Consumer Federation of America

Comments by Consumer Federation of America

In Response to

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Public Input on Reform of the Housing Finance System

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Question 1: How should federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?

The federal government continues to have a significant role to play in realizing the goal set in 1949 to provide every American with a decent home in a suitable living environment. The highest priority attention should be given to supporting the preservation and production of an adequate supply of decent, affordable rental homes, especially for lower and moderate income families, and to ensuring the continued availability of affordable, long-term mortgages for home purchase by low, moderate and middle income families.

Rental homes

Balanced national housing policy must include a significant focus on assuring a reliable and adequate supply of rental housing. Some of this, perhaps even the largest share of it, will be provided through single family (1-4 unit) homes, which still provide the largest share of rental housing, especially for low and moderate income households. But larger multifamily properties also play a significant role. Consistent access to well-priced and well-structured mortgage finance for rental housing is critical to the health of our entire housing finance system.

Long term demand for rental housing is going to continue increase in the coming decade as a large population bulge works its way through the system. While demand for new household units is depressed by economic conditions in the current recession, as the economy improves and employment rises, demand for housing units is going to increase.

Harvard's Joint Center for Housing Studies estimates that even with a conservative estimate of net immigration, US households could grow as much as 12.5 million 2010-2020. In addition, the so-called "echo boomers" reaching household formation age in this same period will assure continued population pressure, with more than 5 million more members in the cohort than the boomers had in the 1970's. *(State of the Nation's Housing 2009, p. 5)* The number of renter households increased by 3.2 million between 2004 and 2009. *(State of the Nation's Housing 2010 p 25.)* Minorities are more prevalent in this generation, and their household income and wealth are considerably smaller than that of their white counterparts *(State of the Nation's Housing 2010, p 14).* This suggests that they will occupy rental housing for a longer period of time than has been the case in the past, increasing demand.

The current recession has depressed demand for housing as incomes have been reduced by unemployment and families have suffered losses in equity in both the housing and asset markets. Many are delaying household formation by remaining at home with parents. A recent study by Gary Painter published by the Research Institute for Housing documents that headship rates have declined noticeably between 2005 and 2008, while overcrowding has increased, by a significantly higher amount. Others are doubling up

following the loss of a home they owned or because of eviction from a foreclosed property. Nevertheless, the Census reports that the actual number of renters increased by 999,000 between 2Q08 and 2Q09, and Harvard's Joint Center for Housing Studies projects that the number of renters between 2010-2020 will grow between 3.8 and 5 million households. *(State of the Nation's Housing 2010, p. 26.)*

Housing cost burdens remain very high for low and moderate income families, and doubly so for extremely low income renters. The Joint Center reports that the number of households spending more than half their income on housing jumped by 30 percent in 2007 to nearly 18 million, while those paying between 30 and 50 percent of their income for housing totaled 21.6 million.

The supply of homes affordable to these households has been in steady decline for decades. HUD's Components of Inventory Change found that the net number of apartments affordable to those with incomes at or below 60 percent of median income declined by 1.5-2.0 million units between 2005 and 2007. Fully 75 percent of this loss was attributed to rents rising in existing units, with the remainder either leaving the inventory altogether, or converting to owner-occupancy. The National Low Income Housing Coalition estimates that there was a shortage of 3 million rental units affordable to very low income renters compared to the demand in 2007.

Vacancy rates are not rising uniformly within the inventory.

The historical vacancy rate for rental housing since 1990 is 8.5 percent, while the reported rate currently is 10.6 percent. At the end of 2008 there were about 4.1 million vacant rental units based on this difference. If half of these were returned to the active inventory, returning the stock to its historic vacancy level, only about 800,000 additional units would be absorbed. Simple household growth would rapidly absorb a far higher number of units. Thus the higher vacancy rate on a gross basis does not necessarily translate into a significant number of additional units.

Vacancies are concentrated much more heavily at the higher end of the market. Adjusting for utilities, 52 percent of vacant rental units have rents over $840 per month, and 64 percent have rents above $720 per month. A renter at 50 percent of the national median income of $64,000 would be able to pay $720 per month; one at 60 percent of AMI, the tax credit limit, would be able to pay $820 per month. Thus rental vacancies are typically much more expensive than these renters could reasonably afford. Nationally, half of all vacant units have rents higher than deemed reasonable for those at 60 percent of the AMI, and 64 percent exceed the rents that are reasonable for those with incomes at 50 percent of AMI or less. Rents in the Northeast and West are well above these levels, while the Midwest and South are slightly lagging.

Rents have been rising generally and vacancies at the low end have been declining. Between 2Q08 and 2Q09 median asking rent for an apartment rose from $678 to $715, while the total number of renters increased by nearly 1 million. The proportion of units with asking rents of $1500 or more rose from 7.6 percent to 9.3 percent. Conversely, the share of vacant units with rents of $400 or less declined from 10.8 to 9.3 percent in the same period, according to analysis prepared by the National Low Income Housing Coalition.

Vacancy rates in projects supported by Low Income Housing Tax Credits, with their restricted affordable rents, are reported to be about half of the overall market, at around 4.5 percent in a sample of 234,000

units (about 17 percent of the total inventory of such units), according to analysis from LISC and Enterprise Community Partners.

The rental housing market has long been characterized by the dilemma of steadily rising costs and stubbornly stagnant incomes among lower and moderate income renters. When a significant portion of the rental consumer market cannot pay economic rents to cover reasonable operating expenses in rental housing, temporary surpluses in the general market are of little use.

These structural problems in the rental market are currently exacerbated by the same forces that have hammered the homeownership market. The extended recession and rising unemployment and underemployment have exacerbated the weak economics of lower and moderate income renters, while apartment owners have seen only modest reductions, if any, in their operating and debt costs. Trends in the capital markets suggest that many apartment owners who took out short term loans to finance their properties will be forced to raise equity and cover much higher debt service coverage ratios when these loans are refinanced, posing real and difficult obstacles for affordable rents. Much of the rental sector losses have been driven by foreclosures on 1-4 unit homes financed speculatively during the bubble and now in foreclosure. *(In some states renters make up as much as 40 percent of those evicted from foreclosed properties, according to the National Low Income Housing Coalition.)* While some of these units will return to the rental market at some point, others are likely to be demolished or lie vacant for extended periods because of tighter credit standards and neighborhood impacts of foreclosures.

