Statement for the Record

of the

American Bankers Association

before the

Committee on Financial Services

United States House of Representatives

December 21, 2018

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Chairman Hensarling, Ranking Member Waters and Members of the Committee, the American Bankers Association is pleased to submit this statement for the record on the important topic of GSE reform and community 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.

The American Bankers Association, 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. We appreciate the work this committee has done thus far to refine proposals for GSE reform. We particularly appreciate the opportunity to share our views with you today on the discussion draft for bi-partisan reform set forth by Chairman Hensarling, and Representatives Delaney and Himes.

The ABA wants to express our appreciation to you, Mr. Chairman and to Representatives Delaney and Himes for your work in setting forth this legislation. The Hensarling, Delaney, Himes legislative draft seeks to move the reform ball forward on all fronts and does so in a more streamlined way than most earlier legislation. That is important, as one of the major hurdles to achieving reform is concern over problems that can occur in transition from the current system to a new one. A more streamlined approach, utilizing existing structures and systems is definitely a step in the right direction. We believe more work is needed to minimize the risk of transition disruptions but we want to recognize and applaud the work you have done to address those concerns in the draft and to chart a clearer path to reform. To provide you with meaningful feedback on the legislation let me reiterate the principles that ABA believes should guide reform, and how the proposed legislation meets or falls short of the goals.

We believe that these principles should form the basis for legislative reform efforts:

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 behavior. 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 GSEs into other businesses or investment areas. For this reason some have suggested that a public utility or member-owned cooperative model may be a desirable evolution for the GSEs. We note only that while ownership structure is one way to limit and direct activities, strong regulation will also be necessary to keep GSEs or their successors focused on their defined role, regardless of what ownership structure is ultimately chosen.

The draft legislation is broadly in line with this principle. The functions currently assigned to Fannie Mae and Freddie Mac would be divided between Ginnie Mae which would provide the government guarantee, and new private sector entities which would provide private credit enhancements. The Private Credit Enhancers would be prohibited from holding mortgages as a portfolio investment, limiting their ability to leverage their status (but also limiting their ability to buy defaults out of pools). Ginnie Mae would be tasked with regulating and examining the financial health of a presumably expanded set of issuers, and FHFA would be charged with the examination and regulation of the new private sector Private Credit Enhancers. While this approach is broadly consistent with our principles, it will be necessary to ensure that both Ginnie Mae and FHFA have the staff, expertise and other capabilities to robustly examine and regulate their charges in a fair and equitable manner.

Available and affordable credit for the broad swath of lower and middle income borrowers with the ability to repay a loan is the rationale for the legislation. Reasonable and enforceable parameters to ensure that these are the borrowers served, and on terms that do not put the taxpayer at risk must be set to keep the government's role appropriately focused and sustainable.

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.

In the environment envisioned by the draft legislation, the GSEs become PCEs – Private Credit Enhancers – and they are required to support all segments of the primary market equitably. The legislation also provides for a limited ability for smaller lenders to sell individual loans to the PCEs to gain access to the Ginnie Mae guarantee without going through an aggregator.

While broadly in line with the principles, the details will matter greatly. Strong oversight and enforcement will be needed to ensure that the PCEs are ensuring equitable access, and we do have concerns over injecting yet another arbitrary definition of a small lender into the lending environment.

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

The To Be Announced 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.

As noted above, the draft legislation would attempt to replicate the cash window by requiring the PCEs to purchase individual loans from smaller lenders without any aggregation. The PCEs would be prohibited from holding these loans as investments. Again, while limiting the PCEs' ability to leverage their status, this prohibition would also curtail a lenders' ability to repurchase defaulted loans out of a pool as there would be no portfolio to swap in a loan for the one being taken out.

We would suggest that a potential alternative would be to allow PCEs to maintain a limited portfolio, subject to other restrictions to limit leverage, which could then be used to address defaults or other servicing problems. We have a number of concerns about whether the proposed structure would adequately replace the existing cash window and provide smaller lenders—or those who only originate a small number of loans—with truly equitable access both to sell loans and to provide adequate service on those loans, especially in working with borrowers facing default or payment risks.

4. Mortgage Backed Securities issued by the GSEs should carry an explicit, fully-priced and fully transparent guarantee from the federal government.

