Testimony of
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Committee on Financial Services
U.S. House of Representatives

Hearing on:

“A Legislative Proposal to Provide for a Sustainable Housing Finance System:

The Bipartisan Housing Finance Reform Act of 2018”

Thursday, December 6, 2018

Chairman Hensarling, Ranking Member Waters, and Members of the Committee:

It is an honor to be here. My name is Edward DeMarco. I am the President of the Housing Policy Council, a trade association comprised of thirty of the nation's leading firms in housing finance. Ten years ago, when Fannie Mae and Freddie Mac (the Enterprises) were placed into conservatorship, I was the Senior Deputy Director and Chief Operating Officer at the Federal Housing Finance Agency (FHFA), an agency I would later lead as Acting Director.

As we all know, the government's fateful decision to pursue conservatorship of the Enterprises was difficult and was elected to protect the U.S. housing finance system and the national economy. At the time, the conservatorship was envisioned as a "time-out" to provide the government a window of opportunity to reform the system, to reconfigure the role and responsibilities of the Enterprises, and to eliminate the substantial risk they posed to the system. While Congress has yet to settle on the best way to accomplish this goal, ***the Bipartisan Housing Finance Reform Act of 2018 proposed by Chairman Hensarling and Representatives Delaney and Himes moves the debate over housing finance reform forward in several key respects.***

I am pleased to represent the Housing Policy Council (HPC) at this important hearing. The mission of our organization is well-aligned with the objectives of the Bipartisan Housing Finance Reform Act. The sponsors of the Act have stated that the "overarching philosophy" behind the Act is to "create an equal playing field across different ways to finance a single family mortgage, allowing risk to be allocated to those entities which are best able to manage it and avoid too-big-to-fail institutions dominating or restricting access go the mortgage market."[1] HPC, too, believes in a competitive marketplace, operating with regulatory consistency and market transparency. Our interest is in the safety and soundness of the system, equitable treatment of all market participants, and the promotion of lending practices that create sustainable homeownership and long-term wealth-building opportunities for families.

Summary Comments on Bipartisan Bill

The Bipartisan Housing Finance Reform Act of 2018 is a positive contribution to the debate over the shape of housing finance reform. The bill advances the policy dialogue on the future of our housing finance system in a very meaningful way. The bill incorporates features from earlier House bills, including Chairman Hensarling's PATH Act, Representatives Delaney, Carney, and Himes' Partnership to Strengthen Homeownership Act of 2014, and Ranking Member Waters' HOME Forward Act of 2014. Like those earlier proposals, the bill provides for an orderly wind-down of the Enterprises while establishing a new framework that preserves the 30-year fixed rate mortgage. It also refines and improves on ideas that are now core to the ongoing discussion, including the need for a government guarantee, a catastrophic government-administered insurance backstop, a market data repository and technology platform, unimpeded access to the secondary market for small lenders, and an affordable housing mandate with dedicated funding.

[1] The Bipartisan Housing Reform Act, Summary of Key Provisions, Summary of Key Provisions, https://financialservices.house.gov/uploadedfiles/bipartisan_housing_finance_act_summary_of_key_provisions_final_version.pdf.

In my testimony today, I will address aspects of the bill that we support, components that we believe need additional consideration and revision, and a few areas of concern. In summary:

- *PCE / Issuer Functions and Regulation*: We support the clear separation of the functions performed by Private Credit Enhancers (PCEs) and Issuers. The separation of these functions would materially reduce the risks inherent in the current system. We also support the distinct regulatory oversight for PCEs and Issuers to be provided by the Federal Housing Finance Agency (FHFA) and Ginnie Mae respectively.

- *Market Exchange*: We support the development of a Market Exchange to set standards, maintain industry data and documents, and supply market-wide technology tools to facilitate efficient execution by all market stakeholders. In fact, we believe that the creation of this essential infrastructure should be more comprehensive, covering both the Private Label Securities (PLS) and conventional conforming segments of the market. We also recommend that the implementation of this Exchange and the related release of loan data and technology be a first order action, taking precedence over all other transition work in order to serve as the foundation for the new system.