When this cycle abates and recovery and job growth resumes, the current supply of decent existing affordable rental housing will become even more valuable than in the past. Single-family homes that may be serving as rental housing today will quickly revert to homeownership, and increased household formation and in-migration to areas that have jobs available will absorb what vacancies exist in rental apartments. Except in distressed communities where job growth remains weak, this will push rents up further beyond the reach of low and moderate income tenants. In those weak markets, disinvestment and deterioration threaten to further reduce supply unless effective strategies to preserve the affordable housing stock are adopted.

The coming flood tide of demand is going to place renewed price pressure on the existing inventory, resume the long term trajectory of rising rents, and place existing affordable units in jeopardy. Identifying effective strategies to extend the useful life of existing properties at affordable rents, to increase their operating efficiency to keep down long term cost increases and to strategically combine these strategies with other community development and stabilization strategies will help protect the remaining inventory of affordable rental housing from further decline. Access to affordable mortgage finance is going to be critical for these strategies' success.

Access to affordable financing for rental housing also is critical for neighborhood stability for all residents, both owners and renters. The inability to finance needed repairs, or refinance expiring mortgages, or finance modernization and upgrading of rental properties can lead to disinvestment, dilapidation and deterioration of the entire neighborhood. More often than not, smaller multifamily properties are owned and managed by smaller entrepreneurs and companies. These are not able to effectively access capital markets for financing. Access to credit on affordable terms is critical to them. If such financing cannot be provided on a reliable basis, a cycle of high-cost lending and owner disinvestment is likely. American neighborhoods have been plagued by these cycles for generations.

Federal support for rental housing through FHA and through the secondary mortgage market has been a critical element in improving access to such credit, and is even more important today.

All Americans start their independent lives and spend much of their young adulthood and beyond in rental apartments. While rent levels have softened in higher cost properties, and vacancy rates in those properties have increased to historically high levels,the number of rental homes available to very- and extremely low income families has continued to shrink through conversions, demolition and abandonment. A strong federal role in assuring adequate capital to this sector is more important than ever.

Homeownership

There is a long tradition of federal support for homeownership. Federal sponsorship in the primary and secondary markets is only part of it. Federal tax policies that strongly favor homeownership through deductions for mortgage interest, property taxes, and exclusion of capital gains and the exclusion of imputed rent for owner occupants are far more powerful macroeconomic incentives.

Homes remain the single largest asset that most households own, even after the steep value losses of the last several years. The Federal Reserve's Survey of Consumer Finances documented that in 2007 only about 53 percent of all US households held a retirement account of some kind; only 11 percent of the households in the lowest income quintile had them. For those in the second and third quintiles the numbers were 36 percent and 55 percent, respectively. Overall, these accounts were worth a median of $45,000 for all families; and $6,500 for the lowest quintile, $12,000 for the second, and $24,000 for the third.

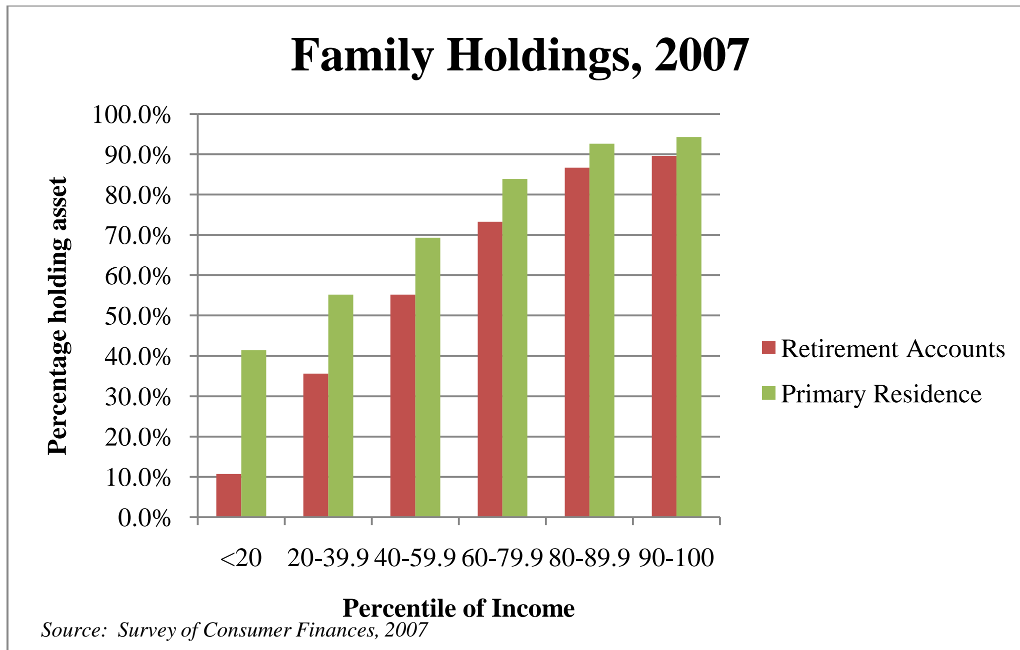
In contrast, 69 percent of all US households in the survey owned their primary residence. In the lowest quintile, this figure was 41 percent, or more than three times the share holding retirement accounts. In the second quintile 55 percent owned their home, more than 50 percent greater than the share holding retirement accounts, and in the third quintiles, 69 percent did, more than 20 percent greater.

The value of primary residences also far exceeded that of retirement accounts, with a median of $200,000 overall, and $100,000 for the lowest quintile; $120,000 for the second and $150,000 for the third. These figures do not take into account the debt that households have on the properties; their equity in the homes would obviously be smaller than the total value of their principal residence. In spite of that, while these values undoubtedly have declined since 2007, and some share of these owners have lost their equity and possibly their homes, the difference in both participation rates and overall asset size documented in these figures is striking. Homeownership has and likely will continue to be the single most valuable asset for families as they age, and home equity represents the most significant source of potential retirement savings they are likely to have.

