Testimony of

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On Behalf Of the
National Association of Home Builders

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<u>Housing Finance – What Should the New System Be Able to Do?:</u>
<u>Part II – Government and Stakeholder Perspectives</u>

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Introduction

On behalf of the 175,000 members of the National Association of Home Builders (NAHB), I thank you for the opportunity to submit this statement on the issue of the future of the housing finance system. My name is Rick Judson, and I am a Charlotte, North Carolina-based home builder and the 2010 NAHB Third Vice Chairman of the Board.

Fannie Mae, Freddie Mac and the Federal Home Loan Banks have been, and remain, critical components of the U.S. housing finance system. Collectively, these organizations are called housing government-sponsored enterprises or GSEs. They were created by Congress to support mortgage market liquidity and help address affordable housing needs.

The GSEs have operated with implicit government backing that allows them to raise funds at favorable rates, which ultimately benefits mortgage borrowers. The housing GSE system functioned well for decades, but the past few years have seen unprecedented turmoil. Freddie Mac and then Fannie Mae were found to have serious accounting irregularities before both companies suffered financial problems that required them to be placed under government conservatorship and receive direct federal support. The Federal Home Loan Banks have experienced much less difficulty and continue to operate outside of direct government control.

The regulatory system for the GSEs also underwent a complete overhaul during this period, with all GSEs now under the oversight of a single regulator, the Federal Housing Finance Agency or FHFA. However, FHFA's regulatory reach has been constrained due to Fannie Mae's and Freddie Mac's conservatorship status and the significant role that Fannie and Freddie have been assigned in supporting mortgage markets and mitigating mortgage foreclosures.

One thing that is clear is that the status quo cannot be maintained. Policy discussions are underway on what should become of Fannie Mae and Freddie Mac following the current, still-indefinite conservatorship period, and what, if anything, should change in the structure and operation of the Federal Home Loan Banks. A key consideration is how to get from the current structure to a future arrangement without undermining ongoing financial rescue efforts and disrupting the operation of the housing finance system.

Flaws in the Current Housing Finance System

The causes of the severe problems that have plagued the housing finance system and broader financial markets have been extensively discussed. NAHB members have identified a number of system flaws that should be considered in overhauling the present framework:

- Underwriting standards and decisions based on expectations of rising collateral value rather than documented borrower credit and repayment capacity.

- Inappropriate focus on fee income rather than mortgage quality.

- Too little concern with credit (as opposed to interest rate) risk.

- Excessive risk-layering in mortgage lending.

- Inadequate regulation of mortgage originators.

- Consumer attitude that a house is a commodity.

- Financing standards and decisions that permitted excessive speculative buying by investors seeking short-term profits.

- Flawed evaluation/appraisal process which increased price volatility.

- Departure of Fannie Mae and Freddie Mac from their core, and previously successful, business model of mortgage securitization to engage in investing in securities backed by Alt-A, subprime and other non-traditional mortgages.

- Limited accountability and liability for mortgage originators and securities issuers.

- Lack of transparency for investors in mortgage-backed securities.

- Rating agency conflicts of interest and lack of oversight.

While not all of these problems can be addressed directly in overhauling the housing GSEs, they are issues that should receive careful examination as GSE restructuring is undertaken in conjunction with other housing finance and financial system reforms.

NAHB Position

NAHB has had a strong and longstanding interest in the maintenance of an efficient secondary mortgage market and the role of the GSEs in facilitating the flow of capital to housing. Last year, NAHB developed principles for reconstituting and improving the housing finance system that included provisions dealing with the secondary mortgage market and the future of the housing GSEs. NAHB recently developed some specific proposals related to the portion of the secondary market involving Fannie Mae and Freddie Mac and is in the process of refining policy recommendations dealing with the Federal Home Loan Bank System. These recommendations are summarized under the following major policy considerations.

Degree and Structure of Government Support

NAHB believes that it is crucial for the federal government to continue to provide a backstop for the housing finance system to ensure a reliable and adequate flow of affordable housing credit. The need for such support is underscored by the current state of the system, where Fannie Mae, Freddie Mac, the Federal Home Loan Banks, the Federal Housing Administration and Ginnie Mae are the only conduits for residential mortgage credit. NAHB feels the federal backstop must be a permanent fixture in order to ensure a consistent supply of mortgage liquidity as well as to allow rapid and effective responses to market dislocations and crises. With regard to the future of Fannie Mae and Freddie Mac, however, NAHB recommends major changes in terms of structure and operations.

NAHB believes the secondary market should encourage a number of private entities to compete in a manner that facilitates innovation and efficiency. While government support is needed to ensure that mortgage credit is available and affordable in all areas of the country under all economic circumstances, for the conforming conventional portion of the mortgage market, that support should not be provided directly to private companies. Rather, the federal government should provide an explicit guarantee of the timely payment of principal and interest on securities backed by conforming conventional mortgages, in the same manner that Ginnie Mae now provides guarantees for investors in securities representing interests in government-backed mortgages.

The operation of the new secondary market for conforming conventional mortgages is illustrated in the diagram attached to this statement.

Operation of the Conforming Conventional Mortgage Market

Private companies, called conforming mortgage conduits (CMCs), would be chartered to purchase conforming conventional mortgages that are originated by approved mortgage lending institutions such as banks, savings and loan associations, mortgage banking companies, and credit unions. CMCs would issue securities backed by those mortgages, which would carry a federal government guarantee of the timely payment of principal and interest for the securities investors.