- *Small Lender Access*: We support the creation of a government-supported mechanism to ensure small lenders have unbiased access to loan aggregation services. We believe, however, that these provisions should be refined to be more consistent with their intended goal.

- *Affordable Housing*: We support an obligatory affordable housing fee, with explicit funding commitments and a clear distribution vehicle to ensure those resources are directed to traditionally underserved borrowers. The bill includes some placeholder provisions related to these issues and HPC is ready to work with the Committee to fill out these provisions so they promote responsible lending and sustainable homeownership.

- *FHA:* The Federal Housing Administration (FHA) is a major feature in the nation’s housing finance system, yet FHA is entirely absent from this bill. In conjunction with the draft bill’s proposed eligibility restrictions on conventional conforming mortgages and the increase in the loan-level credit enhancement attachment point, from 80 loan-to-value (LTV) to 85 LTV, the omission of FHA introduces troublesome incentives that could create added loan volume and risk for FHA. We believe that any housing finance reform proposal should fully envision and embrace complementary rules and requirements for both conventional conforming and government-backed mortgages, to ensure a balanced continuum of financing options for all consumers aspiring to homeownership as well as equitable treatment and fair competition for all industry stakeholders.

HPC Support for Clear Separation of PCE and Issuer Functions and Regulation

The draft bill’s delineation of the credit enhancement function from the role and responsibilities of the issuer represents a powerful and positive evolution in the dialogue over housing finance reform. Security issuers and credit enhancers each have important risk management functions to perform. Clearly separating these functions helps to protect the soundness of the system, and most importantly, the consumers who obtain mortgages and investors who provide the capital to support mortgage lending activities.

The connection between the flow of capital into mortgage lending from the global capital markets to the individual consumers is often lost in the housing finance reform debate. Yet, it is the very heart of the matter – how do we establish a better model, where consumer access to mortgage loans is as simple, consistent, and cost-effective as it can possibly be, and the lenders, issuers, servicers, credit investors, and security investors each understand the responsibilities they undertake in the system and the rules affecting that participation?

The answer to these questions lies in the management of risk, which the bill facilitates through the division of responsibilities across responsible parties, to positively utilize the strengths and capabilities of the various market participants. Effective management of risk requires the minimization of risk coming into the system through solid underwriting of the borrower and property, and the mitigation of losses on closed loans through various strategies that reduce loss severities. When this occurs, pricing improves and the costs to the consumer are reduced. We appreciate that the Bipartisan Housing Finance Reform Act of 2018 takes very seriously these core considerations, drawing out the distinct risk management functions of key market participants.

PCE Functions, Regulatory Oversight, and Backstop Make Sense

A PCE is a private and independent party responsible for evaluating and understanding the credit risk inherent in the mortgages it backs. Whether the credit enhancement is attached at the loan-level or at the security level, the credit enhancement process should add an important layer of due diligence, with PCEs performing quality control reviews (including re-underwriting). HPC expects that various types of insurance companies, particularly mortgage insurance companies, are well-positioned and suited to fulfill the PCE role at the loan level and various types of investors and insurers (including mortgage insurers) have already demonstrated a strong interest in and capacity to serve the role at the security level, as evidenced by the extensive participation in the existing Enterprise Credit Risk Transfer (CRT) transactions.

To-date, these critical risk management roles, and the holding of first-loss credit risk by these types of private providers backed by private capital, has been limited by the Enterprises. As with so many market operations, the Enterprises control not only which entities are permitted to engage in these activities, but also dictate how they may conduct the business. For both loan-level and security-level credit enhancement, the Enterprises have retained a substantial portion of the actual risk management operations in a manner that fundamentally undermines the benefit of redundant underwriting and quality control reviews performed by independent parties to validate the quality of origination and affirm the approval and eligibility determinations of the lending institutions. Prudential regulators and ratings agencies generally demand a form of second-level risk management, but in the context of the Enterprises, this critical element of systemic risk management has been degraded by the expanding span of control of the Enterprises. The bill would remove this conflict, unequivocally separating the functions of PCEs from originators and issuers.