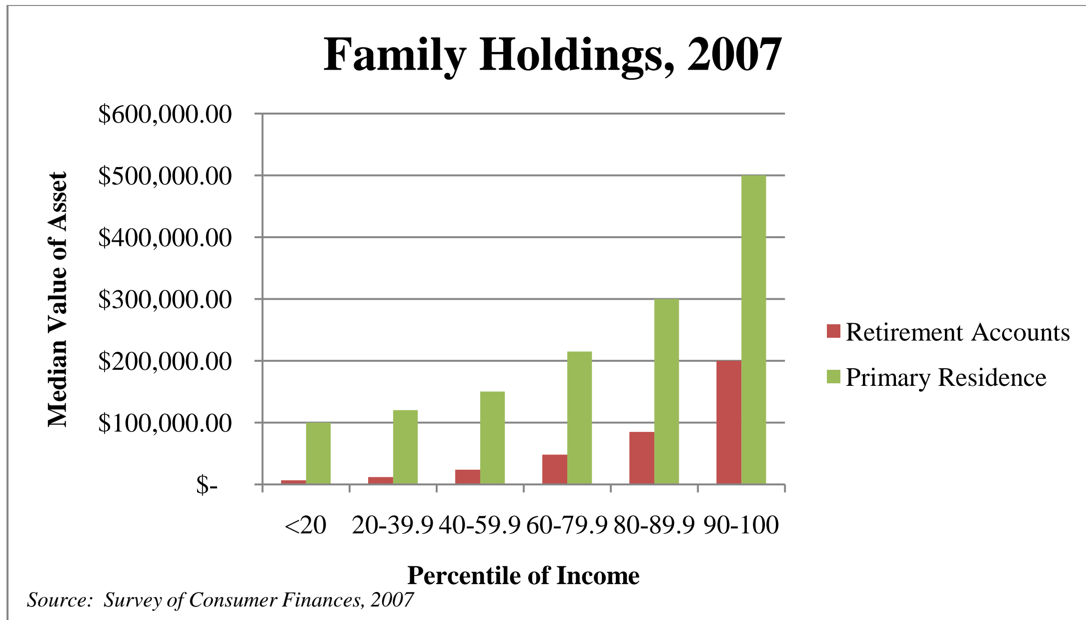
Moreover, research conducted by the Center for Community Capital at UNC Chapel Hill concluded that,

> The results indicate that these low-income borrowers *(participants in the Community Advantage loan program)* have experienced considerable home price appreciation since they purchased their homes, and that they have also accumulated and retained considerable equity, despite the most recent changes in economic conditions and the housing market. The timing of purchase has been a key factor in determining the growth

rate of household wealth, as have the geographic locations in which these borrowers chose to purchase housing. These observations suggest that homeownership continues to make sense as an investment for low-income borrowers in CRA mortgages but is likely to be most effective as a wealth-building avenue for this population when it is purchased as a long-term investment.[1]



[1] *Navigating the Housing Downturn and Financial Crisis*, Sarah Riley, Allison Freeman, Roberto Quercia, Working Paper November 2009, p. 4 http://www.ccc.unc.edu/documents/Navig.Hous.Downturn.APPAM.11.09.pdf



Homeownership has been a reliable and important means of generating and passing on wealth. The continuing difference between homeownership rates among minority and White households remains an important driver of the wealth disparities between these groups.

A 2004 Working Paper published by Freddie Mac concluded that,

> The homeownership rate for families with income below the median was 52 percent in 2003 while only 28 percent held stock market assets. Poterba (2000) reported that in 1998 the top 1 percent of stock equity investors held about one half of total stock market wealth, while the 1 percent of households with the greatest holdings of real estate owned only 15 percent of all real estate. In fact, about three quarters of all stock market wealth is held by the highest decile of income earners in the U.S. and almost none by families whose earnings fall in the lowest third of the income distribution, whereas home equity wealth has a more equal distribution across income groups, as shown in Exhibit 1. Because home equity wealth is more evenly distributed, lower-, middle-, and higher-income families all benefit from a general rise in home equity.[2]

Homeownership also is an important factor in neighborhood stability. The federal government has invested many billions of dollars in the last 25 years to help state and local governments stabilize communities through rehabilitation and homeownership strategies. Communities without a significant portion of homeownership are more likely to suffer from disinvestment and neglect, along with decreasing amounts of civic involvement.

The recent deflation in housing values is, however, a sobering reminder that while housing on a national level has been a historically positive investment for more than 75 years, it may not always be so. Federal

[2] *Refinance and the Accumulation of Household Wealth,* Freddie Mac Working Paper #04-02, Frank E. . Nothaft and Yan Chang, February 2004, p. 4

policy should focus primarily on the shelter components of housing – its utility for individuals and families as a place to live – rather than on its investment components. For most households, owning a home is an important means of stabilizing tenure, establishing a commitment to a neighborhood and its institutions, and performing an important savings function through the amortization of mortgage debt -- even when house price appreciation is modest. Many households will continue to rent, either by choice or by circumstance. Federal housing policy must take a balanced approach that supports both kinds of tenure.

First-time homeownership

For many renters who aspire to own a home, long-standing barriers like a lack of capital for a down payment and inadequate credit remain principal obstacles. For some others, lack of information about the process and who can qualify for a loan also are barriers. These are especially critical obstacles for communities of color. Lack of intergenerational wealth transfers, historical patterns of discrimination in lending and neighborhood development, and historical reliance on so-called "trusted advisors" in these communities has led to both homeownership rates in these communities that are below what they ought to be considering income, wealth and credit factors and a proliferation of toxic mortgage products. Federal policy should recognize these obstacles and provide assistance in overcoming them. Indeed, the origins of the homeownership push initiated by the Clinton Administration in the 1990's was driven by the fact significant portions of the disparity in homeownership rates between white and minority households could not be explained by economic factors such as income or wealth.

A key part of fostering first time homeownership remains insuring that long term fixed rate financing on safe and sustainable terms continues to be available. It also should include support for sustainable mortgage products for borrowers with low wealth but good credit through well-underwritten, lower down payment loans with escrows for taxes and insurance. Pre- and post-purchase counseling also should be a key component of government housing policy to support those for whom information and preparation are significant barriers to sustainable homeownership.

Investor owned homes

In some parts of the country, investor-owned single-family homes (1-4 units) provide a significant portion of the rental housing supply, particularly for low and moderate income renters. Indeed, more than one-half of all rental units are in single family dwellings, and a significant additional share is in properties with fewer than 10 units. (While some small rental properties are owner-occupied, most rental properties are investor-owned. Sometimes these are smaller "mom and pop" operations; larger properties are more likely to be owned by partnerships and corporations.) These are good reasons for identifying how the benefits of federal support can extend to homes rented to people of modest means. At the same time, investor-owners do not behave or perform in the same ways that owner occupants do. Their loss rates are higher, and their willingness to stay with a property when it declines in value or when the income it generates is no longer sufficient to generate a profit is much lower. Historical data from Fannie and Freddie indicate that investor owned single-family properties pose a significantly greater credit risk than owner occupied ones. While some federal support for this sector may be warranted, it should be highly targeted and carefully controlled.

Question 2: What role should the federal government play in supporting a stable, well-functioning housing finance system and what risks, if any, should the federal government bear in meeting its housing finance ojectives?

