Statement of

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Housing Finance Reform: Powers and Structure of a Strong Regulator

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Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear before you today.

My name is Paul Leonard and I am the Senior Vice President of Government Affairs of the Housing Policy Council of the Financial Services Roundtable. The thirty-one members of the Housing Policy Council originate, service, securitize, trade, invest in, and insure mortgages. We estimate that our member companies originate three quarters of all residential mortgages in the U.S. and service about two-thirds of those mortgages.

The Housing Policy Council strongly supports reform of our nation's housing finance system. Our members appreciate the time and attention Chairman Johnson, Ranking Member Crapo and the Committee are devoting to housing finance reform. We also want to thank Senators Corker and Warner and their cosponsors for their thoughtful and significant contribution to advancing housing finance reform.

For many years, consumers, lenders, the housing industry and the broader economy benefited from the secondary mortgage market that was facilitated by Fannie Mae and Freddie Mac, the housing GSEs. At the height of the financial crisis, however, fundamental flaws in the design and operation of the GSEs were exposed. Those flaws included insufficient capital requirements and an inherent tension between the interests of private shareholders and the public mission of the GSEs. The GSEs also were subject to a certain amount of "moral hazard" since they operated under a special congressional charter that shielded them from traditional market forces.

A new model is needed for the secondary market in conventional mortgage loans that preserves the availability of stable mortgage credit for qualified homebuyers, retains key operations, systems and people critical to the current system, and corrects the flaws in the existing GSE model by requiring more private capital and better protection for taxpayers.

The structure and duties of the federal agency charged with overseeing the successors to the GSEs is equally important. Just as the structure of the GSEs contributed to the crisis, so too, did the structure and the limits on some of the powers of the Office of Federal Housing Enterprise Oversight (OFHEO).

Congress corrected many of those problems with the passage of the Housing and Economic Recovery Act of 2008 (HERA). Unfortunately, those reforms came just as the financial crisis was cresting and could not prevent the collapse of the GSEs. Given that history, the members of the Housing Policy Council support a strong and effective regulatory structure for the entities that will replace the GSEs.

In the balance of my statement, I will highlight what we believe are the more important features of that structure, how those features compare to some of the provisions in the Corker/Warner bill, and how they mesh with our vision of housing finance reform.

The Structure of the Federal Regulator

First, as Senators Corker and Warner have proposed, we support the creation of an independent federal agency to oversee the transition from the current GSE system to a new structure for housing finance. We also agree that the independence of this agency is enhanced by a funding structure that is based upon assessments and fees as opposed to Congressional appropriations. While we appreciate the checks and balance that are provided by the appropriations process, insufficient funding of OFHEO inhibited that agency's ability to properly supervise the GSEs.

Like the Corker/Warner bill, we support the creation of a board to govern the agency, the members of which would be appointed for staggered multi-year terms. Multi-year terms remove the members of the board from the shifting winds of politics. And a board, rather than a single director, ensures a greater continuity of policies and sufficient consideration of alternative perspectives. Care needs to be taken, however, not to micro-manage the qualifications for membership on the board. The goal should be to ensure that board members have sufficient experience and judgment to oversee the agency.

The Corker/Warner bill proposes different divisions to handle key duties of the agency. It calls for a division on underwriting, a securitization division, and a division to oversee the Federal Home Loan Banks. Creating separate divisions to focus on the unique issues within each of these areas is appropriate.

The Corker/Warner bill also proposes the establishment of advisory committees. We support the creation of advisory committees to help ensure regular contact with stakeholders to enhance the knowledge base of the agency and the quality of its activities. Indeed, we would recommend that the creation of advisory committees be mandated, since discretionary authorities can be ignored. FSOC provides an example of such a neglected authority.

We agree with the requirement in the Corker/Warner bill that the new regulatory agency have its own Inspector General. It is appropriate to provide for this oversight and prevent fraud and abuse. At the same time, care needs to be taken not to have the Inspector General become a "shadow" regulator by giving the Inspector General authority to review and second guess policy decisions of the board. The additional powers the Corker/Warner bill gives the Inspector General may tilt in that direction.

The Duties of the Federal Regulator

Let me now turn to the duties of this agency. We believe that the fundamental duty of the agency should be to ensure that the secondary mortgage market operates in a safe and sound manner. In other words, the new agency should be, at its core, a prudential regulator that ensures the integrity of the market and the solvency of the reserve fund that stands before a federal guarantee. If the agency performs this basic duty properly consumers, and the economy as whole, should enjoy a steady flow of reasonably priced conventional mortgage credit in all economic cycles.

As a prudential regulator, the agency should have the authority to set standards for the segment of the secondary market that is linked to a federal guarantee. That should include setting the boundaries of the acceptable credit terms associated with federally guaranteed mortgage securities. These boundaries, alone, should prevent the types of problems experienced by the GSEs. Also, to enhance the liquidity of federally guaranteed mortgage securities, the agency should establish the terms and conditions governing pooling and servicing agreements and should establish common terms and conditions for guaranteed mortgage securities. In other words, the agency should provide for the creation of a single form of guaranteed security that promotes a simple, liquid and transparent market. On the other hand, the agency should not have authority to set standards for the private label market. That market will not be supported by any form of federal guarantee and should be able to evolve independently. Indeed, effective operations in that market can serve as a signal on the health of the overall market to the new agency.