The bill provides for FHFA's regulatory oversight of the PCEs, and the establishment of a catastrophic insurance fund, called the Private Capital Reserve, funded by the PCEs and subject to resolution by FHFA using these funds if a PCE becomes insolvent. The clarity of this arrangement, with the capital backstop dedicated directly and solely to protecting the PCE beneficiaries, and the separation of functions that are so central to protecting investors, consumers, and taxpayers from systemic risk, reflects the type of balance that has been absent from our system to-date. With the Enterprises operating in a quasi-regulatory role, overseeing the PCE-like functions of private mortgage insurers and credit risk transfer participants, the first-loss risk function has been intermingled across entities and the regulatory role of the FHFA has become increasingly conflicted and diluted in a manner that contributes to systemic risk.

Under the bill, the FHFA will have explicit authority and obligation to establish standards that ensure the operational capacity and financial strength of the PCEs to engage in the first-loss risk management and risk holding activities that the private sector is well-positioned to perform. The clear delineation of this responsibility and the management of the Private Capital Reserve to resolve failing PCEs provides a level of transparency and financial protection that does not exist within the system today.

FHFA's authority should be made more explicit with respect to the establishment of minimum standards for the amount and quality of credit risk protection provided by a PCE in a given pool as well as the rules for loan-level credit enhancement. HPC also recommends that the level of funding in the Private Capital Reserve be carefully calibrated to ensure that depletion of the reserve is a remote possibility, even in the event of a catastrophic downturn. Moreover, the Committee should consider an additional backstop measure to ensure that any industry-wide PCE failure is contained within this segment of the market and cannot spread to the issuers or other market participants.

Issuer Functions, Oversight, and Backstop Are Similarly Sensible

Like the proposed treatment of PCEs, the bill distinguishes and reinforces a specialized role and discrete responsibilities for Issuers, which aggregate, deliver, and service/master service conventional conforming assets placed in the new Ginnie Mae Plus securities. Issuers serve as the critical intermediary between the primary and secondary market, enabling lending institutions of all types and sizes a means to sell or transfer loans to companies that will perform another layer of systemic risk management when they deliver loans into the capital markets. As such, it is the Issuers that facilitate the flow of capital across the system. Issuers assess the strength of the origination counterparties from which they will accept loans and perform loan-level quality control to ensure that assets meet underwriting, eligibility, and delivery standards. Post-delivery, issuers track the performance of the assets in the securities, performing or overseeing primary market servicing activities to ensure investors receive timely pass-through of principal and interest and that loan delinquencies are resolved as quickly as possible, to mitigate losses.

In the existing Enterprise context, this function is performed by Fannie Mae and Freddie Mac and is the primary means by which the Enterprises hold credit risk. Given the magnitude of the Enterprise business, representing half of the $10 trillion mortgage market today, even minimal negligence to perform and/or enforce adequate counterparty controls and loan-level due diligence creates substantial systemic risk. Some would argue that a level of permissiveness on this front directly contributed to the Enterprise collapse; both companies relaxed their underwriting standards and oversight practices in order to gain market share during the housing boom.

By spreading this function across multiple private Issuers in a new housing finance system, the bill better distributes risk and risk management operations. Issuers would have skin-in-the-game, incenting them to accept only sustainable mortgages into pools, using strong risk controls and oversight. Effective counterparty contracts expressly assign liability to reinforce effective risk management practices.

Under the bill, Ginnie Mae is authorized to establish eligibility standards for Issuers and to oversee Issuers. This is an appropriate arrangement, given the guarantor role of Ginnie Mae in backing the new Ginnie Mae Plus securities. The Issuers must have the financial strength and operational capacity to fulfill issuance obligations - from basic custodial arrangements and routine remittance procedures to more complicated loan servicing and loss mitigation activities - to protect Ginnie Mae investors from losses. In the event of Issuer failure, Ginnie Mae, as the guarantor, would take legal action to penalize the Issuer and seize the mortgage assets, again, to protect the interests of the securities investors.