A stable, well-functioning housing finance system must meet three critical needs: stability, liquidity and affordability.

In this context, a restructuring of the mortgage finance system should address each of the following key questions:

- Will it support the availability of long-term, fixed rate mortgages for consumers?
- Will it offer access to capital by as wide a variety of institutions as possible, from small community banks and credit unions to large money center institutions?
- Will it foster and spread innovation in mortgage products to insure that helpful and sound new products can be made available widely in the marketplace?
- Will it fulfill a significant duty to serve underserved populations and communities?
- Will it provide financing both for affordable single family homeownership and rental housing?

A new system also must insure that the frantic "race to the bottom" in underwriting standards that fueled the housing bubble cannot be repeated. This was financed largely by the shadow banking system of unregulated investment banks. Strong regulatory oversight in the primary mortgage market is essential, and much of this has been put in place in the wake of the meltdown. But it also requires a more systematic approach to the world of mortgage backed securities. A system that fails to take such steps only invites an eventual repeat of the mistakes that led the system to the brink of failure.

Liquidity

Liquidity is necessary to assure that consumers have ready and continuous access to affordable mortgage credit. This liquidity assures that lenders can offer products on a constant basis; that investors can count on a stable and steady supply of mortgages; and that pricing is driven down through transparency and easy trading of mortgage assets in the market.

Assuring this liquidity, especially for long-term, fixed rate mortgage assets, requires the ability to intermediate between investors' appetites for fungible, transparently priced assets that can be funded with short term capital and consumers' need for a long-term, fixed rate liability. In the past this was gained through the guarantee function of Fannie Mae and Freddie Mac and Ginnie Mae, whose participation in

the market standardized mortgage assets and the securities purchased by investors. These "brands" still support a very deep and very liquid market through which prices are determined by market trading.

The standardization of products and assurance of repayment terms remains a critical need to insure that American households continue to have optimal access to mortgage credit, especially long-term mortgages. This is especially true for the "to be announced" (TBA) securities market. This futures market enables rate locks for consumers and effective hedging for lenders because of the standardization of the assets that can be put into such MBS pools. Prices can be set in advance because investors can rely on the standardization of assets to eliminate a significant variable in their pricing assumptions. Standardization helps reduce costs to consumers through commodifying products and making it difficult for any credit provider to charge significantly higher prices for the same product. The establishment and enforcement of standardization is a critical function for the secondary market and housing finance system in general that must be maintained in whatever form the system takes.

Some form of federal support to sustain this standardization function and support constant and deep liquidity for loans serving middle tier assets must be maintained.

Access

A very important goal of the mortgage system must be to maintain access to a range of sustainable and affordable mortgage products both to *consumers* in all communities, and through *lenders* of all sizes and in all locations.

A significant benefit of the current system is that the GSEs enable lenders ranging from small community credit unions and banks to the largest money center institutions in the country to use the same underwriting standards, the same range of products and the same access to both whole loan and securities executions. Through their special purpose charters, Fannie Mae and Freddie Mac ensured continual access to these products and services and provided a healthy counterbalance to the natural tendency of large financial institutions to integrate their delivery channels as much as possible and try to force smaller lenders into relationships that sometimes were not in the smaller lenders' long term best interests. The ability for any small-town lender to offer a wide range of mortgage products to its customers and to take advantage of open access automated underwriting technologies to do so, for instance, have a powerful leveling effect. This also helps to foster widespread competition for business and keep the price consumers pay for mortgages lower as a result. Unless the emerging system provides a secure and durable means for smaller lenders to maintain this access, there is a strong risk the mortgage markets will quickly be characterized by consolidation and dominance by a relative few institutions. This is neither beneficial for consumers nor for stability and diversity in the financial system.

Access to affordable and sustainable mortgage credit by borrowers in all places, at all times, and without discrimination of any kind is also a key outcome that the system must assure. The system must prevent any beneficiaries of federal support from bypassing or disadvantaging any geographic localities, by focusing for instance on only a few states, or only on metropolitan areas within states. The privilege of federal support for mortgage instruments must be accompanied by a requirement that participating institutions serve all markets at all times. They must be required to offer a full range of sustainable and affordable mortgage products, including those with lower down payments, and not be permitted to "skim" the market by borrower type or circumstance.

Innovation

The US mortgage system has benefitted for many decades from the systematic adoption of innovation. Often, these innovations benefitted consumers and contributed to the expansion of sustainable homeownership. Lower down payment requirements, use of nontraditional measures of credit-worthiness and support of pre- and post-purchase counseling, "second look" programs by originating lenders and other initiatives that helped build sustainable homeownership gains in the 1990's were made possible in part because a national, specialized secondary mortgage market could rapidly spread such features to lenders throughout the country. It is important to stress that not all innovation is necessarily positive or desirable. Recent "innovations" that were sold as a means of increasing "affordability" by qualifying borrowers at the lowest, rather than the highest, possible rate in an adjustable mortgage, for instance, destabilized consumers' finances and subjected them to unreasonable cost increases that have, in many cases, led to default and foreclosure.

Large private institutions have every incentive to carefully guard innovations and resist their widespread use, as this reduces their first adopter advantages and the margins that can be charged as more competitors enter the market. The GSE model meant that once they adopted a change it could be offered to any institution of any size, rapidly driving down their cost and benefitting consumers. A new system needs to replicate this function to both foster innovation and insure its rapid diffusion.

A secondary market system dominated by large financial services companies is unlikely to provide the same broad access to financing and products as one that includes government sponsored entities with a specialized role. Large institutions have a natural tendency to drive aggregation and as much vertical integration in their business models as possible. Without a counterbalance with a specific purpose of providing access to all institutions, a system dominated by large financial institutions likely would significantly limit smaller institutions' choices and business models. This might increase efficiency in the short run. But it also would undermine the positive virtues of having a highly deconcentrated originations system that includes community banks and credit unions who likely would suffer under a more consolidated and integrated model.

The need to insure access to safe and affordable credit products is more obvious today in the wake of the financial crisis. The federal government should play a role in assuring that a restructured housing finance system supports the development and spread of responsible and sustainable innovations. This applies to mortgage products as well as services, such as automated underwriting technologies, that reduce business process costs and should ultimately result in reduced consumer costs. In the past this was done through the GSE charters. In future, it could be achieved through a revised form of chartered enterprise, combined with purposeful partnerships between a federal risk taking capacity and private risk takers, such as private mortgage insurers and chartered mortgage enterprises. Alternatively, structuring a charter for MBS issuers that specifically includes a responsibility to foster responsible and sustainable innovation could provide this assurance. Providing federal insurance for the securities issued by qualified and well capitalized entities also could help establish a class of mortgage finance entities with a specific purpose of providing broad liquidity and access to products and services, as would partial or full backing of limited purpose portfolios used to provide liquidity for such purposes.

