Testimony of

Brenda Hughes

On behalf of the

American Bankers Association

before the

Subcommittee on Housing and Insurance

of the

Committee on Financial Services

United States House of Representatives

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Chairman Duffy, Ranking Member Cleaver and Members of the Subcommittee, my name is Brenda Hughes. I serve as Senior Vice President and Director of Mortgage and Retail Lending for First Federal Savings of Twin Falls, Idaho. I have been with First Federal for over twenty years. First Federal is a $607 million asset bank which was established in 1915. We currently have 11 branches and one production office and have 247 employees. We are the largest lender in our assigned lending area and have originated over $1 billion in mortgage loans in the last 10 years.

I am pleased to be testifying on behalf of the American Bankers Association on the important topic of GSE reform and community bank access. 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.

In addition to my role at First Federal Bank, I served on Freddie Mac's Community Advisory Board from 2005 to 2016, chaired the ABA's Mortgage Markets committee from October of 2012 until September of 2014, and currently am vice chair of the ABA's GSE Policy Committee. I also currently serve on the CFPB's Community Bank Advisory Council.

First Federal actively delivers loans directly to Freddie Mac and to the Federal Home Loan Bank of Des Moines and we retain servicing on these loans. We also work with a handful of other market investors to whom we sell loans with servicing released. We currently service approximately 5,000 loans. Like so many banks, both large and small, access to the secondary market in general, and through the federally guaranteed secondary market enterprises (GSEs) in particular, is essential to our ability to meet the mortgage needs of our customers.

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 since 2008. We appreciate the work this committee has done thus far, as well as the opportunity to share our views with you today.

On GSE reform, and on the importance of preserving access for lenders of all sizes and in all regions of the country, ABA believes that:

- Key shared principles should guide reform efforts;
- Without legislative reform, past abuses may be repeated, or new ones may arise which imperil the mortgage markets and put taxpayers at risk; and
- Reform need not be radical or extreme, but should be comprehensive.

I will elaborate on each of these in turn.

I. Key Shared Principles Should Guide Reform Efforts

ABA has (during the many years that Fannie Mae and Freddie Mac have been in conservatorship) worked with bankers from institutions of all sizes and from all parts of the country to develop principles which should guide reform of the GSEs. For the purposes of this testimony, we highlight the following principles, and note that many of these are widely shared among various other trade and industry associations.

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

1. **The GSEs must be strictly confined to a secondary market role of providing stability and liquidity to the primary mortgage market for 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 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.

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.**

The GSEs or their successors, including any potential new competitors that may be chartered, will benefit from a defined market available only to them and with a government guarantee on the securities that are issued. To ensure that those benefits are available to all, GSEs must be required to provide access to all primary market lenders on an equitable basis.

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.

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.

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 to withstand market downturns, especially as they will be monoline businesses whose risks therefore may be concentrated in certain circumstances. Capital support for the guaranteed secondary market can come from a variety of sources, including indirectly from credit risk transfers, and investment of new capital from new member/owners/users of the GSEs or their successors (depending upon the model ultimately chosen by Congress).

Recently concerns have been raised that with no capital buffer the quarterly sweeps to Treasury could require one or both of the GSEs to take a draw from their line of credit. Some have urged that the GSEs be allowed to rebuild capital to avoid this, even absent reform. ABA strongly believes that recapitalization must be coupled with necessary reforms. A draw can likely be avoided by altering the terms of the sweep to annual rather than quarterly payments, and even if a further draw on the line of credit is needed it would be consistent with the terms of the conservatorship and not a cause for undue concern.

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 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 conservatively underwritten 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 non-QM mortgages to a private label secondary market without taxpayer exposure.

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. They must also truly transfer credit risk in a permanent fashion to ensure taxpayer protection. To that end, FHFA (or its successor) 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 crisis performance is traceable in part 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 must be separately capitalized and regulated in such a manner that it does not put at risk the traditional advance business of the FHLBs.

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.

Without Legislative Reform, Past Abuses May Be Repeated

Prior to conservatorship, Fannie Mae and Freddie Mac existed as hybrid companies, in a duopolistic system. They had private shareholders who profited from risks taken with the implied guarantee of the federal government. Changes to the charters of the institutions must be undertaken in legislation to remove this private profit/public risk model. The GSEs should be transformed into cooperatively owned public utilities or other similar limited purpose, well-regulated entities.

