

Testimony of

Michael Middleton

On behalf of the

American Bankers Association

for the hearing

“Creating a Housing Finance System Built to Last: Ensuring Access for Community Institutions”

before the

*Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance and Investment*

United States Senate



American
Bankers
Association

Michael Middleton
On behalf of the
American Bankers Association
before the
Banking, Housing and Urban Affairs
Subcommittee on Securities, Insurance and Investment
of the
United States Senate
July 23, 2013

Chairman Tester, Ranking Member Johannis, my name is Michael Middleton, Chairman and Chief Executive Officer of the Community Bank of Tri-County in Waldorf, Maryland. I appreciate the opportunity to be here to represent the American Bankers Association (ABA) and present our views regarding reforming the government's role in secondary mortgage markets. 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.

The ABA commends Senators Corker, Warner, Tester, Johannis, Hagan, Heitkamp, Heller and Moran on the introduction of the Housing Finance Reform and Taxpayer Protection Act (S. 1217) to address the federal government's role in the mortgage market and resolve the longstanding conservatorship of Fannie Mae and Freddie Mac.

This bi-partisan legislation is a positive first step in what is certain to be a long process toward creating a sustainable, rational and limited role for the federal government in supporting and regulating a mortgage market that is appropriately and predominately filled by the private sector. The bill follows principles long advocated by the ABA, and builds upon the framework detailed by the Bi-Partisan Policy Center's Housing Commission, on which ABA's CEO, Frank Keating, served.

S. 1217 creates the Federal Mortgage Insurance Corporation (FMIC) which would serve as a public guarantor of eligible mortgages and a regulator of the issuers, aggregators and credit enhancers involved in a revised secondary market. The approach taken with the FMIC addresses a number of key concerns with the government's role in the housing finance markets. It provides a set of incentives to shrink the government's involvement, while establishing the structure for a liquid and private market.

We would also note that to fully protect taxpayers from additional losses like those suffered by Fannie Mae and Freddie Mac during the financial crisis, it will be necessary to impose similar reforms on the Farm Credit System, which continues to follow the discredited model of privatized gains and public losses which failed so badly in the housing sector. Without similar reforms to the Farm Credit System, it is only a matter of time until taxpayers again are put at risk.

The task ahead will not be easy. The mortgage market is a complex and intricate part of our nation's economy that touches the lives of nearly every American household. Fannie Mae, Freddie Mac, Farm Credit System and the Federal Housing Administration currently constitute the bulk of available financing for the American mortgage market. It is, therefore, imperative that reform be done so as not to inflict further harm on an already fragile housing economy and, most importantly, does not inadvertently harm creditworthy Americans who want to own a home. Reform must be deliberate, as the current situation is not viable for the long term. Addressing the many concerns and interests of a wide range of participants will require much negotiation, compromise and cooperation. There is much work yet to be done, but this bill is a solid foundation on which to begin the process.

In my statement today, I would like to make three key points;

- S. 1217 is consistent with principles long advocated by the ABA, and builds upon the framework for single-family housing finance detailed by the Bi-Partisan Policy Center's Housing Commission;
- S. 1217 moves to facilitate the reduction of the federal government's role in single-family housing finance; and
- Although S. 1217 addresses a number of key concerns with GSE reform, there remain a number of outstanding issues that must be addressed to ensure the viability of the new system and that the mortgage markets continue to function properly.

I. S. 1217 is Consistent with Principles Long Advocated by the ABA

ABA believes the government's role in housing finance must be dramatically reduced. It should be limited to ensuring access to the secondary market for lenders of all sizes and governmental agencies should not compete directly with the private market. This structure must provide for stability and accessibility of the capital markets in the event of a market failure.