Any new system must address this issue and insure that the "race to the bottom" in mortgage underwriting that drove the subprime and Alt-A crisis is not repeated through unregulated mortgage marketing at either

the primary market or the secondary market level. It also must guard against empowering existing very large and systemically important institutions from dominating the mortgage system through proprietary, closed systems that will increase costs to consumers.

Long Term, Fixed Rate Financing

We strongly believe that the long term fixed rate mortgage is a critical part of a consumer friendly national housing policy. These instruments were invented by the federal government in the depths of the Great Depression to bring the cost of monthly payments for a home within reach of working borrowers and, through self-amortization, to assure that their monthly payments would result in the development of equity.

A home purchase is typically the largest single investment any household is likely to make. The size of the investment, and the long-term nature of the asset that it finances, make it well suited to long term fixed rate financing. Such financing enables large purchases to be capitalized with affordable payments. Fixed rate financing shifts the risk of interest rate changes – and consequent variation in the cost of paying for the home – from borrowers, who are least able to hedge such risks and least likely to be able to quickly accommodate significant increases in their monthly costs, to financial institutions who should be able to do so. Long term fixed rate, fully documented prime mortgages consistently demonstrate the lowest failure rates of any kind of mortgages. Their payments are fixed, providing predictability and certainty; if a borrower's income increases over time, as is likely, the loan consumes a decreasing share of that income, further enhancing the loan's stability for borrower and lender.

Adjustable rate mortgages can play an important role in housing finance. But these instruments can also become powerfully destabilizing for household finances if they are used to qualify borrowers without regard to the ultimate likely cost of the loan. Some form of support for standard, stable ARM mortgages can be useful. But consumers should be able at all times to choose an long term, fixed rate, no prepayment alternative.

While some commentators have speculated that long term fixed rate financing would be available without federal support like that provided historically by the US government, evidence from the rest of the world suggests this is not the case.[3]

Portfolio holders, like banks, have a significant incentive to offer adjustable rate products that shift interest rate risk onto consumers. Where longer term debt was offered by these lenders, it likely would carry prepayment penalties to lock in a yield and cost more than debt benefitting from federal support. In either case, consumers would have to absorb the higher costs.

We believe that some form of federal support will be necessary to assure continued access for consumers to long term, fixed rate mortgages without prepayment penalties. The most efficient form of this support would be explicit federal guarantees for MBS backed by qualified mortgages that emphasize long term, fixed rate terms without prepayment penalties. Such insurance should be available only through entities specifically chartered for this purpose. The guarantees should be paid for, on as actuarially sound a basis

[3]"The United States is unique in having a 30-year, fixed-rate, prepayble mortgage. Other industrialized countries have mortgages with long (25-30) lives, but only in the US do they have an interest rate that is fixed for the full term and the loan is prepayable. Only Denmark, population 6 million, has anything close. Other industrialized countries do have long-term (25 to 30 years) amortizing loans, but the rates adjust at least once every 5 years. As even we in the US have experienced, long-term, fixed-rate prepayable loans can cause systemic trouble." Woodward, http://woodwardhall.wordpress.com/2009/01/

as possible, to create an FDIC-like pre-funded account that would be available for meeting government guarantees should it become necessary. Debt and equity of such entities generally would not have any government backing, except for the possible maintenance of small portfolios to be used primarily for countercyclical and innovation purposes. These entities would be subject to regulation and oversight to insure adequate capital and enable their enforcement.

The charters for these entities need not be as extensive or broad as those held by Fannie Mae or Freddie Mac. But we strongly believe that the GSEs' charters contain critical elements that remain important in any new system, as we explain above and elsewhere. The corporate form that these entities take is not as important as assuring that their use of the federal guarantee will provide not only liquidity for long term mortgages but also the other key outcomes of the system that we enumerate throughout these responses.

Portfolio

Acquiring and holding whole loans in portfolio was Fannie Mae's only business line from its inception in 1938 until it began guaranteeing MBS in the 1980's. This enabled Fannie Mae to provide liquidity when no other institution would do so, and continue to provide it as other market opportunities were developed. The growth of the GSEs portfolios, particularly in the 1990's, with a vaguer "implicit" guarantee, was criticized for arbitraging the firms' borrowing advantages to generate income. But the portfolios remained important elements in assuring two policy objectives: constant liquidity for mortgage assets, and innovation and accommodation of specialized mortgage assets.

The countercyclical value of stable portfolios underwritten with federal support is to provide a buyer in the market for mortgage debt at affordable prices to consumers when other buyers leave the market. Such a credit contraction occurred in 1998, in the wake of the Russian debt crisis and the collapse of Long Term Capital Management. Another occurred starting in 2008. In the former case, Fannie and Freddie were powerful counterweights to the flight of capital from other assets. US housing consumers did not see big spikes in mortgage rates, nor was there a shortage of capital, though other asset classes experienced both. In the more recent case, the GSEs' portfolios were capped through their Conservatorship. In their stead, the Federal Reserve stepped in when faltering demand for mortgage securities started driving up mortgage interest rates and threatening early signs of a budding recovery. After investing more than $1 trillion in mortgage bonds and driving rates down to historically low levels, the Fed has withdrawn and private capital appears, at this moment, to be willing to return to pick up the slack. This could be the default option for providing liquidity in the future, but there are no guidelines to determine when such a drastic step would be called for, which could drive significant swings in both the price and availability of mortgage credit.[4] The political aspects of such decisions also would put unwelcome strain on the central bank's role.

The GSEs also used their portfolios to acquire nontraditional mortgage assets that were not eligible at the time for securitization. In a number of transactions with Self Help Credit Union, for instance, Fannie Mae purchased loans serving low and moderate income homebuyers that were not eligible for securities, or that had features and risks that could not be accommodated by a securities execution. This provided

[4] In fact, many industry participants argued strongly against letting the Fed withdraw from its purchase program, fearing a collapse in prices. Such a collapse did not occur, but this illustrates the strains that Fed policy could be subject to if it were to become the buyer of last resort in a future downturn.

liquidity for Self Help's work, and helped build the foundation for a later, large scale program using a securities execution.

During the current financial crisis, the GSEs' ability to pull nonperforming loans out of their securities and manage them through their portfolios has given them a range of flexible tools to initiate modifications and other approaches for delinquent and defaulting borrowers that are more difficult for servicers operating only for investors in securities to provide.

