Testimony of
The Honorable Mel Martinez
Before the Committee on Banking, Housing and Urban Affairs
United States Senate

Bipartisan Solutions for Housing Finance Reform?

Tuesday, March 19, 2013

Chairman Johnson, Ranking Member Crapo, and members of the Committee, thank you for the opportunity to be here today to discuss housing finance reform. It is a pleasure to return to the Committee, and to see so many good friends and colleagues.

I serve as one of the four co-chairs of the Bipartisan Policy Center's Housing Commission. Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, the BPC is a Washington-based think tank that actively seeks bipartisan solutions to some of the most complex policy issues facing our country. In addition to housing, the BPC has ongoing projects on health care, homeland security, energy, political reform, immigration, and the federal budget.

The Housing Commission was launched in October 2011 with the generous financial support of the John D. and Catherine T. MacArthur Foundation. Along with
Senator Mitchell, former Senator Kit Bond and former HUD Secretary Henry Cisneros have joined me as commission co-chairs. In total, the commission has 21 members from both political parties who bring to the table a wide variety of professional experiences.

Over the past 16 months, the commission engaged in an intensive examination of a broad range of issues in housing. We held public forums in different parts of the country, convened numerous meetings with housing providers and practitioners, consulted with dozens of experts, and commissioned several informative research projects that are available online at www.bipartisanpolicy.org/housing.

Late last month, we issued our report, *Housing America's Future: New Directions for National Policy*, that covers topics such as homeownership, affordable rental housing, rural housing, and the housing needs of our nation's seniors. Today, I am going to highlight the report's key recommendations on housing finance reform.

Our nation's system of housing finance is broken. It's been more than four years since Fannie Mae and Freddie Mac were placed under government conservatorship, yet there is still no clear path forward. The commission felt there was an opportunity to fill this policy void and offer a blueprint for a new system that can support both the homeownership and rental markets of the future.

1. Recommendations on the Key Objectives of the New System

The commission reached consensus on five key objectives for this new system.

Our first objective is a far greater role for the private sector in bearing credit risk. The dominant position of the government in the market is unsustainable. Yes, private capital is now flowing through the system, but it absorbs very little of the system's credit risk. Instead, much of that risk lies with the government – nearly 90 percent of the single-family homeownership market remains government supported. Reducing the government footprint and encouraging more private participation will protect taxpayers while providing for a greater diversity of funding sources.

The second objective is a continued, but more limited, role for the federal government as the insurance backstop of last resort. The commission recommends the establishment of an explicit, but limited, government guarantee administered by a new entity that we call the "Public Guarantor" to ensure timely payment of principal and interest on qualified mortgage-backed securities ("MBS"). There is insufficient capacity on bank-balance sheets alone to meet our nation's mortgage finance needs. A strong, vibrant secondary market for these securities is essential to freeing up additional capital for mortgage lending and connecting our nation's local housing markets to global investors.

Many investors in the secondary market require a government guarantee protecting against catastrophic credit risk as a condition of their investment. These investors are willing to assume the risk of interest-rate volatility, but are unwilling to assume the credit risk associated with the mortgages that make up a security unless these mortgages are of the highest credit quality. In the absence of a government guarantee, investor interest in the secondary market would wane, mortgage credit would become more expensive, and widespread access to long-term, affordable, fixed-rate mortgage financing would likely disappear.

In our proposal, the government stands in the "fourth loss" position behind three layers of private capital: mortgage borrowers and their home equity; private credit enhancers, ranging from capital market products to highly capitalized mortgage insurers; and the corporate resources of the securities' issuers and mortgage servicers. [1] (See Appendix A for an illustration of how the government would stand in the "fourth loss" position under our proposal.) These private companies would be subject to stringent capital requirements that would enable them to weather losses similar in magnitude to those experienced during the Great Recession.

[1] Under the Commission's proposal, the issuer and mortgage servicer do not bear direct credit risk. That risk is borne by the private credit enhancer. However, the issuer and the servicer do bear other risks that help to shield the government from loss. The issuer is responsible for the representations and warranties associated with the mortgage, and the servicer is responsible for the timely payment of principal and interest to investors out of corporate resources (as is currently the case with Ginnie Mae), although the servicer should eventually be reimbursed for this payment by the private credit enhancer.

