in their actions and timetable would seem a prudent and more effective course of action.

Thus, I believe that Corker-Warner should not attempt to create specific capital requirements, or create specific timetables, but should instead substitute high level regulatory targets and mandates, while leaving the specifics to the regulators. Greater flexibility and delegation to regulators are preferable for managing a transition of this scale and scope.

Phase in the transition in parts, not all at once

The current transition plan contemplated by Corker-Warner effectively calls for flipping on a switch (certification of the FMIC), at which point the GSEs will turn off and the FMIC and CSP will turn on. But as recent events may highlight, unanticipated problems may arise, particularly with any transition as complex as moving a trillion dollars in mortgage origination financing over from one platform to another. Flipping the switch may lead us to discover that the lights are not working, or only working in parts of the building.

Rather, I believe a preferable approach would be to adopt a piecemeal approach to transition, turning over small (but increasingly greater) parts of the mortgage markets to the new infrastructure. For example, rather than preparing the CSP architecture to handle the mortgages financed by GSE securitization all at once, we could first start with a dedicated subset of mortgages, such as 15-year fixed-rate mortgages, or "high cost" conforming mortgages. Such an approach would have a myriad of benefits. First, it would allow regulators to test the new system in a meaningful way, and develop data that can help them perfect the new infrastructure. Second, it would help build investor liquidity in the new MBS being produced. Instead of requiring investors to all become early adopters, a piecemeal approach to transition would build volume over time in specific product segments. Third, to the extent that there were problems with liquidity in the transition, such an approach would leave in place the GSEs to pick up any slack that might be needed.

Under this approach, transition could proceed based on meeting specified liquidity benchmarks, and not on a preordained timeframe. Such an approach might actually proceed more quickly than the transition called for by Corker-Warner, since this would allow for earlier partial certifications of FMIC, rather than the all-or-nothing approach currently specified in the legislation. This would also wind down the GSEs in an orderly fashion by removing increasingly larger parts of their business and transferring them to the new system.

Convert legacy securities into new FMIC-backed MBS

One way to build liquidity in the new system is to offer all holders of legacy securities the option of converting their securities into the new, explicitly guaranteed MBS created under the new housing finance regime.[35] Assuming transition was phased in as described in the previous section, each class of securities could be converted at the time that an equivalent product was offered by the FMIC. This approach would build immediate volume into the new architecture, which would improve liquidity and lower prices.

Pre-approve the new MBS for use in TBA market and as collateral

Another relatively simple step that could improve liquidity for the new security is to ensure, ahead of time, that it will be accepted for delivery into the TBA market. As I discussed previously, the TBA market is an enormous futures market that is responsible for over 90% of the trading in Agency MBS, and thus is a critical source of liquidity. On their face, these new securities should have no problem fitting into the TBA market, as they are government-backed (an important de facto requirement for TBA trading) and seem to possess all of the other predicate characteristics.[36] As part of the transition process, regulators should open up discussions with the Securities Industry and Financial Markets Association (SIFMA), which sets standards for the TBA market, and take any steps necessary to ensure that the new MBS are accepted for TBA trading.

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[35] Compelling investors to convert their securities could raise contractual and other issues, and thus is likely to raise more problems than it solves. However, if there were cost-effective ways to encourage these investors to convert, those might be worth considering as well.

[36] *See generally* Vickery and Wright, *TBA Trading and Liquidity in the Agency MBS Market*, *supra* note 14.

Similarly, regulators should seek to pre-approve the new MBS as collateral in the various markets and transactions in which Agency MBS is accepted as collateral, such as the Fed's discount window lending, the OTC derivatives market (standards set by the International Swaps and Derivatives Association), and repo markets (standards set by SIFMA). Given that the new MBS carry an explicit government guarantee (typically the most important requirement), this should not be a difficult task, but simply setting expectations ahead of time may have a large beneficial impact on liquidity.