Smaller multifamily loans, rental property loans underwritten on terms that do not conform to the GSEs' high volume acquisition models and the broader debt market for rental housing debt also benefit from the GSEs' portfolios.

Without some form of federal support for limited, special purpose portfolios, most, if not all of these functions will be lost. This is especially important in maintaining a deep and liquid market for MBS. Some research has suggested, for example, that Ginnie Mae's do not trade better than Fannie Mae's – counterintuitive given the former's explicit federal backing – because Ginnie lacks a portfolio and thus cannot assure a constant bid for its securities.[5]

The capability to step into markets to provide liquidity cannot be created at the moment a crisis emerges. A robust, expandable portfolio capability has to be maintained throughout credit cycles in order to have the expertise and capacity to move into markets when demand from other outlets has slackened. This suggests that some form of ongoing portfolio capability is necessary to have the option for its use in countercyclical markets.

There are other portfolio lenders in the mortgage market, and in normal markets they can provide most, if not all of the liquidity necessary, in combination with capital markets investors, to sustain stable prices and widespread access to credit. But without some cost advantage for their funding, prices for their services will be higher, leading to higher consumer costs and limiting access further. Their ability to step into markets to soak up supply also will be limited, inasmuch as their investment choices and spreads will be the same as other market participants'.

There is a legitimate concern that backing debt for these purposes would expose the federal government to risk, or could raise federal debt itself to higher levels. But one grim lesson of the 2007-2008 financial collapse is that all very large financial institutions have an effective government guarantee, and that this can be very costly when needed. In most cases, this guarantee was neither paid for nor balanced by explicit expectations on its recipients. The Frank-Dodd legislation recognizes this problem and makes

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[5] "An important source of pricing disadvantage for Ginnie Mae is its lack of portfolio capability….The model results indicate that Ginnie Mae MBS yields would have been one or two basis points lower than yields on Fannie Mae MBS if Fannie Mae did not increase the liquidity of the MBS market through its portfolio purchases." Stuart Gabriel, *Opening Doors to Homeownership: Challenges to Federal Policy*, Cityscape: A Journal of Policy Development and Research, Vol. 5, No. 2, 2001, U.S. Department of Housing and Urban Development, p 38-39

important improvements to try to mitigate its implications. Explicitly extending government support for limited public purposes is a reasonable policy alternative in this context.

Limited support for special purpose, limited portfolio capacity is a function that needs careful consideration in the design of a new system. Such support could be paid for through an explicit insurance arrangement, or government could through an ownership stake in such portfolio operators provide an effective umbrella that likely would reduce borrowing costs significantly.

Transition Issues

Fannie Mae and Freddie Mac together guarantee roughly $4.6 trillion in outstanding MBS. These securities remain among the deepest and most liquid securities in the world and consequently are used in a wide variety of financial transactions. They also hold portfolios in excess of $1.5 trillion composed of MBS, whole loans and other mortgage-related assets.

Although operating under Conservatorship, the two companies retain experienced human capital and well developed systems for managing mortgage asset risks. They are monoline entities focused exclusively on ensuring the outcomes we enumerate throughout this paper. A future system should encourage the development of additional chartered entities to provide secondary market services. But it is also possible that the current companies could be restructured in effective ways to insure that the key conflicts between their public purposes and private shareholder interests are mitigated while insuring at least two entities focused on mortgage finance that are not affiliated with larger systemically important institutions. We are concerned that other chartered institutions with conflicting interests could make their participation in the mortgage system less robust and meaningful than we believe is necessary.

The government is in a unique position with Fannie Mae and Freddie Mac. It is the majority shareholder in both companies; common and preferred shareholders essentially have been wiped out; and the managements and boards that led the companies into crisis have, for the most part, left. This provides an unusual opportunity to learn from past experience, restructure the firms to more completely fulfill the public purposes for which they were originally chartered and to assure the presence of well organized and focused entities that could continue to maintain liquidity as others consider taking advantage of a new framework.

We strongly urge consideration of various alternatives for the two firms. One alternative could be government ownership of the companies through retention of their majority shareholdings. The companies could continue to be run outside the government with a limited purpose charter. This would be analogous to their status before being wholly privatized in 1968.

An alternative would be to reorganize the companies in some other form that would reduce or eliminate potential conflicts driven by private shareholders. A mutual form of ownership by consumers benefitting from their guarantees would be one possible alternative. Retained earnings would reduce current and/or future guarantee fees, as well as build capital to protect against losses. Strong government oversight to insure fulfillment of chartered purposes would be necessary.

A similar form would be to return to the 1954-1968 ownership model for Fannie Mae, in which seller-servicers were required by buy stock in the company alongside the existing government stake. This is more similar to the cooperative model of the Federal Home Loan Banks. It would force the business beneficiaries of the firms' work to share in the capitalization and subsequent risks of their business. However, we are skeptical that any structure dominated by seller-servicers, particularly large banks who likely would be the largest customer/shareholders, will effectively serve the broader functions of access and innovation. In such a structure the interests of the shareholders may not be aligned with that of consumers and the system at large, constraining the benefits that liquid, standard and freely accessible financing can have for consumers.

Yet another alternative would be to liquidate the firms and sell all of their business assets to buyers who might build new mortgage enterprises using them as a foundation.

The form that any mortgage finance entities take in a new system take is not immaterial. But more important than the structure is whether the structure will create the multiplicity of outcomes that we have enumerated. The system for the last 75 years did so, with varying degrees of success. It was not perfect and should be improved on significantly. But it is critical that a reinvention not "throw the baby out with the bath water" and eliminate any of the important direct and indirect systemic benefits to the detriment of consumers.

Level Regulatory Playing Field

One of the critical elements of the recent mortgage crisis was the ability of Wall Street banks to compete with the GSEs in the secondary market with securities of their own. Even at their pre-crisis peak, Fannie and Freddie accounted for around 70 percent of the mortgage securities issued. So-called "private label securities" accounted for the rest. But as the housing asset bubble inflated, so did the role of these private securities in providing capital, driving GSE shares to around 40 percent.

Without effective regulation and oversight, these private market competitors initiated a "race to the bottom" in underwriting and securitization. This vicious cycle contributed to inflation of property values by supporting higher prices with cheap and unsustainable debt, and to the failure of the subprime and Alt-A mortgage securities, which in turn triggered the near collapse of the banking system. Any new system must address this issue. The "race to the bottom" in mortgage underwriting that drove the subprime and Alt-A crisis must not be repeated through unregulated mortgage marketing at either the primary or the secondary level.