Early in the conservatorship, Fannie Mae and Freddie Mac were unable to pay the 10 percent required interest rate on over $180 billion injected by U.S. taxpayers to prevent their collapse. As a result, the two were de facto nationalized with profits, if any, being swept to the U.S. Treasury. Under this arrangement, the interest payments on government bailout funds has been waived. The GSEs operate with little and shrinking capital and are, under terms of the conservatorship, expected to go to zero capital by 2018.

Since returning to a positive cash flow in recent years, the terms of the conservatorship as amended have remained in place. Though funds swept to Treasury have been substantial, the amount falls substantially short of the taxpayers' direct investment plus the waived interest obligations on that investment. The terms of the conservatorship do not provide for a cutoff of payments (or for the debt incurred to be considered repaid) and do not allow for the GSEs to retain earnings to build capital.

Some have suggested that the GSEs simply be recapitalized and released back to the private market, with limited changes to their charters, noting that reforms to the entire mortgage market have addressed many of the problems that lead to the financial crisis and the insolvency of the GSEs.

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 and undue risks to U.S. taxpayers. Instead, legislation should establish directed and limited activities, strong capital standards and a clear set of benchmarks for implementing and meeting those standards.

It will also be essential for legislation to firmly establish a mandate that the GSEs provide equitable access to all primary market participants, regardless of size or geographic location. As cited in principle 2 above, in return for the GSE status, these entities must be willing to serve all primary market participants on an equitable basis in all market conditions. That includes access to the TBA market (also known as the "Cash Window") with the ability to sell individual or groups of loans.

In recent years, and primarily as a result of a mandate by the FHFA, the GSEs have moved to standardized Guarantee fees (G-fees) for all primary market originators selling to the GSEs. Going back to the early 2000's, however, great pricing differentials existed, with the GSEs giving large volume discounts and other preferential pricing to some institutions. This un-level playing field severely hampered community banks' ability to compete and serve their communities.

Going even further back, some community banks found it difficult to do business with the GSEs at all, as their pricing and other policies were geared toward higher volume lenders and the GSEs showed little interest in working with smaller, lower volume banks.

It will be necessary to incorporate into statute the mandate that the GSEs serve all primary market participants equitably in order to avoid the potential for backsliding.

Some will argue that this can be accomplished via regulation, and indeed, FHFA has done an admirable job in recent years ensuring equitable treatment. However, regulators and regulatory approaches can change over time. While a strong regulator must be part of reform, so too must be clear statutory guidance in this area.

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

Separate legislative efforts considered by the Senate Banking Committee in the last Congress and by the House Financial Services Committee earlier envisioned a complete restructuring of the secondary mortgage market system. Those legislative approaches were ultimately 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.

Consensus is forming around the view that a limited and controlled government involvement in the secondary mortgage market is needed to ensure the availability of stable, affordable long term financing for mortgage finance.

Legislation need not recreate the entire secondary market structure from scratch. In fact, guided by the principles detailed above, and incorporating key elements laid out here, we believe that relatively tailored legislation that takes a surgical but comprehensive approach to making necessary alterations to the current system is both desirable and achievable.

In addition to changes to the charters and ownership structure of the GSEs, the creation of clear, achievable and strict capital requirements, and the mandate to serve all primary market participants equitably, these changes should also include creation of an insurance fund to backstop the GSEs capital to protect taxpayers further from again having to bailout the GSEs. While the government will stand behind the securities issued by the GSEs, the insurance fund should stand in front of the

explicit government guarantee to protect taxpayers to in the event that the guarantee is ever drawn upon. The fund should be actuarially sound and modeled on the FDIC insurance fund.

Conclusion

Americans have relied on long-term, fixed-rate mortgages for affordable mortgage finance for 70 years. Fannie Mae and Freddie Mac have facilitated access to this product by providing access to the capital markets for primary market lenders. Absent aggregation and securitization provided through the TBA market, access to long-term, lower-rate funding would be far more difficult to come by for most primary lenders. The government guarantee provided to mortgage backed securities issued by the GSEs makes them attractive to the capital markets, ensuring liquidity. All of these elements must be preserved and remain available to all primary market participants regardless of size or geographic location.

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. Nine years of conservatorship is more than enough.

Thank you for the opportunity to share our views with the committee. The American Bankers Association stands ready to work with members of the committee to advance this important set of issues.