Give a running start to institutions focused on underserved markets

As I described earlier, the transition process may have particular issues in maintaining liquidity in underserved market segments. As the GSEs are unwound, it may be the case that the new infrastructure is not yet set up well enough to fill the void. To help alleviate this problem, it makes sense to give a head start to the new institutions tasked with serving these markets.

Thus, it may make sense to start funding the Market Access Fund immediately, taking these funds out of the g-fee that is currently being levied by the GSEs. Since 2008, Fannie and Freddie have financed roughly $2.5 trillion in new mortgage originations, and they are charging 50 basis points on these. Taking even a small amount out of this could go a long way in getting the MAF up and running, so that it is able to take on a greater share of the underserved market once transition is underway.

Similarly, it would be useful to immediately fund and activate MBS guarantors with a specific focus on affordable housing finance, with an eye towards immediately becoming part of the new Corker-Warner architecture. Some of you may be familiar with the plan put forth by Raphael Bostic, Shekar Narasimhan, and Mark Willis, which proposes the immediate spin-off of the multifamily securitization assets and business of Fannie and Freddie into a new joint subsidiary.[37] This new multifamily entity would, for a fee, piggyback off of the guarantees of Fannie and Freddie, until such time as the GSEs were eliminated and the FMIC was operational. At that point, the new multifamily entity would convert into an issuer in the new Corker-Warner system.

Whether or not the Bostic/Narasimhan/Willis plan is adopted, it provides an interesting template for thinking about how to serve affordable housing finance needs. As this plan illustrates, it is critical to get things up and running immediately, to give these entities a running start and thus help to ensure that liquidity in these underserved markets will not be lacking when transition occurs.

Providing expanded emergency powers to FMIC to deal with housing crises

Finally, we should think about the importance of tools that can allow our housing finance system to respond to emergency situations. In addition to the current provisions articulated in Corker-Warner, which allow for FMIC to guarantee MBS that don't meet the 10% private capital

[37] Raphael Bostic, Shekar Narasimhan, and Mark Willis, *Multifamily Finance Reform*, June 24, 2013, *available at* http://www.beekmanadvisors.com/presentations/Multifamily%20Finance%20Reform_Moving%20to%20a%20Solution-2013-06-24-DRAFT%20FOR%20DISCUSSION.pdf.

requirement, other powers should be provided, which allow FMIC to effectively provide countercyclical liquidity in the event of another crisis, like the one we are currently emerging from. At a bare minimum, this should include the ability to raise loan limits and lower its insurance fees. Policy makers may want to consider the feasibility of emergency powers that would allow for expanded eligibility for FMIC guarantees, or the ability to (temporarily) directly invest in mortgage assets.

Conclusion

The topic of transitioning into the new housing finance system of the future is a critically important but highly complex one. The Corker-Warner transition plan provides us with a good starting point to start thinking about some of these difficult issues, and I appreciate the opportunity to discuss this topic with you today. Thank you again for holding this hearing, and for the opportunity to testify. I look forward to your questions.

Figure 1: Bank Deposits Compared to Residential Mortgage Debt Outstanding[38]