The limited government guarantee would kick in only after the private credit enhancers standing ahead of it had depleted all of their resources. Even then, these losses would be paid for through a fully-funded catastrophic risk fund capitalized through the collection over time of insurance premiums, or guarantee fees, from mortgage borrowers. In many respects, this model is similar to that of Ginnie Mae.

The third objective is the ultimate elimination of Fannie Mae and Freddie Mac over a transition period – perhaps five to ten years. Like other observers, the commission believes the business model of the two government-sponsored enterprises – publicly traded companies with *implied* government guarantees and other advantages – should not be reproduced.

The commission recognizes that a dynamic and flexible transition period will be necessary before the new, redesigned housing finance system is fully functioning. During this period of transition, it will be critical to avoid market disruption and to adjust course, when necessary, in response to shifts in the market and other critical events. The goal should be transition, not turbulence.

As first steps toward the new system, we support the continuation of current efforts to reduce the government footprint through reduced GSE loan limits and sale of the GSE portfolios. We also believe the GSE guarantee-fee pricing structure should move closer to what one might find if private capital were at risk.

The transition to the new system could be facilitated by continued use of existing capabilities at Fannie Mae and Freddie Mac. They have skilled staff, established processes, and state-of-the-art technologies that could and should be tapped. We can also build on the good work of the Federal Housing Finance Agency ("FHFA") in laying out a plan for a single securitization platform and developing a model pooling and servicing agreement.

The fourth objective is ensuring access to safe and affordable mortgages for all borrowers. This is a core principle for the commission – the housing finance system of the future must be one from which all Americans can benefit on equal terms. The commission also believes that access to the government-guaranteed secondary market must be open on full and equal terms to lenders of all types, including community banks and credit unions, and in all geographic areas. Again, Ginnie Mae's success in empowering smaller institutions to participate in its programs is instructive here.

And, finally, our fifth objective is for the Federal Housing Administration ("FHA") to return to its traditional mission of primarily serving first-time homebuyers and borrowers with limited savings for down payments. The recent concerns over the solvency of FHA's single-family insurance fund only underscore the urgency of what the commission has proposed – that far more risk-bearing private capital must flow into our nation's housing finance system. A system in which private capital is plentiful will reduce the pressure that is sometimes placed on the FHA to act as the mortgage-credit provider of last resort and allow it to perform its traditional missions more effectively.

Our proposals for reforming the *rental*, or multifamily, housing finance system are rooted in the same principles as single-family reform: the gradual wind down of the GSEs; a greater role for at-risk private capital; a continued government presence through a limited "catastrophic" guarantee; and reform of FHA to improve administrative efficiency and avoid crowd-out of the private market.

In addition, an "affordability" requirement for issuers of securities will ensure that the system primarily supports rental housing affordable to low- and moderate-income households.

2. The Actors in the New System

The commission's report goes into considerable detail about the individual components of the housing finance system we envision. It describes the structure and responsibilities of the Public Guarantor that will administer the limited catastrophic backstop. And it outlines the roles of the other actors in this new system – the originators, mortgage servicers, issuers of securities, and the private entities that will "credit enhance" these securities. Let me now take a moment to briefly describe the responsibilities of these actors in the new system we propose. More detail can be found in the commission's report.

a. Securitization—Approved Issuers

As noted above, the commission recommends a model similar to Ginnie Mae, where approved lenders are the issuers of mortgage-backed securities. The functions of an issuer of securities include:

- *Obtain certification from the Public Guarantor* that it is qualified to issue MBS based on such factors as (i) ability to meet credit and capital standards and cover all of the predominant loss risk through a separate well-capitalized credit enhancer, and (ii) capacity to effectively pool mortgages.
- *Ensure that the guarantee fee is paid for* and collected from the borrower along with all other fees and fully disclosed to the borrower as a part of originating the mortgage.
- *Issue the mortgage-backed securities* and, where appropriate, sell the MBS to investors through the To-Be-Announced ("TBA") market.[2]
- *Retain responsibility for representations and warranties* under the terms specified by the Public Guarantor.