The key benefit conveyed by the GSEs 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 on a cost averaging basis.

The draft legislation makes a noble attempt to adhere to this principle. It provides for an explicit, fully priced and fully paid for guarantee provided through Ginnie Mae. This is an essential element of any reform and we particularly appreciate Chairman Hensarling's revised approach in this area.

We would note that it will also be essential that fees charged by the PCEs under the proposed approach for the credit enhancements they provide must be tightly controlled and regulated to ensure the equitable access discussed above and to ensure that they are appropriate to the level of credit enhancement being provided by the private sector.

5. The GSEs or their successors 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.

The proposed legislation would charge FHFA with setting new capital standards and ensuring that the PCEs meet them, which the draft refers to as "bank like-equity" requirements, as well as mandating credit risk transfers to diversify risk outside of the housing finance system.

It also would require the establishment of a Private Capital Reserve fund to cover "catastrophic" risk upon the potential failure of any PCE. This seems especially prudent as the PCEs are likely to be subject to pro-cyclical risks that will require an additional layer of support to prevent catastrophic losses resulting from a failure.

We believe that these are all positive requirements, and that detailed coordination with FHFA to further refine and define these requirements is needed. 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.

6. Regulation of the GSEs 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's 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. Such loans are inherently 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.

However, the GSE Patch is designated to expire when conservatorship of the GSEs ends, creating the necessity and opportunity to revise the QM/ATR rules so that the GSEs or their successors are not permitted to define what is QM without restriction. Whatever regulatory definition replaces the open-ended GSE patch, GSE guarantees should be limited to loans that have well-defined and fixed criteria, and transition to a revised QM designation should be managed to avoid constricting credit availability. A properly designed QM requirement to "earn" a federal guarantee is essential to protect taxpayers, and will help to guide needed non-QM mortgages to a private label secondary market without taxpayer exposure.

Here, the proposal is directly in line with our principles. It would require that to be eligible for the government guarantee a loan must have a down payment of at least five percent, have a maximum LTV of 85 percent or supplemental private mortgage insurance or equivalent credit risk transfer that covers loans with an LTV between 85 and 95 percent, have a maximum loan to value below a conforming loan limit, and meet the definition of a Qualified Mortgage through a combination of statutory and regulatory requirements which represent a minimum set of underwriting standards to prevent the government guarantee from being used to back high-risk loans.

The parameters detailed in the proposal are clear and well-defined. We would encourage the Congress to consider carefully the impact of these restrictions on borrowers' ability to qualify, and consider appropriate adjustments if necessary to ensure that qualified borrowers remain able to access stable and affordable mortgage credit. Additionally, the interaction between these parameters and the Ability-to-Repay rules will require that those rules are appropriately reformed and adjusted with input and oversight from the Congress.

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/PCE 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/PCEs, investors, primary market lenders, and for the borrowers they serve. They must also truly transfer credit risk in a permanent fashion to ensure taxpayer protection.

We are pleased that the draft legislation envisions credit risk transfer becoming a permanent part of the secondary mortgage market. To that end, FHFA must vigorously regulate, examine and enforce credit risk transfer requirements.

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.

Because the proposed draft envisions an expanded role for the Federal Home Loan Banks as aggregators and issues for the Ginnie Mae guarantee, this principle is especially pertinent. While the Chicago Federal Home Loan Bank carries out this function for nine of the eleven Federal Home Loan Banks today, under the proposed new system that business can be expected to grow substantially, and it is imperative that it be appropriately – and separately – capitalized from the traditional advance business of the System in order to protect the advance business and the FHLB member banks' capital investment in it if it is expanded in such a way as to put members' investment at any additional risk. Further, consideration must be taken to determine the potential impact of additional regulatory scrutiny from Ginnie Mae which will be necessary to ensure proper compliance with issuer rules, and the costs and burdens that could impose upon the System—which will surely be passed along to their cooperative members.

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.

In this regard, the proposed legislation sets forth a concept for a direct tax or flat “affordability fee” which would be assessed on each mortgage loan that collateralizes any security on which Ginnie Mae provides a guarantee. The ABA remains neutral on such a concept until more detail can be provided, but would encourage the Congress to consider both the potential impact on mortgage affordability of such a fee, as well as the best way to distribute the funds collected under such a proposal. We would observe that such a fee based approach would lend itself well to equitable distribution at the local level, through the community banks and other lenders who directly or indirectly will assess the fee on borrowers. While taxes are rarely embraced, the imposition of such a tax could be softened if a lender is able to explain that the tax will be used locally to address housing needs.

