HOUSING POLICY COUNCIL

Testimony of
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on behalf of
the Housing Policy Council
of the
Financial Services Roundtable

Before the House Financial Services Committee
Of the
United States House of Representatives
On

Housing Finance – What Should the New System Be Able to Do: Part II
Government and Stakeholder Perspectives

April 14, 2010

Mr. Chairman and Members of the Committee, my name is Anthony T. Reed, and I am the Executive Vice President for Capital Markets with SunTrust Mortgage, Inc. I am appearing today on behalf of the Housing Policy Council ("HPC") of The Financial Services Roundtable. The Housing Policy Council represents 26 of the leading national mortgage finance companies. HPC members originate, service and insure mortgages. We estimate that HPC member companies originate approximately 75 percent of all mortgages originated in the U.S. and service some two-thirds of those mortgages.

Introduction

Thank you for the opportunity to testify on the future of the housing finance system. The recent crisis in our financial system revealed several problems with the existing system. Lenders and securitizers relaxed underwriting standards and risk management practices. Gaps in regulation permitted bad practices to multiply. Inherent flaws in the structure and operation of Fannie Mae and Freddie Mac (the "GSEs") contributed to the collapse of these firms.

The members of the Housing Policy Council have taken a number of actions to address these problems.

First, to help homeowners, HPC was instrumental in the formation of HOPE NOW, a voluntary private sector alliance formed to prevent foreclosures through outreach to at-risk homeowners, counseling and loan workouts. Since 2007, this private sector initiative has resulted in more than 6.7 million workout solutions, including almost 2.7 million loan modifications. Servicers completed 95,000 proprietary modifications and 53,000 permanent HAMP modifications in February 2010. Details on this initiative appear in Appendix A.

Second, our members have taken steps to improve underwriting standards, and HPC has supported actions taken by federal regulators to strengthen underwriting standards. We have also endorsed the establishment of some form of risk retention requirement for loan originators and securitizers for certain types of securitized loans. Recent changes to accounting standards suggest, however, that this issue requires some further analysis to avoid unintended constraints on mortgage finance. This issue is discussed in Appendix B.

Finally, over the past year, we have developed a proposal to revitalize the secondary mortgage market for conventional mortgage loans, which I would like to describe to the Committee in some detail.

Reform of the Secondary Mortgage Market

Fannie Mae and Freddie Mac (the GSEs) were established by Congress to facilitate and support a consistent secondary market in conventional mortgage loans. This secondary mortgage market has become an essential feature of our system of housing finance. It has produced a steady supply of mortgage finance for homebuyers by allowing lenders to convert mortgage loans into highly liquid mortgage backed securities (MBS) for purchase by investors. It permits lenders to take individual loans off their balance sheets thereby freeing capital to make new loans. The secondary mortgage market also has permitted the development of mortgage instruments with special benefits for U.S. home buyers, such as the 30-year fixed rate mortgage.

For many years, and even throughout the financial crisis, the GSEs performed their secondary market functions efficiently and effectively. The crisis, however, revealed several fundamental flaws in the mandate and operational structures of the GSEs. First, ambiguity over the relationship between the GSEs and the Federal Government caused investors to conclude that the government stood behind Fannie Mae and Freddie Mac as companies, despite the absence of any legal responsibility to do so. Second, there were inherent conflicts between the interests of private shareholders and the public mission of the GSEs. Finally, a lack of adequate supervision and regulation created the opportunity for the GSEs to employ excessive leverage and to grow their portfolios in excess of what was necessary to achieve their original objectives.

In order to ensure the continued vitality of the secondary market, these flaws in the structure and mandate of the GSEs must be addressed. This also presents Congress with an opportunity to make significant improvements in the operation of the secondary market that will benefit homeowners and the economy.

We believe that reform of the secondary market should be based upon three policy goals. First, reform should continue to ensure a steady flow of reasonably priced housing finance for borrowers, and should not disrupt the economic recovery. Second, reform should minimize risk to taxpayers. In other words, it should be clear that the Federal Government does not stand behind the companies that succeed the GSEs. Third, reform should include some mechanism to ensure a flow of funding to contribute to affordable housing.