Financial reform legislation has created a series of important new safeguards and incentives at the primary market level to prevent a recurrence of the most abusive forms of mortgage lending. But an important lesson of this crisis is that the secondary market also needs regulation. *Any* institution offering mortgage backed securities should be required to obtain a regulatory license from the government. This license could establish minimum requirements for capital, structures, ratings and other aspects of the business. This would enable the government to establish and implement a basic set of regulatory standards for the industry, ensure that issuers are sufficiently well-capitalized to stand behind the securities they issue, and help avoid the proliferation of private unregulated MBS issuers that directly fueled the credit boom and crisis. This charter need not offer specific benefits beyond the ability to issue

MBS. Instead, it would ensure the registration and oversight of the entire industry, much the same way any portfolio mortgage lender is subject to similar scrutiny through its basic charter.

Supporting other critical housing needs

As noted earlier, American homeowners benefit from a wide array of supports and incentives that have helped make homeownership an affordable and sustainable housing choice for many decades. But these devices do little to assist those with the greatest housing needs: very low and low income households who cannot afford to pay the economic costs of housing. Assistance for these households consistently has been inadequate, in spite of the bold promise of the 1949 Housing Act to assure all families a decent home in a suitable environment.

We believe that the financing system that supports homeownership for a large majority of the population should also help provide the means through which these other critical housing needs can be met. Thus we recommend that a future system require any issuer of mortgage backed securities to include a fee paid through the securities that would be set aside to finance direct government intervention to assist these other households. Such a millage could provide significant financing for the National Affordable Housing Trust Fund, the Capital Magnet Fund in the CDFI program, and finance some of the risk sharing partnerships that we recommend be part of a future secondary market structure.

We would expect such a fee to be passed on to all mortgage consumers that benefit from mortgage securitization, but we believe it will represent a very small increase on an individual basis while providing a significant source of funding to meet these other needs.

Question 3: Should the government approach differ across different segments of the market; and if so, how?

The government's principal responsibility in the mortgage market should be to assure an adequate supply of sustainable, affordable mortgage credit for owner-occupied homes that serve first time homebuyers, purchasers and owners of homes around the median price for their area, and owners and investors in rental homes that serve low, moderate and middle income residents.

These segments break down both by asset size and by borrower type. American housing needs range from those of extremely low and very low income families who suffer from disproportionate levels of physically inadequate housing and costs that exceed their ability to pay to those of higher income owner-occupants or renters. On this continuum, we believe that mortgage policy can only be an effective stand-alone intervention in the middle segment of the market, in which consumers have the income to support sustainable mortgages for reasonably priced homes. The lower segment of the market requires other supports as well, including direct subsidies both to producers of rental housing and renters themselves, and deeper credit support for those who are more marginally able to purchase a home. The segment of the market serving the highest-priced assets, both for rental and ownership, does not need significant support from government support of mortgage markets. Indeed, this segment already consumes a disproportionate amount of the assistance provided by government for housing in the form of tax benefits.

Part of this broad responsibility across markets must include vigorous and effective enforcement of fair housing laws and other non-discrimination requirements, and affirmative promotion of fair housing objectives. There is ample evidence that minorities and many communities with high minority concentrations have suffered historically from cyclical shortages of affordable and responsible mortgage credit. Most recently this kind of mortgage credit was systematically replaced by irresponsible, higher priced credit that siphoned away equity, bankrupted borrowers and devastated communities. Recently enacted primary market reforms and the establishment of a Consumer Financial Protection Bureau are important elements in mitigating this history. But protecting all households from discrimination remains a key and essential federal responsibility in the mortgage system. And a future system that reinforces, rather than mitigates, the devastation that many low income and communities of color suffered because of the unfettered and irresponsible lending of the last cycle is unacceptable.

Government policy must strike a better balance between promoting homeownership and supporting affordable rental housing. As noted in earlier responses, we believe homeownership remains a very important part of wealth and asset building strategies. It is important to stable neighborhoods. But it is valuable only if it is based on sustainable and affordable terms. Thus it is important for federal support in the mortgage system to focus on assuring continuous access to affordable and responsible mortgage credit throughout business and economic cycles. But policy should not promote home purchase for people unlikely to succeed or support or permit the marketing of inappropriate mortgage products.

For those without the ability to afford the economic costs of housing, federal policy should focus on direct subsidies to reduce rent burdens. It should support the preservation and expansion of the supply of existing affordable rental housing units through direct subsidies like the Low Income Housing Tax Credit,

Section 8 and other rental assistance, and support for affordable long term mortgages to provide capital for them.

There also are households that can afford modest, market rate housing costs but because of low wealth, uncertain credit characteristics, or other impediments will not easily access unassisted mortgage finance. FHA's insurance programs long have served this market. While its share of the market in today's conditions is too high, it remains an effective and important tool to serve borrowers who remain outside the coverage of market rate lending.

In the middle market, federal policies should focus on assuring a ready supply of affordable, responsible long term mortgage funds to consumers who can pay market costs. Federal support should be limited to mortgages that encourage and enable responsible homeownership. This support should not be based on the income of borrowers, but instead on the size of the asset being financed. Higher income owner occupants of modestly priced homes should have the same access to affordable and responsible credit, but not for homes worth more than a reasonable amount in relation to market area medians.

Support for this segment should leverage private investment in the form of both owner equity and risk retention by lenders and other third-party credit enhancers by providing only a catastrophic back up to assure investors that securities backed by such mortgages will be repaid. The government should be paid for this support, and should require in return that supported entities operate in all markets at all times, provide access to mortgage credit on the best possible terms to both *lenders* of all sizes and locations and *borrowers* regardless of their location. This federal support must be used to drive standardization and to reduce costs to consumers through scale and efficiency. Private capital should take first loss responsibility for loans. But some form of government support will be necessary to sustain liquidity for long term fixed rate loans and to ensure they are available throughout business and credit cycles.

In return for this support of the broad consumer mortgage market, the government should levy a millage on *all* mortgage securities, whether guaranteed by the government or not. This "user fee" on the mortgage system, which is supported in many direct and indirect ways, should be used to fund direct interventions through means such as the National Affordable Housing Trust Fund, the Capital Magnet Fund in Treasury, and to support new forms of risk sharing between the federal government and private mortgage insurers. These latter efforts would help bridge needs between the "lowest" segment of housing policy and the middle market where additional credit enhancement is necessary to encourage new products or extensions of existing products to new customers or markets. The scale of the government's role in these different markets should be different, and the tools that can and should be brought to bear on them will be different in degree and in kind.