CMCs would guarantee the timely payment on the mortgages that are pooled in the government-guaranteed securities. However, CMCs, and the mortgages backing their securities, would not have implicit or explicit support from the federal government. CMCs would be required to be well-capitalized and to maintain reserves at levels appropriate for their risk exposure. CMCs would also pay fees in exchange for their securities receiving a federal guarantee. Those fees would capitalize an insurance fund, similar to that maintained by the Federal Deposit Insurance Corporation for insured depository institutions, which, along with CMC reserves and private mortgage insurance coverage, would cover loss exposure on the mortgages in the CMC securities. The federal government, therefore, would only be called on to support the conforming conventional mortgage market under catastrophic situations, when the capital and insurance of the securities issuers and the resources of the CMC mortgage insurance fund have been depleted.

Conforming Conventional Mortgages

Mortgages eligible for inclusion in securities receiving an explicit federal guarantee should be those with tested and well-understood features and well-known risk characteristics, including fixed-rate mortgages, standard adjustable rate mortgages and select multifamily mortgage loans. These mortgages would satisfy the following criteria:

- There should be continued availability of financing for long-term (at least 30-year) fixed-rate mortgages.
- Mortgage maturities should also be available for longer than 30 years.
- There should not be overly rigid adherence to loan-to-value limits that results in inappropriate rejections of creditworthy borrowers.
- Mortgage originators, lenders and investors should have appropriate accountability and liability for the instruments in which they are involved.
- Underwriting standards and decisions should be based on documented borrower credit and repayment capacity rather than expectations of rising collateral value.
- Underwriting decisions should be based on mortgage quality and not driven by fee income.

The characteristics of a conforming conventional mortgage would be established in broad terms by Congress, with CMCs developing specific mortgage programs under the oversight of their regulator. The maximum amount of a conforming conventional mortgage would continue to be determined by statute. The current limit is 125 percent of the median area home price, not to exceed $729,750 but with no area having a limit below $417,000.

Regulatory Oversight

There should be separate regulatory oversight for the primary and secondary mortgage markets. CMCs should operate under the diligent oversight of a regulator charged with ensuring the CMCs are conducting their business in a safe and sound manner, have adequate capital reserves, and are meeting housing mission requirements established by Congress.

Mission Focus

The primary mission of CMCs should be to support mortgage market liquidity in a safe and sound manner. These entities should focus on a core business of securitizing mortgages. However, their activities should be directed at a broad range of housing market needs, to enable all Americans at all income levels to achieve decent, safe and affordable housing.

Capital and Portfolio Requirements

CMCs should have capital requirements that ensure their safety and soundness. These requirements should include minimum as well as risk-based capital thresholds.

CMCs should be permitted to hold a portfolio of loans sufficient to facilitate transactions as well as loans, including housing production loans, which do not have a secondary market outlet.

The Federal Home Loan Bank System

NAHB is in the process of updating its policy regarding the future of the Federal Home Loan Bank (FHLBank) System but continues to support a number of basic principles with regard to the FHLBanks. NAHB views the FHLBank System as an essential component of the U.S. housing finance framework that has served as a key source of liquidity for institutions providing loans to home buyers and home builders as well as credit for community and economic development. The fact that each of the twelve FHLBanks is owned cooperatively by its financial institution members, and that increases in member borrowing from a FHLBank require members to purchase additional FHLBank stock, ensures there is adequate capital reserves in the FHLBank System through all stages of economic cycles. NAHB notes that the FHLBank System, while benefiting from an implicit federal government guarantee, is self-supporting, through funding raised by issuance of securities backed collectively by all twelve FHLBanks, and has never required infusions of taxpayer funds.

During the recent period of mortgage and financial market turmoil, the FHLBanks played a vital role in sustaining mortgage liquidity for depository institutions. The FHLBanks increased their loans to member institutions by a third between year-end 2006 and year-end 2008, a period where financial markets worldwide were at the brink of collapse. The FHLBanks also contribute 10 percent of their net income for an affordable housing program that is an important source of support for affordable housing production for homeowners and renters.

The FHLBanks are significantly different from Fannie Mae and Freddie Mac in structure and operations and these differences should be acknowledged and respected during the consideration of the future structure of the housing finance system. NAHB urges policymakers to undertake any changes to the housing finance system in a manner that will not diminish the favorable cost of funds for the FHLBanks or impair the role of the FHLBanks in supplying liquidity to institutions providing mortgage and housing production credit, support for community and economic development, and resources to address affordable housing needs. In addition, NAHB believes that the future regulation of the mission and safety and soundness of the FHLBank System should reflect the uniqueness of the System's mission, cooperative operating structure, charter type and other characteristics.

Transition Considerations

Fannie Mae and Freddie Mac are operating under conservatorship and experiencing severe financial pressures, and the private component of the conventional secondary mortgage market is not functioning at all. In addition, the housing and economic recovery is still sputtering and is vulnerable to relapse, while surging mortgage defaults and foreclosures continue to absorb a major portion of the resources of the current finance system as well as the attention of policy makers. Under these circumstances, finding a means of moving to a new secondary market framework may be as great, or greater, a challenge as developing the new conforming conventional secondary market structure. NAHB urges Congress to carefully consider and address the short-term, unintended consequences that could occur during the transition to a new housing finance system. Any changes should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is abandoned and a new system is put in place.

Conclusion

Thank you for the opportunity to participate in this important and timely hearing. NAHB looks forward to working with all stakeholders to develop an effective as well as safe and sound means to provide a reliable flow of housing credit under all economic and financial market conditions.

Conforming Conventional Mortgage Secondary Market