The Housing Policy Council has developed a proposal based upon these goals. Our proposal seeks to achieve these goals through reliance on private capital, a clear delineation of the roles of the private sector and the Federal Government in the securitization process, and the transfer of a stream of funding to affordable housing. We also recommend strong federal regulation and oversight of this system.

Additional opportunities to improve the housing finance system can be found by separating the main functions performed by the GSEs. Traditionally, the GSEs have performed four basic functions: (1) they convert pools of mortgage loans into mortgage backed securities (i.e., a securitization function) and they administer the flow of payments from lenders/servicers to MBS investors; (2) they guarantee the payment of principal and interest on mortgage backed securities in return for a fee paid by lenders (i.e., a credit enhancement function); (3) by purchasing and holding mortgages and mortgage backed securities in their portfolios, they help to ensure a steady flow of funding for mortgages (i.e., a liquidity function); and (4) through the statutorily mandated housing goals, they help to ensure mortgage financing for all categories of borrowers (i.e., an affordable housing function).

Separating and isolating these functions helps address the problems inherent in the current structure of the GSEs and facilitate additional improvements in the operation of the secondary market. It permits each function to have the appropriate management, regulation, ownership, and incentives.

To perform the credit enhancement function, we propose the creation of federally chartered but privately-owned Mortgage Securities Insurance Companies (MSICs).

To perform the securitization function, we propose the establishment of a single Mortgage Backed Security (MBS) Issuance Facility that would create and administer MBS guaranteed by the MSICs.

In exchange for their federal charter, we recommend that MSICs should be required to contribute a stream of revenue that would be distributed to state and local housing finance agencies by formula to support competitively evaluated affordable housing programs.

As for the liquidity function currently performed by the GSEs, the recent financial crisis has demonstrated that the Federal Government is fully capable of performing this function in times of market stress. Moreover, it is now apparent that the portfolios of the GSEs were not used solely to provide liquidity for housing finance, but became a source of investment income for the GSEs and the desire to preserve this income contributed to their problems. Therefore, any successors to the GSE should not be required or permitted to maintain large portfolios.

Appendix C illustrates this proposal, and describes the roles and responsibilities of the different parties in the secondary market process.

A Private Sector Solution to Minimize Taxpayer Exposure

Under our proposal, the credit enhancement function of the GSEs would be performed by privately capitalized entities, MSICs that would be chartered and supervised by the Federal Housing Finance Agency (FHFA). These MSICs themselves would not have a Congressional charter and they would not be explicitly or implicitly backed by the Federal Government.

Attracting sufficient private capital to these entities is essential to the implementation of our proposal. As a result, we have not recommended or endorsed a particular organization structure for the MSICs. Instead, we believe the investors should be able to determine the most appropriate structure for a MSIC. The structure would be reviewed by the regulator (FHFA) as part of the charter process. Nonetheless, we recognize that the structure most likely to generate needed start-up capital could be a cooperative structure in which lenders that wish to securitize mortgages would be required to contribute capital to the MSIC. Appendix D summarizes the advantages and disadvantages of different organizational structures.

Similarly, we do not call for a specific limit on the number of MSICs. We believe that at least 4 would be preferable to serve the market, but probably not more than 8 would be needed or competitive. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one company. On the other hand, too many MSICs with different underwriting systems and procedures could be overly burdensome to lenders, particularly smaller lenders. A useful real world model is the private mortgage insurance industry, which provides a credit enhancement function similar to the function performed by MSICs. There are now 8 firms in that space.

MSICs would be regulated and supervised by an independent federal agency, presumably the FHFA, with additional authority. To help ensure the safe and sound operation of MSICs, we propose several specific types of regulation.