S. 1217 is an important first step in addressing the role of the federal government in supporting and regulating mortgage markets. As Congress works to develop a consensus on broad reforms, ABA believes lawmakers should be guided by the following principles developed by the bankers serving on ABA's GSE Policy and Federal Home Loan Bank Committees:

1. The primary goal of any government-sponsored enterprise (or a GSE successor) in the area of mortgage finance should be to provide stability and liquidity to the primary mortgage market for low- and moderate-income families.
2. In return for the GSE (or a GSE successor) status and any benefits conveyed by that status, these entities must agree to support all segments of the primary market, as needed, in all economic environments.

3. Strong regulation, examination and authority for immediate corrective action of any future GSE must be a key element of reform.
4. Any GSE or successor involved in the mortgage markets must be strictly confined to a well-defined and regulated secondary market role and should not be allowed to compete with the private, primary market.
5. Any reform of the secondary mortgage market must consider the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks, their member's access to advances or to its mission as it has been defined and refined by Congress over time.
6. GSEs or successors must both be allowed to pursue reasonable risks, but the risk/reward equation must be transparent and more rigorously defined and regulated.
7. GSEs or successors must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.
8. A better alternative to arbitrary "skin in the game" is the establishment of strong minimum regulatory standards to assure sound underwriting for all mortgages, regardless of whether they are sold or held. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.
9. Accounting and regulatory changes should be developed to more appropriately reflect and align securitizations with underlying risks. True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures.
10. Affordable housing goals or efforts undertaken by the GSEs or successors should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects. GSEs or successors must provide for 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-sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to facilitate the ability of the primary mortgage market to provide credit for borrowers who have the credit and skill sets required to achieve and maintain homeownership. S. 1217 would replace Fannie Mae and Freddie Mac with a new federal guarantor, the Federal Mortgage Insurance Corporation (FMIC), modeled in part on the Federal Deposit Insurance Corporation (FDIC).

The FMIC is designed to provide fully-priced and fully-paid federal guarantees on securities backed by loans meeting specified requirements. By fully pricing the risks associated with insuring these mortgage

loans, the legislation addresses a key shortcoming that has plagued the existing system and provides for the development of a private market. For too long, the guarantee fees (G fees), paid to insure loans backed by the current GSEs, were too low—the compensation being paid for what amounts to full government backing was simply not priced correctly.

Although the conservator of the GSEs, the Federal Housing Finance Agency (FHFA) has raised the G fee to encourage development of the private market, and to begin to repay the government for its current support, more needs to be done both to protect taxpayers and to encourage the return of capital to the private market. G fees must be set high enough so that the private market will be able to price for risk in a fashion that allows for safe and sound investment and lending at a rate that is comparable (and eventually better) than the rate charged by the GSEs or any successor such as the FMIC. Such a structure also allows the FMIC tools to intervene if necessary in the event of crisis or market failure.

Underwriting will also play an important role in the proposed FMIC. The FMIC will only cover eligible loans that meet strict underwriting requirements. In order to be eligible a loan must have at least a 20 percent down payment as well as meeting Qualified Mortgage requirements. While we support this approach, we note that it does make it that much more essential for the Consumer Financial Protection Bureau to get the Qualified Mortgage rules right, and that banks be given the appropriate time needed to come into compliance with those rules.

Another provision of this legislation is the lowering of the maximum loan limit for eligible single family mortgage loans to a more reasonable \$417,000. The current maximum loan limit of \$625,500 in high cost areas and \$417,000 in all other regions is dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide. While some high-cost areas persist (and a recovery of the housing market will entail a hoped for stabilization and recovery in home values), the conforming loan limits for most of the nation should be reduced. This will assist the development of a private market for loans outside of the conforming loan limits as a step to a more fully private market for most loans.

The legislation allows the Federal Home Loan Banks (FHLBs) to continue their existing mission, providing a key source of liquidity to our nation's banks, while also allowing for the FHLBs to act as aggregators and issuers of securities guaranteed by the FMIC. The FHLBs play a vital role in the mortgage markets and community economic development that must be protected. This plan preserves the traditional advance business of the FHLBs and access to advances by their members, particularly for community banks which play a vital role in providing mortgage finance and economic development.

