

September 10, 2019

Statement for the Record

On behalf of the

American Bankers Association

before the

Banking, Housing, and Urban Affairs Committee

Of the

United States Senate

September 10, 2019



Statement for the Record

On behalf of the

American Bankers Association

before the

Banking, Housing and Urban Affairs Committee

United States Senate

September 10, 2019

Chairman Crapo, Ranking Member Brown and Members of the Committee, the American Bankers Association (ABA) is pleased to submit this statement for the record on the important topic of Government Sponsored Enterprise (GSE) reform and bank access to the secondary market. The ABA is the voice of the nation's \$17 trillion banking industry, which is composed of small, mid-size, regional and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits and extend more than \$9 trillion in loans.

We appreciate the work this committee has done thus far to refine proposals for GSE reform and the further efforts undertaken by the Administrations to move reform forward. The ABA, through input and deliberation from banks of all sizes and from all parts of the country, has developed a set of principles to guide the reform of Fannie Mae and Freddie Mac, which, as you know, have been in conservatorship for over a decade. These principles that should form the basis for legislative reform efforts, many of which are reflected in the Treasury report. We will withhold detailed comments on the Treasury's Reform Plan pending further review, analysis and feedback from our members, but we do commend the Administration for moving the process forward with this report. The report provides both legislative and administrative recommendations for reform and recognizes that legislative action is necessary in order to lock in durable reforms to the government's role in the secondary mortgage market – a point with which we strongly agree.

Below, we share again our principles for reform, along with initial commentary on how the Treasury report reflects or differs from those principles.

1. **The GSEs or their successors must be strictly confined to a secondary market role of providing stability and liquidity to the primary mortgage market for qualified low- and moderate income borrowers and must be strongly regulated, thoroughly examined and subject to immediate corrective action for any violation.**

A reformed system must ensure that the GSEs or their successors stay focused purely on ensuring qualified borrowers are able to access affordable mortgage credit by advancing stable, affordable and readily available secondary market access to the primary market. Shareholder returns or other investment goals cannot be allowed to drive their mission. While a certain level of competition is desirable to ensure innovation and responsiveness to the market, competition cannot be allowed to spin out of control and take the existing or any future GSEs into other businesses or investment areas. Strong regulation will be necessary to keep the GSEs or any future competitors focused on their defined role.

The Treasury report recommends legislative action to lock in durable reforms to the GSE's, including restrictions on their investment portfolios and the scope of their activities. This is consistent with ABA's principles.

2. **In return for the GSE status and any benefits conveyed by that status, these entities must agree to support all segments of the primary market, as needed, in all economic environments and to provide equitable access to all primary market lenders.**

While the Treasury report is not explicit on serving all markets in all conditions, it does recommend that the GSEs or any future competitors be mono-line businesses serving only the secondary mortgage market. We urge the Congress, when considering reforms and potential future competitors to the GSEs, to make explicit the requirements to serve all markets in all economic conditions and to ensure equitable access to all eligible primary market lenders.

3. **Access must also include preservation of the “To Be Announced” (TBA) market and both servicing retained and sold options.**

The TBA market, also known as the Cash Window, allows originators to sell loans on an individual basis to the GSEs. This option must be preserved to ensure access to the secondary market for lower volume lenders or those who choose for business purposes to sell individual loans. Similarly, to ensure that originators may continue to service loans consistent with their chosen business model, flexibility to sell loans servicing retained or servicing released must be preserved in any reformed system.

The Treasury report explicitly recommends maintenance of the “Cash Window” for the existing GSEs and any future competitors.

4. **Mortgage Backed Securities issued by Fannie Mae, Freddie Mac or any future competitor should carry an explicit, fully-priced and fully transparent guarantee from the federal government.**

The key benefit conveyed by these entities to the primary market is access to long-term affordable liquidity for mortgage lending. To preserve that liquidity, the government

guarantee is necessary, but taxpayers need to be fully compensated for the risks they bear in providing that guarantee. Fees necessary to support the guarantee must be charged and must be transparent so that they reflect the true cost of the guarantee, and only that cost. Fees should not be assessed to offset other government spending or priorities. It may be desirable to establish a segregated insurance fund to cover potential losses in the event that the guarantee is tapped in a crisis. Further, to ensure equitable access, the fees must be assessed equally on all lenders and in proportion to their volume of business with the GSEs.

The Treasury report recommends legislation to make the government guarantee explicit, and fully priced and fully paid for through the appropriate fees.

5. Fannie Mae, Freddie Mac and any future competitors must be capitalized appropriately to the risks borne and regulated to ensure that they remain so in all market conditions.