- Strong capital and liquidity requirements – In hindsight it is clear that the GSEs were permitted to operate with insufficient capital and liquidity. We believe that FHFA should impose, by regulation, strong capital and liquidity requirements on MSICs.
- Underwriting Standards for Mortgages in MBS – We propose that FHFA set standards on the type of mortgages that could be included in the MBS insured by a MSIC. These standards should provide that the mortgages in a MSIC-insured MBS are prudentially underwritten. In other words, we envision the MSICs as the guarantors for MBS backed by conventional

mortgages. MSICs could not insure MBS composed of mortgages that do not meet the standards set by FHFA.

- Loan Limits – FHFA would set, by regulation, limits on the size of mortgages that could be included in MBS insured by a MSIC.

Unlike the GSEs, MSICs should not be permitted to establish and hold portfolios purely for investment purposes. Small portfolios should be permitted to facilitate the development of new products and certain types of loans for which there are limited markets such as multifamily mortgages. MSICs also could use their portfolios to warehouse whole loans from smaller banks prior to securitization.

Ensuring a Steady Flow of Mortgage Finance at Reasonable Rates

While MSICs would not be backed by the Federal Government, our proposal does call for the Federal Government to provide an "explicit" backup-guarantee directly on MBS that are insured by the MSICs. To be clear, this catastrophic guarantee would not apply to the MSICs themselves; it would apply only to the MBS that they guarantee.

This explicit guarantee for MBS is needed to give the broadest possible range of MBS investors confidence in these securities and to help ensure a steady flow of mortgage finance at a reasonable cost to borrowers. Without such a guarantee, investors in MBS (especially pension funds, insurance companies, banks and foreign governments that have fiduciary obligations) will seek other investments, and as they do so, the level of funds available for housing finance will be reduced and the cost of mortgage loans will increase. Moreover, as the recent crisis showed, in times of market stress even well-capitalized firms can find that funding becomes prohibitively expensive or even inaccessible, and this can prevent them from continuing to provide new credit when borrowers need it.

We would limit the government's guarantee to a form of catastrophic "reinsurance." In other words, the government's guarantee should cover interest and principal payments on MBS **only** after all private capital backing an MBS is exhausted. A MSIC would pay a fee for the government guarantee on the MBS and the fees paid by all MSICs would be placed in a reserve that would provide an additional buffer between private capital and the federal guarantee.

The private capital standing before the government's guarantee would be:

- The down payment on a mortgage made by the homebuyer;
- Any private mortgage insurance on the mortgage loan (if the LTV is greater than 80 percent);
- The shareholders equity in the MSIC; and
- The reserve established by fees paid by MSICs in return for the government's guarantee.

These layers of private capital should insulate the Federal Government from paying claims on its guarantee.

The explicit guarantee is intended to be budget neutral. The fees paid by MSICs for the guarantee would be deposited into a reserve, and, assuming the fees are priced properly, the reserve would cover any payments made by the government under the terms of the guarantee. FHA and Ginnie Mae are models for the budgetary treatment of this fee structure. Under existing federal credit procedures, the cost of federal credit activity in a budget year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in that year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover the cost of loan defaults. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee normally cover claims on the guarantees and other operational expenses.

We recognize that catastrophes do happen, and some day the Federal Government may have to make good on the guarantee. Should this occur, we would support some form of assessment upon the industry to recoup any costs incurred by the government.

Ensuring Funding for Affordable Housing

We propose that, in exchange for their federal charter, MSICs be required to transfer a specified percentage of revenue to affordable housing programs, much like the Federal Home Loan Banks do today. We do not support the extension of the existing numerical GSE housing goals. Those goals created conflicting incentives for the GSEs. In contrast, the FHLB Affordable Housing Program (AHP) has been a successful model for supporting affordable housing. The funds for affordable housing could be distributed under an application and grant program similar to the FHLB program, or could be transferred to HUD for subsequent distribution by formula to state and local housing finance authorities.

Centralized Securitization and a Single MBS

Our proposal also calls for the creation of a single MBS Issuance Facility to perform the securitization function currently performed by the GSEs. This entity would accept pools of loans from originators and exchange those loans for MBS. It would then process payments on those MBS from the lenders/servicers to the investors. It also would place and administer the federal catastrophic guarantee on the MBS. In other words, it would perform similar functions to those performed by Ginnie Mae today for FHA.