The bill would allow for a potential expansion of the role played by the FHLBs in housing finance if they choose to become aggregators and issuers for the FMIC. In doing so, the FHLBs would be required to establish a new subsidiary, authorized by this bill, which would be separately capitalized from the existing

FHLBs. The bill makes clear the intent that activities of any subsidiary are not part of the joint and several obligations applicable to the FHLB system. We support this intent and would like to work with the authors and the Committee to ensure that any necessary additional provisions to protect the existing FHLB system and its members which may be identified as the process continues are also incorporated. In particular, we emphasize that existing capital in the FHLB system is fully deployed, and as a general circumstance is a member asset that would not be available to capitalize new ventures.

The bill also provides for the creation of a mutual entity to ensure small-lender access to the capital markets if such access were not available through another issuer, or through a Federal Home Loan Bank issuer. Small-lender access to the secondary market is of vital importance. In order for community banks to remain competitive, they must have access to the liquidity provided by the secondary market on an equitable basis regardless of size, location or market served. We applaud the attention the bill pays to this concern, though we note that capitalization of a new cooperative owned by small lenders may pose a challenge. We also note that many community banks also have existing relationships with larger institutions which may choose to become issuers under the bill's provisions, while others engage in correspondent or other arrangements with larger institutions. FMIC is tasked with maintaining equitable access to the portals for smaller lenders. Preserving this multiplicity of access points will be important as the reform process evolves, and we want to work with the Committee to ensure that in establishing new structures and access points, existing relationships and mechanisms are not inadvertently harmed.

Similarly, we note that the bill would ensure that existing debt already guaranteed by Fannie Mae and Freddie Mac benefits from the full faith and credit of the United States. Because of the trauma suffered by the financial markets and the borrowers they served during the recent financial crisis, it is important to move forward in a cautious and well-considered fashion. By ensuring that currently guaranteed mortgages remain covered, this plan would prevent an unexpected shock that could destabilize mortgage markets.

II. S. 1217 would Reduce the Federal Government's Role in Housing Finance

ABA believes that the role of the government in housing finance should be dramatically reduced from its current level and a private market for the vast majority of housing finance should be fostered. The government's role should be limited to well-targeted borrowers and covered loans and ensuring stability and accessibility of the capital markets in the event of market failure. The proposed FMIC intends to reduce governmental involvement and foster private sector financing—ensuring that financing can involve private sector banks of all sizes. Multiple sources of liquidity for private market lenders will lead to a more diverse and ultimately safer housing financing system.

A well-regulated private market should be the desired financing source for the bulk of borrowers whose income and credit rating qualify them for conventional financing. Private markets function much more efficiently, better allocating the limited resources and credit. Additionally, a larger private market means fewer loans guaranteed by taxpayers, reducing the potential liability.

As proposed, the FMIC's role would be much more limited than the existing role of Fannie Mae and Freddie Mac. Currently, the GSEs undertake a wide set of mortgage market services, securitizing, bundling and issuing mortgage-backed securities. There is no reason for this function to be performed by a government entity. By limiting the FMIC's scope to simply insuring and regulating these markets, the bill creates the environment for a strong and healthy private market to perform the same function. And because the legislation requires participating private entities to take a first loss position ahead of any government guarantee provided by the FMIC, it limits taxpayer exposure.

The FMIC's role would be two-fold. It would insure the smaller set of covered loans, ensuring a liquid and resilient housing finance market as well as the availability of credit. Also important, would be its role as regulator. The FMIC would replace the Federal Housing Finance Agency, regulating the players in the new housing finance market. Strong regulation, examination and authority for prompt corrective action are key elements of any reform proposal and which, if implemented correctly, will also help to reduce taxpayer liability.