In exercising its standard setting authority, the agency should be required to seek public comment. While we give FHFA high marks for the manner in which the conservatorship has been conducted, many of the policy actions taken under the conservatorship have fallen outside the scope of the normal notice and comment process. Going forward, the basic standards and policy actions taken by the new agency should be subject to public notice and comment. This process will give all market participants and the public the opportunity to comment on proposals and decisions by the regulator and will increase confidence in the process and the decisions made by the regulator.

This federal regulatory agency also should have the power to federally charter, or otherwise certify, the key participants in the market for guarantee securities. In other words, the Congressional charters granted to the GSEs should be repealed and the entities that take their place should be subject to a chartering process similar to the chartering of a national bank or a federal thrift. This new regulatory chartering process will also eliminate the perception of the special status that the GSEs experienced through their unique charters.

The agency should have examination and enforcement powers, including resolution powers. Congress did give such authorities to FHFA in HERA, and those authorities should be extended to the new agency. Congress should also require the agency to have a concrete resolution plan for the successors to the GSEs so that all market participants can understand how they would be resolved, if necessary.

The agency should have rulemaking powers, including the power to set appropriate capital standards and the power to adjust conforming loan limits. Congress should resist hardcoding some standards, including capital standards, in law. Setting appropriate capital standards requires a complex analysis and detailed consideration of market conditions, as well as consumer impact. Moreover, setting specific standards into the statute could have unintended consequences in different economic cycles. Congress has long deferred to the expertise of the federal banking agencies to set the specific capital standards for banking firms. We believe that a similar approach should be applied to the firms that replace the GSEs. This discretionary authority also would permit the agency to adjust capital in periods of severe economic downturns to ensure that the market continues to function.

Likewise, Congress should give the new agency some flexibility to determine the point at which the federal guarantee on qualifying mortgage securities is triggered. This trigger point may differ for different structures. In other words, the trigger point for securities backed by a federally chartered guarantor may not be the same as the trigger point for a securities structure in which investors assume some first loss risk on those securities. However, whatever the triggering point is should be clearly disclosed to investors, and it should be clearly understood that the government guarantee stands behind private capital and a reserve fund that is funded by industry.

In those cases in which the agency is given some flexibility to set prudential standards, the agency should be required to explain its rationale for the standards and justify them. This could be achieved through regular reports to Congress.

The agency should have responsibility for the reserve fund that stands in front of the federal guarantee. This should include setting the price for the guarantee and the premiums to be paid into the reserve fund to ensure that private capital stands before the taxpayers. We strongly disagree with the assertion by some that such a fee structure cannot be priced to protect taxpayers. The FDIC's bank insurance fund serves as an example of a federal guarantee program that has never imposed a cost on taxpayers.

The agency should be authorized to oversee the establishment of a securitization platform for federally guaranteed securities. This platform should be used as the basis to securitize and manage a single agency security created by multiple participants. Such a platform would likely influence the private label market, but the issuers of private label securities should not be required to use the platform. While some issuers may choose to do so, it would be preferable to have separate and distinct platforms to maintain a clear distinction between guaranteed and nonguaranteed securities.

Finally, the agency should not be burdened with too many responsibilities that would detract from its basic prudential mandate. For example, we do not see the need for the agency to oversee a Mutual Securitization Corporation for smaller firms as long as a cash window is available for such firms The cash windows operated by the GSEs have provided smaller firms with full access to the secondary market, and the GSEs should continue to provide this function during the transition period. We would not, however, oppose the creation of a Mutual Securitization Corporation or similar facility it is deemed necessary.

More importantly, the agency should not have antitrust and market pricing powers, as implied by section 216 of the Corker/Warner bill. Other agencies already have sufficient antitrust powers, and pricing controls would only have a market distorting impact. Nor do we believe that the agency should be responsible for overseeing an electronic mortgage registry, as proposed in the Corker/Warner bill. This may be needed, but this authority would detract from what should be the prudential mandate of the new agency.

Our Vision of Reform

The model for the secondary market that we favor is a guarantor structure built around several privately-capitalized companies that would be chartered and regulated by the new agency. Under this model, lenders of all sizes and business models would originate mortgage loans that meet certain minimum standards and sell those loans to the guarantors in exchange for mortgage securities or cash. The federally chartered guarantor then would assume the credit risk on the securities.

The Corker/Warner bill also envisions a capital markets structure, in which any entity could issue government guaranteed mortgage securities provided the entity met appropriate standards, including the assumption of a first loss position. We have no objection to the inclusion of such an option in the legislation. However, we believe that there are significant impediments to its effective implementation, not the least of which is the ability for investors to assess the credit risk of the securities.