This Issuance Facility also will permit the creation of a single MBS. Today, there are some differences in the terms and repayment characteristics of the MBS marketed by the two GSEs which from time to time result in differences in market liquidity. We propose that all MSICs be required to adhere to a standard form of MBS that has the same repayment terms and other conditions. A common – or single MBS – would promote better understanding of the MBS by investors, and it would enhance the liquidity of the market. This would help ensure home buyers consistent access to reasonably priced home finance.

A single MBS does not mean that all MBS would be composed of the same type of mortgages, only that the basic legal structure, terms and conditions governing repayment and other administrative features of the MBS would be the same. MBS backed by MSICs could be composed of loans from a single lender or multiple lenders, allowing lending institutions of all sizes access to this liquidity. Above all, these MBS should not in any way interfere with the “To Be Announced” (TBA) securities market which the lending industry relies on to reduce risks in the origination process and reduce borrowing costs.

Whether this Facility is part of the Federal Government or owned by the private sector may depend upon how its operations might be reflected on the federal budget.

Transitional Issues

The transition from the current GSE structure to this new structure must be conducted with care to ensure the continuity of mortgage finance. Moreover, the existing operations of Fannie Mae and Freddie Mac should serve as the foundation for this new structure. The GSEs have personnel and systems that should be retained in the transition from the current system to the new system. As a first step, the securitization functions of the two GSEs could be transferred to the MBS Issuance Facility. Subsequently, the GSEs could become MSICs after a solution is found for their existing portfolios.

Conclusion

Thank you for the opportunity to testify on the future of mortgage finance. We believe our proposal accomplishes four main goals: (1) ensures a stable secondary market to provide liquidity for mortgage loans to Americans; (2) addresses key weaknesses of the current model; (3) minimizes the risk to taxpayers; and (4) ensures a flow of funding to contribute to affordable housing. The members of the Housing Policy Council are committed to the issues I have discussed today, and welcome the opportunity to work with the Committee as it develops its own proposals and reforms.

Appendix A
Foreclosure Prevention

Since 2004, foreclosure prevention has been a top priority for the Housing Policy Council. In 2005, HPC partnered with the Homeownership Preservation Foundation and NeighborWorks America to reach and assist homeowners struggling with their mortgages. In 2007, HPC was instrumental in forming a voluntary private sector alliance of mortgage lenders and servicers, mortgage insurers, investors, and not-for-profit housing counselors to help homeowners avoid foreclosure. This private sector effort pre-dated – and has supplemented and complemented – the administration's Home Affordable Modification Program or HAMP.

HOPE NOW reaches at-risk borrowers through a variety of channels. In 2009, HOPE NOW sponsored 31 homeownership workshops across the country, at which over 31,000 homeowners obtained free counseling and were able to work with their loan servicers. In 2010, there have been 10 homeownership events that reached over 10,600 homeowners and an additional 16 are schedule for the rest of 2010. Since November 2007, HOPE NOW has sent nearly 5.7 million letters to delinquent borrowers with information on how to contact their lender or a credit counselor. HOPE NOW also operates a web-based portal that allows HUD-approved housing counseling agencies to work with at-risk homeowners to submit completed HAMP applications to servicers in a secure manner. HOPE NOW also supports the Homeownership Preservation Foundation's Homeowners' HOPE™ Hotline, 888-995-HOPE, which connects borrowers to one of 450 counselors from one of ten non-profit, HUD-approved counseling agencies. Since its establishment, the Hotline has received over 3.8 million calls and counselors have assisted over 840,000 homeowners in need. Finally, HOPE NOW continues to partner with NeighborWorks America and other HUD-approved counselors to provide in-person counseling to borrowers in need.

These outreach efforts have helped thousands of homeowners. In February of this year, for example, over 95,000 homeowners received proprietary loan modifications which are in addition to the

50,000 permanent HAMP modifications completed by servicers. In other words, in February, 145,000 homeowners received loan modifications that enabled them to avoid foreclosure and stay in their homes. Approximately 78 percent of the proprietary loan modifications completed in February included a reduction of principal and interest. These loan modifications resulted in lower monthly payments for at-risk borrowers- the kind of sustainable loan mods that are necessary to help whether the housing crisis..