Currently, Fannie Mae and Freddie Mac are operating under conservatorship, with little capital and with all profits being swept to the U.S. Treasury as compensation for the federal investment and risks borne of behalf of taxpayers. It will be essential that going forward the GSEs or their successors have adequate capital relative to their exposures in order to withstand market downturns and must take into account the fact that they will be monoline businesses whose risks may be concentrated in certain circumstances. The ongoing risk to the taxpayer is perhaps the strongest reason that legislative reform is necessary.

We would note that FHFA has set forth a proposed capital structure for the existing GSEs on which ABA provided extensive commentary. We commend that to the committee for further detail on our views on capital requirements going forward and are including our comment letter as an attachment to this testimony.

The Treasury report recommends both administrative and legislative actions to establish more appropriate capital requirements for the GSEs and makes the meeting of such capital requirements a condition of the GSEs being removed from conservatorship.

6. Regulation of Fannie Mae, Freddie Mac and any future competitor must include establishment of sound and fair underwriting standards for the loans they purchase, and must be based upon and coordinated with underwriting standards applicable to the primary market.

Significant underwriting requirements imposed under the Dodd-Frank Act, most notably Ability to Repay (ATR) and Qualified Mortgage (QM) rules, while less than perfect, have significantly strengthened mortgage underwriting in the primary market. Going forward we believe it is desirable that these primary market underwriting requirements serve as a basis that supports all secondary market activity, regardless of whether residential mortgages are sold to the GSEs or their successors or to private label purchasers. As a general matter, mortgages sold into the secondary market with government guarantees should meet QM standards, whereas private label securitizations will only require the less stringent ATR standard as a baseline, although investors may establish additional standards at their discretion.

For the primary market, loans originated and held in portfolio should automatically be granted QM status so long as they meet basic Ability-to-Repay requirements and do not run afoul of safety and soundness regulations. There is a powerful incentive that such loans are underwritten conservatively, as portfolio lenders hold 100 percent of credit risk and thus will only make loans that have a high degree of ability to be repaid.

For the secondary market, the so-called GSE Patch currently in place effectively allows Fannie Mae and Freddie Mac to confer Qualified Mortgage status to any loan they are willing to purchase. As a result, Fannie Mae and Freddie Mac define the nature and extent of risks to which taxpayers are exposed. This was a necessary but flawed mechanism to ensure that the new rules did not overly restrict mortgage credit when regulations in 2014 subdivided ATR mortgages into QM and non-QM categories and was deemed to be manageable as long as the GSEs were in conservatorship.

We are pleased that the Consumer Financial Protection Bureau has begun an effort to revise the QM standard and stated its intention to let the GSE Patch expire and replace the existing framework with a new one which is more broadly applicable, regardless of loan destination. We encourage the CFPB to work with the industry, the GSEs, the FHFA and all other interested parties work toward a smooth and seamless transition to avoid constricting credit availability.

No matter what regulatory definition replaces the open ended GSE patch, GSE guarantees should be limited to loans that have well-defined criteria. GSEs should adhere to a properly designed QM requirement to “earn” a federal guarantee that limits risk to taxpayers and will help to guide needed non-QM mortgages to a private label secondary market without taxpayer exposure.

The Treasury report endorses the CFPB’s view that the patch should expire. Treasury also calls for “further revisions to the ATR rule to ensure that mortgage lenders continue to have a bright line safe harbor after expiration of the QM patch.” The report recommends that Appendix Q, a set of preexisting guidelines used to comply with the CFPB rule, should be “revised or removed,” and that Congress and the CFPB should consider alternative approaches to establishing bright line safe harbors for ATR compliance that do not rely on prescriptive underwriting requirements, including setting a simple threshold for financing cost, below which a loan is considered QM. Another option would be to establish that a loan is QM after a specified seasoning period.

7. Credit Risk Transfers required by FHFA should be continued and expanded. Credit risk transfer must be a real transfer of risk and must be economically viable for the GSEs and the lenders they serve.

Several mechanisms for credit risk transfers have been critically important innovations introduced to the GSE model in recent years. They have helped to bring private market participation back to the mortgage markets and have had a real impact on reducing taxpayer exposure to GSE risks. They should become a permanent feature of secondary market financing. However, they must continue to be developed in ways that make economic sense for the GSEs, investors, primary market lenders, and for the borrowers they serve. Also,

credit risk transfers must truly transfer credit risk in a permanent fashion to ensure taxpayer protection.

The Treasury report recommends FHFA use its existing authority – and recommends further legislation to allow for appropriate capital relief for the GSEs when they transfer mortgage credit risk through a diverse mix of approved credit risk transfers.

8. Any reform of the secondary mortgage market must consider the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of Federal Home Loan Banks or access to advances by their members.