[2] The TBA market was established in the 1970s with the creation of pass-through securities at Ginnie Mae. It facilitates the forward trading of MBS issued by Ginnie Mae, Fannie Mae, and Freddie Mac by creating parameters under which mortgage pools can be considered fungible. On the trade date, only six criteria are agreed upon for the security or securities that are to be delivered: issuer, maturity, coupon, face value, price, and the settlement date. Investors can commit to buy MBS in advance because they know the general parameters of the mortgage pool, allowing lenders to sell their loan production on a forward basis, hedge interest rate risk inherent in mortgage lending, and lock in rates for borrowers. The TBA market is the most liquid, and consequently the most important, secondary market for mortgage loans, enabling buyers and sellers to trade large blocks of securities in a short time period.

b. Servicing

Under our proposal, servicers would need to be qualified by the Public Guarantor. Responsibilities of a servicer include:

- *Make timely payment of principal and interest* should the borrower be unable to do so. The servicer will advance the timely payment of principal and interest out of its own corporate funds and will be reimbursed by the private credit enhancer at the time the amount of the loan loss is established.
- *Work with the borrower* on issues related to delinquency, default, and foreclosure and advance all funds required to properly service the loan.

c. Credit Enhancement

The commission's proposed single-family housing finance system depends on credible assurance that private institutions will bear the predominant loss credit risk, will be capitalized to withstand significant losses, and will provide credit that is generally unrestricted with little leverage. As such, private credit enhancers will bear the risk on the mortgages they have guaranteed until they go out of business or have met their full obligation, as defined by the Public Guarantor, to stand behind their guarantee. Private credit enhancers will generally be single-business, monoline companies and will be required to:

- *Provide regular reports to the Public Guarantor* on the nature of the credit enhancement, who holds the risk, the amount and nature of the capital they hold, and other measures of credit strength. These measures would include a quarterly stress test to determine that available capital is adequate, with a "capital call" to assure there are sufficient reserves to protect the government guarantee from being tapped except in extreme cases.
- *Establish underwriting criteria* for the mortgages and mortgage pools they will be guaranteeing beyond the baseline underwriting criteria established by the Public Guarantor.
- *Reimburse servicers for their timely payment of principal and interest and other costs* at the time the amount of the loan loss is established. This reimbursement is paid out on a loan-by-loan basis until the private credit enhancer runs out of capital and goes out of business.
- *Establish and enforce servicing standards* (in conjunction with national servicing standards) in order to ensure that the interests of the private credit enhancer and servicer are fully aligned.

- *Provide credit enhancement with standard, transparent, and consistent pricing to issuers of all types and sizes*, including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions.

- *Meet credit enhancement requirements* through one or a combination of the following options: (1) well-capitalized private mortgage insurance at the loan level for any portion of the loan where specific capital requirements are established and the servicer and/or Public Guarantor has the ability to demand margin calls to increase capital if there is an adverse move in house prices; (2) capital market mechanisms where the amount of capital required to withstand severe losses is reserved up front, either through a senior/subordinated debt model with the subordinated piece sized to cover the predominant risk or approved derivatives models using either margined Credit Default Swaps or fully funded Credit Linked Notes; and (3) an approved premium-funded reserve model, where a premium-funded reserve is established, either fully capitalized at the outset or where the reserve builds over time.

These approaches to meet capital requirements are designed to ensure that private capital will stand ahead of any government guarantee for catastrophic risk. The Public Guarantor will establish the minimum capital levels required to survive a major drop in house values and will require any private credit enhancer to have sufficient capital to survive a stress test no less severe than the recent downturn (e.g., a home price decline of 30 to 35 percent, which would correspond to aggregate credit losses of 4 to 5 percent on prime loans).

d. Government Guarantee for Catastrophic Risk

Under the commission's proposal, the Public Guarantor would guarantee the timely payment of principal and interest on the MBS, but this guarantee would be triggered only after all private capital in front of the guarantee has been expended. The guarantee would be explicit, fully funded, and actuarially sound, and the risk would apply only to the MBS and not to the equity and debt of the entities that issue and/or insure the MBS. Other functions of the Public Guarantor would include:

- *Establish the level of capital* necessary to ensure that private-sector participants in the housing finance system (issuers, servicers, and private credit enhancers) are all properly capitalized.