With almost 4 million loans currently in default, the work of HOPE NOW is far from over. Yet, since 2007, this private sector initiative has resulted in more than 6.7 million workout solutions, including almost 2.7 million loan modifications. Mortgage servicers and housing counselors have worked extremely hard through aggressive borrower outreach. The member companies of HOPE NOW remain determined to keep as many families as possible in their homes. Table 1 summarizes the total workout solutions generated through HOPE NOW since its inception in 2007.

Table 1

HOPE NOW
Total Solutions
Industry Extrapolations (July 2007 - February 2010)

WORKOUT PLANS (Non-HAMP)[1]

	Q3-Q4 2007	2008	2009	Dec-09	Jan-10	Feb-10	**Total**
Total Workout Plans	912,671	2,258,603	3,140,177	236,263	237,532	226,926	**6,775,908**
Prime	380,858	941,247	1,871,136	151,338	149,137	146,523	3,488,901
Subprime	531,813	1,317,356	1,269,041	84,926	88,395	80,403	3,287,007
Owner-Occupied				216,937	221,871	176,762	615,571
Non-Owner Occupied				18,986	15,604	14,046	48,637
Repayment Plans Initiated[2]	706,431	1,297,248	1,964,822	131,841	138,033	131,339	**4,237,872**
Prime	314,510	674,270	1,374,414	98,224	104,058	101,331	2,568,582
Subprime	391,921	622,978	590,407	33,617	33,975	30,008	1,669,290
Owner-Occupied				122,367	129,413	88,238	340,018
Non-Owner Occupied				8,724	8,589	7,034	24,348
Modifications Completed[3]	206,240	961,355	1,175,355	104,423	99,499	95,586	**2,538,036**
Prime	66,348	266,978	496,722	53,114	45,079	45,192	920,319
Subprime	139,892	694,377	678,634	51,309	54,420	50,394	1,617,717
Owner-Occupied				94,571	92,458	88,524	275,553
Non-Owner Occupied				10,263	7,015	7,011	24,289

[1]Based on "MBA Delinquency Survey" for Q4-2009. MBA 85% of the market. MBA estimates that its survey covers approximately 85% of the total industry. HOPE NOW data estimates for January and February 2010 may increase or decrease slightly when the MBA releases its Delinquency Survey data for Q1-2010.

[2]Definition of this field was revised in December 2009. HOPE NOW also began collecting Occupancy data at this time.

[3]Modifications Completed was revised in December 2009 to include Current Modifications and specifically exclude HAMP.

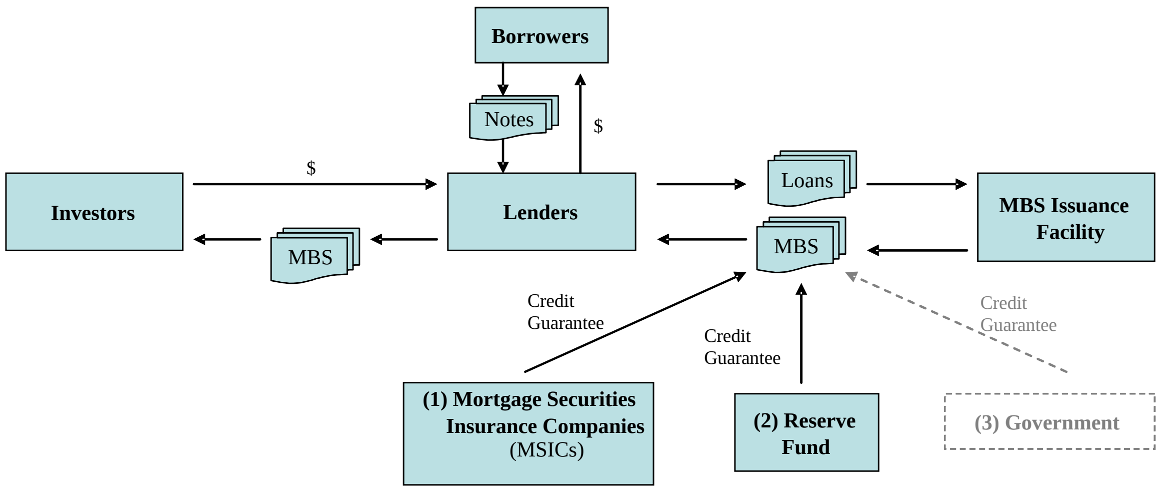
Appendix B
Strengthening Loan Origination Standards