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

The draft legislation represents a significant and improved approach over those considered in the recent past. Separate legislative efforts considered by the Senate Banking Committee in the last Congress and by the House Financial Services Committee at several points envisioned a complete restructuring of the secondary mortgage market system. Those legislative approaches ultimately were not able to gain approval at least in part over concerns that they were too complex and untested, and that the transition from the current system to those envisioned by either approach would be too disruptive to the housing finance system.

Still, those legislative efforts were helpful in focusing attention on the key services provided by the GSEs, the need for those services, and in delineating how some of those services could be separated into component parts, and reassigned in a new system to reduce risk and create opportunity for greater competition.

In that regard, the proposal set forth by the Chairman and Reps. Delaney and Himes is a step forward, at least in theory, relying on existing infrastructure like Ginnie Mae and setting forth a simplified structure for selling loans and gaining the protection of government guarantee – at least in comparison to earlier legislation.

Nonetheless, the draft creates new uncertainties. This can best be illustrated by a description of how the bill, if enacted in its current form would likely impact one ABA member institution. While each bank is unique, this bank is representative in broad terms of many of ABA's members who are engaged in mortgage finance. We believe their views on the draft legislative are illustrative of how many banks would view its potential impacts.

First Federal Savings Bank of Twin Falls, Idaho is a relatively small bank at $645 million in assets, but is the largest mortgage lender in their market. The bank sells loans directly to Freddie Mac and through the Federal Home Loan Banks. It is not a Ginnie Mae issuer. Because of the bank's market share it would not likely be eligible for the small lender exemption allowing it to sell individual loans to a PCE. Therefore, the bank would either need to work with a new PCE to replace sales to Freddie Mac, or increase sales through the Federal Home Loan Banks, or become a Ginnie Mae issuer and securitize loans directly. If the bank were to work through a PCE, because it would not qualify for the small lender exemption, it is unclear if it would be able to sell loans servicing retained, which could negatively impact the bank's service to its customers. Additionally, if Ginnie Mae is to become the guarantor for all eligible loans, it seems that their capacity and staffing would have to be significantly increased.

While the legislation calls for the open adoption of the Combined Servicing Platform (CSP), many uncertainties remain about how that would be adopted across the industry and the costs and benefits of using it. That, combined with the additional level of regulation that would come from being a Ginnie Mae issuer makes executives at the bank doubt that this would be an attractive path.

The affordable housing fee that is contemplated would drive up the cost of homeownership. First Federal already serves a very expensive market, and this additional fee would likely put a home purchase out of some borrowers' reach.

The proposed legislation has a five year transition period, time which should allow for many of the questions to be answered, and for further adjustments to be made either to the legislation if necessary or to impacted parties business models.

Ideally, however, reform should be as seamless as possible, with minimal disruption to the housing finance system. While the proposed legislation makes great strides in simplifying the approach to reform, it may need further refinement before anyone can be confident that it will not disrupt the housing finance system.

Conclusion

Congress has an essential role in providing the certainty necessary to ensure long-term stability of the housing finance system. Just as the federal debt market provides the bellwether that makes all private debt markets more efficient and liquid, an explicit, fully priced, fully paid-for federal guarantee for a targeted portion of the mortgage market will be a catalyst for broader market growth and development. Congress should not defer action any longer. Ten years of conservatorship is more than enough. Without legislative reform, past abuses may be repeated, and new problems may arise.

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 full 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.

The discussion draft meets nearly all of these principles, at least in intent. It will be necessary however, to ensure that a reformed system can meet them in practice and that reform is not overly complicated or uncertain in ways which could disrupt the housing finance system.

The ABA appreciates the work of the Chairman and Representatives Delaney and Himes in keeping this focus on reform and moving the process forward. We congratulate the Chairman on his leadership of this committee and wish him well in his next endeavor. We wish the same for Rep. Delaney, and we look forward to working with Representative Himes, as well as Representative Waters as the presumptive next Chair of this committee, and all the committee members to continue this important work. Thank you.