- *Establish the guarantee fees* to be collected from the borrower to cover the operating costs of the Public Guarantor and to offset catastrophic losses in the event of a failure of the private credit enhancer and/or servicer failure. For both the single-family and rental housing markets, a reserve fund would be established for catastrophic risk that will build over time.

- *Ensure the actuarial soundness of the funds* through careful analysis and the use of outside expertise, and report to Congress regularly regarding their financial condition.

- *Ensure access to the government-guaranteed secondary market on full and equal terms* to lenders of all types, including community banks, independent mortgage bankers, housing finance agencies, credit unions, and community development financial institutions. The Public Guarantor must ensure that issuers of securities do not create barriers using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the government-guaranteed secondary market.

- *Provide one common shelf* for the sale of government-guaranteed securities to offer greater liquidity for the market as well as establish an equal playing field for large and small lenders.

- *Establish a single platform* for the issuing, trading, and tracking of MBS. With multiple private issuers, this platform could provide greater uniformity and transparency, and therefore lead to greater liquidity.

- *Create and enforce uniform pooling and servicing standards governing the distribution of mortgage proceeds and losses to investors and ensuring compliance with relevant federal tax laws.*

- *Encourage loan modifications when a modification is expected to result in the lowest claims payment on a net present value basis.* The Public Guarantor should require participants in the new government-guaranteed system to structure and service securities in a way that would facilitate such loan modifications.

- *Qualify private institutions* to serve as issuers of securities, servicers, and private credit enhancers of MBS. The Public Guarantor will also have the power to disqualify an issuer, servicer, or a private credit enhancer if it determines that requirements and standards are not met.

- *Establish loan limits, under the direction of Congress*, so that the loans backing the government-guaranteed MBS will be limited based on the size of the mortgage and any other criteria Congress may prescribe.

- *Set standards for the mortgages* that will be included in the MBS, including baseline underwriting criteria, permissible uses of risk-based pricing, and clear rules of the road related to representations and warranties.

- *Specify standards for mortgage data* and disclosures.

For a graphic illustration of how the new system proposed by the commission would work, see Appendix B.

The commission envisions the establishment of a single Public Guarantor with responsibility for both the single-family and rental housing markets. The Public Guarantor would consist of two separate divisions each with responsibility for administering its own separate catastrophic risk fund. Each division would also establish its own approval standards for lenders, issuers, servicers, and private credit enhancers as well as underwriting standards, predominant loss coverage requirements, and catastrophic guarantee fees.

In the commission's view, the Public Guarantor should be established as an independent, wholly-owned government corporation. As a government corporation, the Public Guarantor will be a self-supporting institution that does not rely on federal appropriations but rather finances the two catastrophic funds and its own operational expenses through the collection of guarantee fees. The Public Guarantor should operate independently of any existing federal department and, with this greater independence, should be able to respond more quickly to contingencies in the market and operate with greater efficiency in making staffing, budgeting, procurement, policy, and other decisions related to mission performance.

The commission recommends that the Public Guarantor be led by a single individual, appointed by the President of the United States and confirmed by the U.S. Senate, who would serve a director. The commission also recommends the establishment of an Advisory Council to the Public Guarantor consisting of the chairman of the Board of Governors of the Federal Reserve System as chairman of the Council, along with the director of the Public Guarantor, the secretary of the U.S. Department of the Treasury, and the secretary of the U.S. Department of Housing and Urban Development. The Advisory Council would meet on at least a quarterly basis to share information about the condition of the national economy, marketplace developments and innovations, and potential risk to the safety and soundness of the nation's housing finance system.

3. Potential Impact on Mortgage Rates

While the new housing finance system proposed by the commission will minimize taxpayer risk, this protection will come at the cost of higher mortgage rates for borrowers. Three factors will contribute to the added costs:

First, our proposal calls for a far greater role for the private sector in mortgage finance, with private capital taking the predominant loss risk and standing ahead of a limited government guarantee. Private credit enhancers will charge a fee to cover the cost of private capital to insure against the predominant loss if a mortgage default occurs.