The Federal Home Loan Banks (FHLBs) have provided mortgage financing in the form of collateralized advances to their member/owners for over 80 years. They have performed as intended, ensuring liquidity even in times of market crisis. Their effective crisis performance is traceable in part to incentives inherent to mutual ownership status, relatively high statutory capital requirements and fully collateralized lending. Changes to Fannie and Freddie may affect the FHLBs, even if unintended or indirect, and potential effects must be considered, accounted for, and preferably avoided. Additionally, the FHLBs may have the potential to play an expanded role in a revised secondary market system, but any expanded role that exposes members' investment in the System to additional risk must be separately capitalized and regulated in such a manner that it does not put at risk the traditional advance business of the FHLBs.

The Treasury report recommends legislators consider expansion of FHLB membership eligibility. This recommendation is of concern to ABA and our members, as it has the potential to destabilize the FHLB system, which is a member-owned cooperative. Introducing new members with different (or no) capital and a different risk profile for their business has the potential to undermine the operation of the FHLB system and to put existing members' capital at risk. ABA urges extreme caution to legislators looking at any potential changes to the FHLB system.

9. Affordable housing goals or efforts undertaken by the GSEs to expand the supply of affordable rental housing should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects.

The bright line between the primary and secondary market in the single family housing finance area should also broadly apply to the affordable housing and multifamily market. Primary market lenders should be the originators of these loans supported by access to stable, long term liquidity from the GSEs. Only in complex originations where the primary market lacks capacity should the GSEs be involved in direct financing, and strong regulation and oversight should be employed to ensure that there is no “cherry picking” of deals by the GSEs from the primary market.

We believe the Federal Home Loan Bank Affordable Housing Program (AHP) provides a good model for other GSE affordable housing programs. The AHP is a competitive grant program created by Congress in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 and began operations in 1990. The AHP is designed to address local housing needs. It is administered regionally by each Federal Home Loan Bank, working through its financial institution members and those members' community-based partners. Such community-based partners are working at the grass roots level and most closely understand the housing needs of their communities. To further ensure that AHP-funded projects serve local housing needs, each Federal Home Loan Bank is advised by an Advisory Council made up of community and nonprofit affordable housing and economic development organizations from within the Federal Home Loan Bank's district. This model helps to ensure that affordable housing funds are directed by actual needs in a community as identified by community groups and private market lenders in that community. The participation and guidance of local partners is a powerful tool when combined with the resources that can be made available through any GSE-based affordable housing fund or program. To date, the Federal Home Loan Bank AHP has awarded more than \$5.4 billion that has assisted in the purchase, construction or rehabilitation of more than 827,000 units of affordable housing across our nation.

The Treasury report recommends that Congress replace the GSE's statutory affordable housing goals with a more efficient, transparent, and accountable mechanism for delivering tailored support to first-time homebuyers and low-and –moderate income, rural, and other historically underserved borrowers, with a portion of the associated funding potentially transferred to the Department of Housing and Urban Development to expand affordable housing activities. Pending legislation, the report recommends that FHFA consider alternative and more efficient mechanisms to achieve the existing statutory goals.

Reform Need Not Be Radical or Extreme, but Comprehensive in Effect

Some have said the least disruptive path is to recapitalize and release the GSEs, without legislative reform – relying instead upon continuing regulatory actions such as those that have been put in effect during the conservatorship and are unique to the powers of conservatorship.

We reject that approach, as it would return us to the untenable situation of public risk-taking to the benefit of private investors. Even with current reforms in place it would encourage future abuses, instability and undue risks to U.S. taxpayers. Further, legislation is necessary to establish the explicit and targeted government guarantee that virtually all have come to accept as necessary.

Legislation should establish directed and limited activities, strong capital standards and a clear set of benchmarks for implementing and meeting those standards and a mandate to provide equitable access to all primary market participants, regardless of size or geographic location along

with the ability to sell individual or groups of loans. A strong regulator must be part of reform, so too must be clear statutory guidance in this area.

It will also be necessary to ensure that a reformed system can meet these standards in practice and that reform is not overly complicated or uncertain in ways which could disrupt the housing finance system.

The Treasury report recommends specific legislative actions to lock in reforms and to set clear and defined standards. Administrative reforms that are recommended, including the rebuilding of capital by the GSEs will make legislative reform essential to prevent a repeat of past abuses, but the report also recommends safeguards pending legislative action – both to prevent abuses, and to ensure the stability of the mortgage markets.

The ABA appreciates the work of the committee and the Administration in keeping this focus on reform and moving the process forward. We look forward to working with Congress and the Administration to achieve lasting and significant reform.