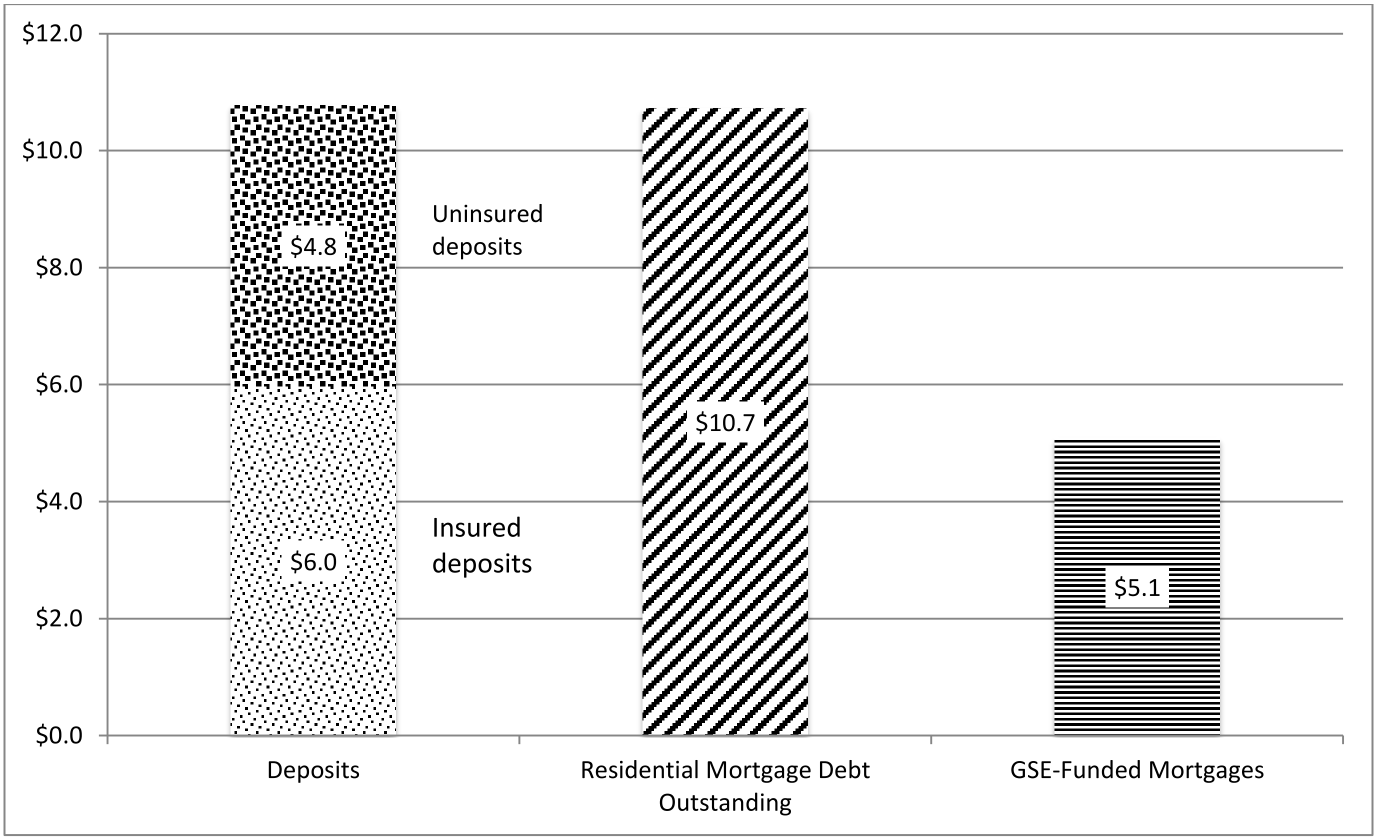


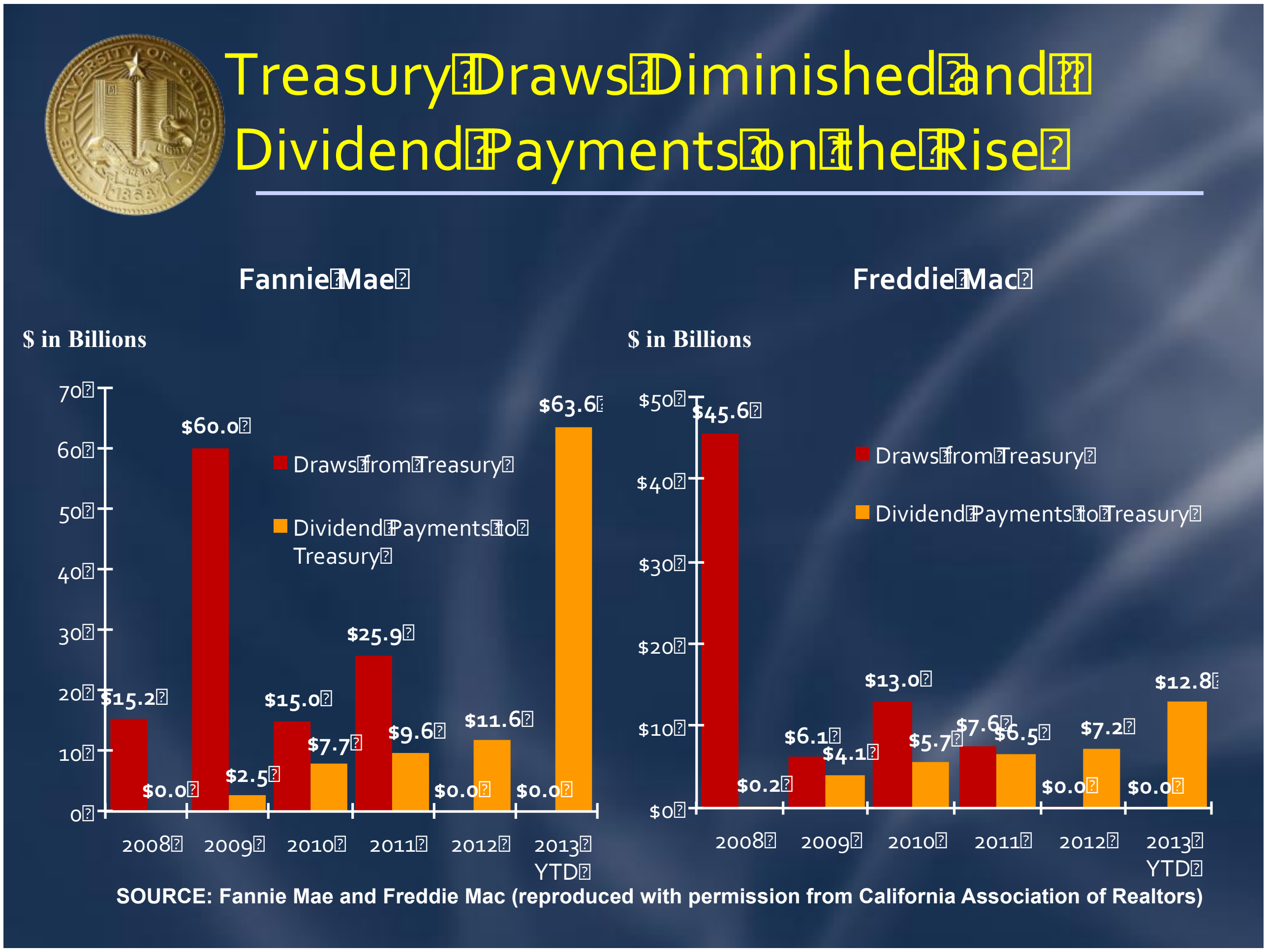
Figure 2: Characteristics of Post-Crisis Private-Label Mortgage-Backed Securities[39]

Total Dollar Volume	$15.3 billion
Total number of deals	33
Total number of securitized mortgages	16,778
Average home price	$1.26 million
Average mortgage balance	$825,000
Average combined loan-to-value ratio	65%
Average debt-to-income ratio	30%
Average FICO score	723

[38] FDIC Quarterly Banking Profile (Second Quarter, 2013), Federal Reserve Statistical Release Z.1 (Second Quarter, 2013), Fannie Mae and Freddie Mac Monthly Summary Reports (September 2013).

[39] Adam J. Levitin, *Housing Finance Reform: Fundamentals of a Functioning Private-Label Mortgage Backed Securities Market*, *supra* note 20 (citing Kroll Bond Rating Agency, RMBS: Transaction Comparison Report (Sept. 19, 2013)).

Figure 3: The Improving Health of Fannie and Freddie[40]



40 California Association of Realtors (using data from Fannie Mae and Freddie Mac).