The Corker/Warner bill also provides that guarantors and issuers could be separate entities. Again, we have no objection to this option, but would note that separate entities would require separate capital structures and there are limits on the amount of private capital to support housing finance. Moreover, there are market efficiencies associated with the combination of the guarantor and issuance functions. Such a structure provides a single point of contact for lenders in the securitization process. Additionally, to the extent that the separation of these functions is based upon concerns related to market concentration, we would note that current accounting and capital rules would prevent an originator from controlling a guarantor since it is unlikely that the originator could gain "true sale" treatment for the mortgages it acquirers.

The securities issued under this model should carry an explicit "backstop" federal guarantee that ensures payments to investors in the event a guarantor could not perform on its guarantee. Guarantors would pay a fee for the federal guarantee and part of that fee would be placed into a reserve fund, administered by the federal agency. Guarantors also should be able to transfer the credit risk that they assume to other parties through reinsurance and capital markets structures. Additionally, as I previously noted, guarantors should maintain a "cash window" to purchase and to aggregate whole loans for smaller lenders. On the other hand, guarantors should not be permitted to engage in loan origination, mortgage servicing or speculate in mortgages or mortgage backed securities.

The securities created by guarantors would be run through a shared securitization platform. This shared platform would provide common administrative and systems support for the guarantors and would ensure that the securities have a single form with common terms and conditions.

While this model has some similarities to the existing GSE model, it differs in several key respects:

- *Market Distortions Created by "Implicit" Federal Support for the GSEs Eliminated* – Guarantors would not be granted any of the special privileges currently given to the GSEs under their Congressional charters (e.g., exemption from state taxation, line of credit with Treasury). The guarantors would be chartered by the federal agency, and the "explicit" federal guarantee provided under this model would apply only to the securities, not to any other debt or equity of the guarantors;

- *Systemic Risks Reduced Through More Limited Role In Securitization Process* – The role of the guarantors would be limited to credit enhancement and securities issuance. Other key processes associated with securitization would be performed by a shared securitization platform. This limitation on the functions of the guarantors reduces systemic risks and reduces barriers to entry.

- *Systemic Risks Reduced Through Limitations on Activities* -- Unlike the GSEs, guarantors could not establish portfolios to speculate in mortgages or mortgage securities;

- *Tensions Between Competing Missions Eliminated* – Guarantors would not be subject to specific housing goals, thereby avoiding the conflict that existed between the shareholders of the GSEs and the public mission of the GSEs;

- *Competition Enhanced Through Multiple Guarantors* – This model envisions more than just two guarantors. The mandatory use of a common securitization platform would reduce barriers to entry for entities seeking to act as guarantors since it would reduce the costs associated with designing and implementing key administrative functions associated with securitization. The new federal agency also should be encouraged to promote the development of multiple guarantors.

- *Prudential Regulation and Supervision Enhanced* – Guarantors would be subject to more stringent regulation and supervision than the GSEs, including heightened capital standards set by the new agency.

<u>Some Transitional Steps</u>

The transition to any new model for the secondary market will take some time. We commend FHFA for the key steps that it has taken in that process, including new risk sharing arrangements, adjustments to guarantee fees and proposed adjustments to conforming loan limits. We commend FHFA for the steps it has taken, and suggest the following additional actions during the transition to a new system:

- *Single Security* – FHFA could increase the liquidity in the current agency market and reduce taxpayer costs by creating a unified agency security that can be substituted for Fannie Mae MBS and Freddie Mac PCs (the terms and conditions applicable to this new security would then serve as a foundation for the standard securitization agreements applicable to guaranteed securities issued under our proposed new system);

- *Reps and Warranties* – FHFA has made some progress toward reforming representations and warranties applicable to mortgages sold to the GSEs. However, the rep and warranty framework continues to inhibit new loan generation, and requires additional reforms;

- *Risk-Sharing Structures* – FHFA should continue to develop risk-sharing arrangements with GSE securities to increase the level of private sector capital in front of the federal government. These structures could then be adopted by guarantors following the transition from the GSEs to the new model;

- *Data Disclosure* – FHFA has facilitated some greater data disclosure, but additional data on credit performance and loan loss severity is needed to attract investors to new risk sharing arrangements;

- *Guarantee Fees* – FHFA's efforts to induce or "crowd" private capital back to the market by increasing guarantee fees are not the only steps needed to entice additional private capital into the market. The obstacle to a more vibrant private market is not only price, but a more efficient securitization process. Additional increases in guarantee fees may only increase costs for consumers and profits for the GSEs; and

- *Conforming Loan Limits* – Gradually reducing the existing conforming loan limits and aligning the limits applicable to the GSEs and FHA. The reduction in the loan limits should be done with careful consideration of current market conditions.

<u>Conclusion</u>

The Housing Policy Council supports reform of the secondary mortgage market system. These reforms should create a system that can provide consistent availability of stable products like the thirty year fixed rate mortgage to American consumers by requiring more private capital and stronger protections for the taxpayer. A reformed system should include a government backstop behind layers of private capital and a strong prudential regulator to set standards and oversee the participants in a new secondary mortgage market system.

We look forward to working with the Committee in its efforts to produce bipartisan housing finance reform legislation. Thank you.