Second, the Public Guarantor will charge an unsubsidized fee to cover catastrophic risk should a private credit enhancer be unable to fulfill its obligations to investors.

Third, the Public Guarantor will be structured as an independent, self-supporting government corporation that finances its activities through an operating fee.

The borrower will indirectly pay for all three of these activities through a guarantee fee that is included in the mortgage rate.

Analysis by Andrew Davidson & Co., Inc., using two research methods and a pool of nearly 5,000 conforming loans originated in 2012, provides a range of estimates of the possible costs of the commission's recommendations. Utilizing this pool of loans, Davidson & Co. estimates the guarantee fees paid by a borrower with no mortgage insurance will range from 59 to 81 basis points.[3] By comparison, the guarantee fees for mortgages now supported by Fannie Mae and Freddie Mac are currently in the range of 50 basis points (including a 10 basis point charge paid to the U.S. Treasury to finance the payroll tax deduction). Some of these mortgages with higher loan-to-value ratios are also supported by private mortgage insurance.

4. A Path Forward

The commission has proposed a plan to substantially reduce government intervention in the housing market and protect the taxpayers, while ensuring the broad availability of affordable mortgage credit. I believe it strikes the right balance among competing policy goals, and deserves your consideration.

The commission recognizes there may be sound alternative approaches to achieving the same objectives, but the key to success is first achieving bipartisan consensus on what these objectives are. It is our hope that the commission's recommendations – the product of extensive deliberations and enjoying the broad bipartisan support of its 21 members – will offer a viable way forward and serve as a catalyst for action.

As members of the Committee know, the Federal Housing Finance Agency – under the able leadership of Acting Director Ed DeMarco – is engaged in an effort to prepare Fannie Mae and Freddie Mac for a post-conservatorship world. Without clear policy direction from Congress and the Administration, one possible and undesirable outcome of this effort is that the two institutions could become permanent wards of the state. Ironically, those who unrelentingly pursue a pre-Depression vision of a purely private mortgage market may end up hastening this outcome and strengthening the government-dominated *status quo*. The idea of removing the federal government entirely from the housing market is not only bad policy; it is also unrealistic and politically unachievable. The goal should be to limit government involvement and taxpayer exposure to the greatest extent possible, while ensuring that the system has sufficient liquidity to meet the mortgage needs of the American people.

[3] Andrew Davidson & Co., Inc., has prepared a working paper on this topic that provides the details of their analysis. See *Modeling the Impact of Housing Finance Reform on Mortgage Rates* found on the BPC Housing Commission website at www.bipartisanpolicy.org/housing.

5. Short-Term Obstacles to Market Recovery

As a final note, the commission has identified several factors that continue to stall a housing recovery in the immediate term. These factors are:

- Overly strict lending standards, which now go well beyond those in place before the housing bubble;
- Lack of access to credit for well-qualified self-employed individuals;
- Put-back risk – that is, the risk that lenders will be required to buy back a delinquent loan from Fannie Mae, Freddie Mac, or FHA;
- Ongoing issues with appraisals, including calls for multiple reappraisals sometimes just days before closing that can derail home sales;
- Application of FHA compare ratios; and
- Uncertainty related to pending regulations and implementation of new rules.

While not our primary focus, we believe these issues must be resolved before the housing market can fully recover.

Thank you for your attention. I look forward to your questions.

Appendix A. The "capital stack" in a reformed housing finance system

Resources	Entity	Risk/Responsibility
1. Household resources	Homeowner/ mortgage holder	Down payment and home equity
2. Corporate resources	Originator/ Issuer	Representations and warranties
	Servicer	Timely payment of principal and interest (to be reimbursed by the private credit enhancer)
3. Private credit enhancer resources	Private credit enhancer	Credit risk – with sufficient capital set aside to survive a stress test no less severe than the recent downturn (e.g., home price decline of 30 percent to 35 percent, which would correspond to aggregate credit losses of 4 percent to 5 percent of prime loans)
4. Government resources	Government guarantee for catastrophic risk/ Public Guarantor	Catastrophic credit risk (with dollars set aside in a catastrophic risk fund paid for by a portion of the g-fee)

Appendix B. Flow of mortgages