With separate and distinct regulatory functions, FHFA and Ginnie Mae can specialize and focus on the unique roles and responsibilities of their respective regulated entities, monitoring the particular forms of risk management practices that each apply, to ensure that these two distinct types of market participants engage appropriate and adequate risk controls that keep pace with market trends and conditions. Collaboration between the two regulatory agencies is key and the bill may need to provide additional specificity for mandatory coordination in some areas. Finally, the Committee should recognize that these new responsibilities for FHFA and Ginnie Mae require a commensurate investment in their respective staffing and operational capabilities. Time and resources must be allocated to ensure that each agency is prepared for its added responsibilities.

HPC Suggests Refinements: Market Exchange, Small Lender Access, and Affordable Housing

The Exchange, the Platform, and the Repository

The bill provides for the establishment of a privately-owned, non-governmental Mortgage Security Market Exchange (the Exchange) that would function as a data standardization body for the reporting, administration, and maintenance of mortgage transactions. The primary functions of the Exchange would be to:

- Develop standards for the pooling, securitization, and servicing of residential mortgage loans that do not carry a federal guarantee, so-called private label securities;
- Operate the Common Securitization Platform (the Platform), which has been developed by Fannie Mae and Freddie Mac, and which would be transferred to the Exchange; and
- Establish and operate a national Data Repository (the Repository) for mortgage-related documents.

FHFA would approve the organization of the Exchange and would oversee its operations. The Exchange would be required to operate as a not-for-profit entity, but could take any corporate form, including as a mutual or cooperative. A majority of the directors of the Exchange would have to have experience in housing and finance businesses, and at least one director must have knowledge of smaller financial institutions.

The transfer of the Platform to the Exchange would be required to occur within 2 to 5 years after the date of enactment of the bill. In conjunction with this, Fannie Mae and Freddie Mac also would be required to transfer historical loan-level data and their underwriting systems. Once operational, the Platform would be open to all issuers.

The Repository would accept and register mortgage-related documents. Any party that holds an interest in the mortgage note could rely upon registration with the Repository to enforce their interest in the note.

Each of these features of the bill -- the Exchange, the Platform, and the Repository – has roots in earlier versions of housing finance reform legislation. Variations on the Exchange and the Platform can be seen in the National Mortgage Market Utility proposed in Chairman Hensarling's PATH Act and the Mortgage Securities Cooperative proposed in Representative Waters' HOME Act. Similarly, both the PATH Act and the HOME Act called for the creation of a national mortgage data repository.

HPC supports the creation of the Exchange, the Platform, and the Repository. The standards developed by the Exchange would help to revitalize the market for private label mortgage-backed securities, which has yet to rebound from the financial crisis. The transfer of the Common Securitization Platform to the Exchange would transform this proprietary system into an open system for all issuers of mortgage securities. This transfer also would give market participants access to data and technologies that would facilitate better underwriting and pricing policies, to the benefit of the market and mortgage borrowers. Likewise, the Repository would make mortgage loan data more accessible to the public and would reduce legal complexities associated with mortgage loans.

We believe, however, that these provisions should be modified to achieve more fully their intended purpose.

First, and foremost, we recommend that the establishment of the Exchange and the release of all existing mortgage data held by Fannie Mae and Freddie Mac should be accelerated. The Exchange can serve as a foundation for housing finance reform, and the release of data including loan-level and property appraisal data, will enable other market participants to better evaluate and price credit risk to the benefit of mortgage borrowers.