III. A Number of Issues Must be Addressed to Ensure Viability of the New System and to Allow Mortgage Markets to Function Properly

This bill is an important step in the right direction. In order for it to accomplish its goal of a more limited governmental role while also ensuring that mortgage markets continue to function properly, a number of outstanding issues must be addressed.

The first loss and capitalization requirements will limit the number of private entities participating in securitizations

A key concern is the ability of private sector entities to participate in the activities given the capital requirements set forth in the bill. Although the bill allows private entities to participate in the securitization, bundling and issuing of mortgage-backed securities, doing so requires a separately capitalized entity. These entities are required to have capital sufficient to cover any losses and are required to maintain a first loss position of not less than 10 percent of the face value of any covered security. At a time when the financial services industry is being asked to raise capital levels, it will likely be difficult, if not infeasible, for many potential participants to fund these separately capitalized entities and, thus, to participate.

Presently, a host of new banking regulations are coming into effect including Basel III and new leverage requirements—requiring banks to raise capital levels. ABA fears that few, if any, financial services institutions will have the free capital to fund a separately capitalized entity to undertake the securitization activities with the first loss positions required under the bill, particularly when other capital requirements are taken into consideration. Potentially, only a handful of large banks and other institutions with significant access to capital markets may be able to participate. This will only serve to further concentrate the industry. As previously noted, we also have similar concerns about the Federal Home Loan Banks’ and the proposed mutual entity’s ability to capitalize sufficiently to meet the bill’s requirements. This concern would extend to the other credit enhancers such as mortgage insurers and guarantors encompassed by the bill.

ABA supports the overall structure envisioned by the bill with the FMIC acting as a guarantor, and private entities acting as aggregators, issuers and credit enhancers, but we believe further work is needed in setting the appropriate level of first loss and capitalization required of these entities.

The FMIC should not serve as the regulator for the Federal Home Loan Banks

ABA also has concerns with tasking the FMIC with the regulation of the Federal Home Loan Bank System. While it is logical and prudent to have the FMIC regulate approved issuers under the new system, including any subsidiary of the Federal Home Loan Banks that serves as an issuer, we fear that having the FMIC regulate the entire FHLB System will create potential conflicts of interest that may harm the System and its members. Essentially the FMIC and its regulated entities will serve as a replacement for Fannie Mae and Freddie Mac. The Federal Home Loan Banks will continue in their traditional role, which means that they will function as a counterpart and, in some respect, competitive alternative to the FMIC. It is ill-advised to have one competitor regulate another. For this reason, we strongly urge that an alternative structure be considered for the regulation of the Federal Home Loan Banks in carrying out their traditional mission. One potential alternative is to keep that function as part of an ongoing single purpose Federal Housing Finance Agency.

A more thorough examination is needed on the FMIC’s role in multifamily housing finance

Although this bill moves to reform most aspects of the government’s involvement in housing finance markets, it would retain a large role for the FMIC in multifamily finance. Currently Fannie Mae and Freddie Mac play an outsized role in the finance of multifamily real estate. This bill does little to change that, other than to transfer existing authorities and activities from the GSEs to the FMIC. We believe that a more thorough examination is needed regarding the proper role of the government in the multifamily finance

market, and that additional legislation may be needed to more appropriately reform the multifamily housing market and the role played by the federal government in multifamily finance.

Conclusion

S. 1217 provides an important first step towards creating a sustainable, rational and limited role for the federal government in supporting and regulating a healthy mortgage market provided predominantly by the private sector. The mortgage market is an important part of our nation's GDP, which touches the lives of nearly every American family. As such it is important that these reforms are carefully considered, so as to ensure the continued functioning of the labor market.

We emphasize our caution that Congress be deliberate and reasoned in crafting such a monumental endeavor to avoid any disruptions of the nascent housing market recovery which would materially impact the nation's broader economic recovery.

ABA commends the authors of this legislation for approaching this difficult issue in a manner that encourages discussion and moves to the establishment of a healthy private mortgage market. The ABA stands ready to work with the authors and the entire Congress to achieve such ends.