To encourage greater accountability on the part of loan originators and securitizers, HPC supports strengthening underwriting standards and also supports the idea of credit risk retention for certain types of securitized loans. However, the recent adoption of new accounting standards for securitizations (FAS 166 and 167) has created substantial doubt on the efficacy of a broad, across-the-board risk retention requirement. As a result of these new accounting standards, we now believe that the better approach to addressing underwriting and risk management practices is to establish strong uniform underwriting standards for all originators.

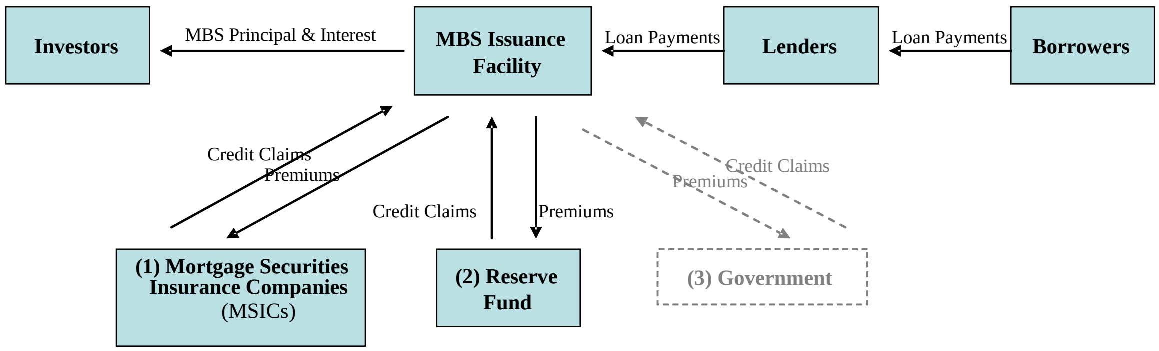
Under FAS 166 and 167, originators must retain the entire credit risk of the securitization vehicle on their balance sheet if they retain a “material” risk of loss on loans transferred. Unfortunately, there is no bright line test for what constitutes the retention of a “material” risk. It seems clear, however, that if servicing rights are retained, *any* percentage interest retained will cause the entire risk to be placed on the balance sheet of the originator. This, in turn, would require lenders to consolidate on its balance sheet all loans securitized through this structure and to also possibly hold additional capital. While it is difficult to calculate the magnitude of this capital requirement, it could be so large that it could result in a dramatic reduction in the amount of mortgage credit available to borrowers. Sound underwriting standards applicable to all lenders could achieve the same result as a percent risk retention requirement, without risking a substantial contraction in mortgage finance.

Appendix C
Proposed Secondary Mortgage Market Model

I. Flow of Mortgage Finance



II. Flow of On-Going Payments



III. Roles and Responsibilities of Parties

Borrowers
- Obtain funds from lenders
- Make loan payments to their lender/servicer

Lenders
- Exchange qualified mortgage loans for mortgage backed securities (MBS) with the MBS Issuance Facility
- Sell MBS to investors
- Service loans (i.e., collect payments from borrowers) or sell servicing rights to others

MBS Issuance Facility
- Convert qualified mortgage loans into MBS
- Administer flow of payments between parties (master service)

MSICs
- Pay for all credit losses on MBS after mortgage insurance
- Receive premiums from lenders for insuring MBS
- Pay a premium to the government for backstop guarantee of MBS