Because of their duopoly position in the housing finance market, Fannie Mae and Freddie Mac collect, and then claim a proprietary interest in, a vast amount of mortgage loan data, which gives them a competitive advantage over other market participants. With this data, the Enterprises control where and when to relax their traditional lending standards, and whether to do so through appraisal waivers, alterations to underwriting, or direct reductions in credit costs for some borrowers. This data also enables them to identify market trends and develop new products and technologies in response to those trends. Furthermore, the data they gather from their operations affects their pricing decisions, an area where they otherwise have an advantage over other participants because taxpayer support enables them to issue debt at approximately government pricing levels.

The provisions related to the transfer of underwriting systems and other technology to the Exchange also should be modified to require Fannie Mae and Freddie Mac to provide technical and staffing support for the transfer. The people that run these systems are as important as the systems themselves. The provision of technical and staffing support would help to ensure a smooth transfer of the systems until the Exchange can hire and train its own employees.

Finally, we recommend that the bill provide for a convergence of the standards applicable to private-label securities and the conventional securities backed by Ginnie Mae. Common standards for securitization of mortgages, including servicing standards, would reduce complexity and facilitate more liquid markets. To achieve this goal, the bill could direct FHFA, which oversees the Exchange, to coordinate with Ginnie Mae and the Bureau of Consumer Financial Protection, which have their own authority over standards. In short, HPC expects that FHFA, the Exchange, and other entities responsible for standard-setting would work together to drive alignment wherever feasible.

Access for Small Lenders

The bill directs Ginnie Mae and FHFA to oversee a small lender access program under which an approved credit enhancer could purchase eligible conventional mortgages from small lenders and issue Ginnie Mae Plus securities backed by such mortgages. Credit enhancers would be prohibited from discriminating in the price paid for these loans based on loan volume. The section-by-section analysis accompanying the bill also indicates that small lenders could retain the servicing on the loans sold under this program. Additionally, the bill would give the Federal Home Loan Banks the authority to purchase eligible conventional mortgage loans from their members, which would benefit many small bank lenders.

These provisions are critically important. Small lenders must have the ability to sell loans into the secondary market on a non-discriminatory basis. Again, however, we believe that these provisions should be modified to achieve more fully their intended purpose.

The authority for a credit enhancer to serve as an aggregator and issuer for a small lender is an exception to the “bright-line” distinction in section 107 of the bill, which prohibits credit enhancers from acting as issuers. We recommend that the bill maintain this distinction, and not create this exception. As I have explained above, the separation of credit enhancement from issuance is a central feature of the bill. It helps to reduce the systemic risk inherent in the current system. To address the needs of small lenders, the bill could direct Ginnie Mae to approve specialized issuers for small lenders. Alternatively, the bill could direct that the reconstitution of Fannie and Freddie include chartering one or both as lender-owned issuers such as contemplated in Ranking Member Waters’ HOME Act.

We also have a concern with the bill’s definition of a small lender, should the Section 116 provision that permits PCEs to issue on behalf of small lenders remain. As drafted, the bill defines a small lender to be one that does not originate more than 5 percent of the total amount of the eligible mortgages purchased by a credit enhancer in any calendar year. This definition incentivizes having very few and very large credit enhancers. If there are only a few credit enhancers in the market, 5 percent of their purchases could be a sizable amount. To avoid this potential, we recommend that the definition of small lender be tied to loan volume. Furthermore, to avoid any cliff effects associated with volume limits, FHFA could increase the credit enhancer's capital requirement, or fees paid by credit enhancers to the proposed Private Capital Reserve Fund, based upon a sliding scale of issuance volume on behalf of a lender.

Finally, to facilitate the ability of the Federal Home Loan Banks to purchase eligible conventional mortgages from members, we recommend that the bill authorize the Banks jointly to establish a subsidiary for this purpose. This would centralize the function and produce efficiencies that could not be achieved through multiple programs.

Affordable Housing

The bill includes a set of principles related to affordable housing. These principles endorse an affordable housing fee imposed on all mortgage loans that collateralize Ginnie Mae securities. The drafters also state that the funds generated from this fee should be managed and allocated by the Federal Government and should be "substantially" more than what is available under today's system. Additionally, the drafters call on Ginnie Mae and FHFA to ensure access to housing credit for creditworthy borrowers in all parts of the country in all business cycles.

We agree that housing finance reform must address affordable housing. Toward that end, we urge the Committee to promote a dialogue among all stakeholders – industry, advocates, and government – to develop solutions to this important issue. Any such dialogue should consider who pays the fee, how it is distributed, and how any new programs created will reduce the risk to borrowers, assist in wealth-building, and promote long-term sustainable homeownership.

HPC Concerns: FHA Reform Should be Included in Bill

HPC believes that the bill was intended to establish the framework for a new housing finance system that is stronger and fairer than the existing system. The bill's Market Exchange, which supports the PLS market, demonstrates the sponsors' interest in creating infrastructure, market discipline, prudential standards, and market-wide tools to support a full continuum of lending activities and products, from private label to conventional conforming. Unfortunately, the omission of FHA from this framework creates a gap in that continuum, a gap that introduces new risks to the government.

The bill establishes a definition for conventional mortgages that is far more limited than what is permitted today. For example, the bill restricts conventional products to financing secured by primary residences and prohibits loan balances that exceed 95 percent of the appraised value of the property. It is not entirely clear if the motivation for these new constraints is to limit the government guaranteed securitization vehicle to products that directly support only financing primary residences or if the new constraints are intended to expand the private marketplace to reduce the scope of taxpayer involvement. Regardless of the intent, HPC believes that it is important for Congress to consider the benefits and drawbacks of the new parameters selected as well as the impact on the market.

Of primary concern, the displacement of some portion of conventional conforming mortgages will not only expand the private lending market, but also will shift higher-risk loans into the government lending segment of the market, particularly to the FHA. For example, loans with lower down payments and those with non-Qualified Mortgage (QM) status (but that receive such designation today under the QM regulatory exemption for loans eligible for delivery to Fannie Mae and Freddie Mac), would likely shift to FHA.

The more liberal underwriting standards of FHA, in conjunction with FHA's government-subsidized insurance premiums, will result in a larger share of the market moving to FHA in a manner that was likely unintended by this bill. Absent changes to FHA's reserve requirements or statutory pricing controls, the negative pricing differential between FHA and the PCEs will be inevitable. PCE pricing sometimes will be higher than that of FHA under the terms established by this bill; in addition to standard private-market risk-based pricing, the PCEs will need to hold more capital than FHA and will be obligated to pay fees to the Private Capital Reserve. The bill also moves the private credit enhancement attachment point from today's 80 LTV to 85 LTV, a change that moves the risk management benefits in the wrong direction and makes the underpriced FHA product, with one-hundred percent insurance coverage, ever more attractive. HPC believes that the Committee should adjust the private credit enhancement attachment point to 80 LTV and explicitly authorize and encourage deeper coverage, when appropriate.

To correct the market imbalance the bill may create, HPC recommends that the Committee develop an FHA subtitle. The risk management considerations embedded throughout the discussion draft should also lead to complementary standards and requirements for FHA. HPC believes that harmonized standards for FHA would result in a well-balanced continuum of lending products across the market, from wholly private to conventional conforming to government-backed, an objective HPC members would promote as the best means to ensure that all segments of the population have access to a variety of safe, fair, and well-priced loan products.

Conclusion

HPC commends the Committee and the sponsors of the Bipartisan Housing Finance Reform Act of 2018 for advancing the housing finance reform dialogue with this bill, which presents a practical path to a stronger, more resilient U.S. housing finance system. By distributing critical risk management functions across distinct industry stakeholders, the bill sharpens our focus on the foundational principles that create a liquid, competitive, and fair marketplace. The bill balances the role of the government and the private sector in a manner that fulfills the needs of all stakeholders, including American consumers who deserve safe, well-priced mortgages, global investors who commit capital to support the U.S. economy, and private companies engaged in housing finance. HPC appreciates the opportunity to share our initial thoughts on the bill with the Committee. We stand ready to engage in further discussion on this critical subject as we continue to evaluate the provisions and implications of this framework.