Government
- Receive fees from MSICs in exchange for backstop guarantee of MBS
- Pay for credit losses in the event of MSIC bankruptcy

Appendix D
Alternative Organizational Structures

Organization	Ownership Structure	Advantages	Disadvantages
Fannie and Freddie	Private sector shareholders, but the President appointed 5 of the 18 directors and the entities were exempted from state income tax and certain federal securities laws	• Attracted sufficient private sector capital for operations • Was conducive to innovation and efficient operations	• Implicit federal guarantee of entities distorted market • Conflict arose between interests of private investors and public mission
Co-op	Owned by lenders	• Lenders have a vested interest in managing properly • Conducive to innovation and efficient operations • Individual lenders can control their capital commitment if ownership is linked to volume of loans sold to the co-op • Freddie once operated in co-op form	• Requires good collaboration among lenders • Could exacerbate consolidation of industry and benefit larger lenders over small lenders • Limiting ownership to lenders would limit potential pool of capital needed to operate co-op
Utility	Private sector shareholders subject to regulated limits on returns, and entity potentially subject to greater limits on activities	• Reduces incentives for risk-taking • Promotes standardization of mortgage products • Transparency	• Could limit potential pool of capital needed to operate company • Reduces incentives to innovate and improve process • The ability to achieve "stable" returns is questionable • If only one or two entities, they could be viewed as "too big to fail"
Corporation	Private sector shareholders	• Promotes innovation and efficient operations • If multiple entities, they would reduce systemic risk • Activities directed by customer needs	• Too many entities could complicate process/systems, especially for smaller lenders • Search for higher returns intensified
Government	Government agency or authority	• Easy transition from current system • Eliminates challenge of private capital raising • Promotes standardization of mortgage products	• Reduces incentive to control costs • Innovation and efficiency reduced • Potential impact on federal budget • Creates a new bureaucracy

HOUSING POLICY COUNCIL
THE FINANCIAL SERVICES ROUNDTABLE

MOVING BEYOND FANNIE MAE AND FREDDIE MAC: A PROPOSAL FOR NEW PRIVATELY CAPITALIZED ENTITIES THAT FACILIATE A SECONDARY MARKET FOR CONVENTIONAL MORTGAGES

Our Goal: Maintain consistent affordable access to 30-year fixed rate mortgages and other prudent mortgage loans in a way that minimizes taxpayer exposure.

Minimize Risk to Taxpayers

- Eliminate hybrid GSE structure and remove the implicit federal support for the GSEs.
- Create a new form of privately-capitalized, federally-chartered entities to credit enhance MBS (we call these entities Mortgage Backed Securities Insurance Companies or MSICs).
- Limit the type of mortgages that could be included in the MBS to conventional, prudently underwritten mortgages.
- FHFA would issue federal charter and regulate MSICs.
- MSICs could take various organizational forms (e.g., co-op, utility, traditional corp.).
- Limit portfolio to product incubation and multi-family loans, not for arbitrage purposes.

Maintain Liquidity for Mortgage Credit through an Explicit Federal “Back-Up” Guarantee on MBS and a Single MBS

- Provide for an explicit federal guarantee of payment of principal and interest on MBS issued by MSICs, only upon failure of MSICs.
- MSICs would pay a risk-based premium for guarantee to ensure that guarantee is budget neutral.
- Federal guarantee would be catastrophic “back-up” coverage. Several layers of private capital would stand before the federal guarantee:
    - downpayment on mortgage
    - private mortgage insurance
    - capital of MSICS
    - shareholders of MSICs
    - reserve established by fees paid by MSICs for federal guarantee.
- Create a single facility to service MBS for all MSICs.
- Create a single MBS.

MSICs Should Support Affordable Housing

- Affordable housing could be promoted in various ways such as: transfer a portion of MSICs revenue stream to state and local housing finance agencies, FHLB-like grant program, and/or a MSIC dedicated to affordable housing rather than specific housing goals.
- MSICs should not be subject to specific affordable housing goals.

Strong Supervision and Regulation:

- Provide for strong, independent regulator of MSICs, with clear authority to unwind failed MSICs.