Rental Housing

Government support is also needed to promote effective and affordable mortgages for rental homes that serve the needs of low, moderate and middle income renters. Our response to Q. 1 provides an extensive analysis of rental housing needs.

Smaller rental properties (generally those with 5-50 units) stand to benefit the most from targeted sustainable support. While the GSEs in 2009 accounted for 40 percent of the financing for multifamily housing, they financed only 5 percent of loans between $1-1.9 million but 27 percent of loans of $10

million or more.[6] Very high percentages of the most cost burdened, lowest income renters live in smaller properties; fully 39 percent of unsubsidized renter households live in properties classified as single family.

[6] *State of the Nation's Housing 2010,* p. 24

Question 4: How should the current organization of the housing system be improved?

Clarify roles

There is an urgent need to clarify the roles that various parts of the government play in supporting the housing system. There has been an historic segmentation of federal interventions through which direct and full credit guarantees have been available through FHA, VA, RHS, and Ginnie Mae for markets that would not be served without such strong federal support. The objective of the sponsored enterprises like Fannie Mae, Freddie Mac and the Federal Home Loan Banks has been a functioning system, rather than support of particular types or classes of borrowers who likely would not be served without full federal support. Tax policy and broad regulatory authority over financial institutions has served to support the housing market for high end assets, as well as these other segments. For many decades these distinctions were fairly clear. But a combination of factors has blurred the distinctions and made developing effective policies more difficult in recent years.

Because of a combination of business and political reasons, FHA during the 1990's and 2000's sought to expand the market it served through significant increases in the limits on mortgage amounts it could insure. This potentially moved it into parts of the market that historically had been served through the GSEs. At the same time, the market segments served by the GSEs also were expanding. The establishment of housing goals for Fannie Mae and Freddie Mac in 1992 and corporate policies to broaden their participation led the companies further into FHA's traditional territory to serve lower asset classes and borrowers. As these goals increased, so did this trend, sometimes at the same time FHA was redefining its own segment to include more of the GSEs' traditional markets. At the same time, increasingly higher loan amounts were authorized for the GSEs as house price inflation ignited and drove up the broad, median house price level that determined the upper limits of their participation. This increased the share of their business that served higher balance borrowers, moving them into market territory formerly left to so-called "jumbo" lenders that did not enjoy access to the sponsored secondary market.

A proper resetting of the mortgage system would start by clarifying the roles that government should play in these three broad market segments: 1) financing for rental and ownership opportunities for households that cannot pay economic rents without additional support, and whose credit profile, income and wealth make them weaker candidates for private mortgage financing; 2) financing for rental and ownership homes that are in the middle of the market spectrum where owners and renters need no special subsidy or deep credit enhancement to pay for their home; and 3) higher priced rental and ownership opportunities where consumers can fully pay the cost of financing and for whom sponsored credit is not appropriate.

Consistent Regulatory Oversight

Another key prerequisite for a new system is a comprehensive system of oversight and regulation to prevent a recurrence of the "race to the bottom" in underwriting, risk taking and capital adequacy that drove the recent financial crisis. Regulation of the underwriting, issuance and servicing of *all* mortgage backed securities must be consistent and applied to all participants in the secondary market.

This consistency must run horizontally between markets and types of institutions and vertically from origination through securitization to insure that minimum standards are applied to the origination of mortgages.

The primary market reforms included in the Frank-Dodd legislation establish an important new level of protection that will greatly help achieve this goal. Much work remains to be done in the drafting of implementing regulations for these new provisions, though, and the next phase of this reform must insure that the secondary market is subject to similar constraints and oversight.

Risk Sharing

Government support through guarantees and other means should supplement, not replace, risk sharing and risk bearing by private capital. Borrower equity should be supplemented by other private risk sharing capital, from private mortgage insurers or public agencies, and any entity issuing securities backed by home mortgages should be required to have sufficient capital to ensure their timely repayment.

We believe that maintaining deep liquidity for long term fixed rate home mortgages is a key objective for the system and that federal support will be necessary to sustain it. This federal support should, however, apply to the securities, not to the entities issuing them. We support a federal guarantee to be paid for through a fee that will "pre-fund" resources should private capital standing in front of the federal government fail. The FDIC model of deposit insurance, which guarantees the deposits but not the institution holding them, is a similar model. We anticipate that such a guarantee would provide investor confidence in securities backed by mortgages and that should any entity fail its obligations could be transferred to other holders because of the continuing guarantee of the securities.

Risk Management

A successful secondary mortgage model must align risk taking with effective and comprehensive risk management. Risk taking entities must be able to manage the underwriting of mortgage assets, selection and oversight of counterparties, and the servicing of loans. It is particularly important that such entities have the ability and are required to work with borrowers who encounter problems with their mortgages and to offer a full range of potential modifications that will balance the interests of investors and of borrowers.

Duty to Serve

Entities benefitting from federal guarantees of securities must agree to basic requirements in return for access to them. First, the guarantee must be paid for in order to provide sufficient funds to pay any claims in all but the most catastrophic market scenarios.

Second, entities must be required to offer services to originating lenders of all sizes, in all locations, without regard to their affiliation with or commercial relationships to the securitizing entity. Fannie Mae and Freddie Mac provided a valuable alternative to the dominance of very large and systemically important institutions seeking to build closed, proprietary systems through which they could dominate market segments. The federal government has a compelling interest in assuring that small banks and credit unions are able to access the capital markets for mortgage financing without having to embrace or succumb to a much larger institution's ambitions. This also will maintain wider choice for consumers, and should help hold down costs through open and transparent access to executions with the best price.

Third, these entities must be required to provide capital markets support for *all* geographic markets at *all* times. The federal government should not support investments that discriminate against any regions of the country or against metro versus nonmetro areas. This is important for risk diversification and liquidity, but also because the point of a federal guarantee should be to insure broad, constant and deeply liquid access to mortgage credit *for the whole country*. Lenders who wish to specialize and serve only certain markets or segments of markets should be free to do so, but without the benefit of a federally supported secondary market.

Fourth, these entities must adhere to all applicable fair housing and fair lending laws. They should also have an affirmative obligation to further fair housing objectives, through their marketing, their support of community based and industry groups that promote diversity in lending, and their product offerings.

Fifth, entities using federal guarantees should be required to actively participate with public agencies and with the federal government to reach segments of the population that may be more difficult to serve without deeper credit enhancements or other assistance. The broadening of mortgage credit availability through mortgage product enhancements that increase sustainable and responsible mortgage lending should be an obligation of any entity that takes advantage of a federal guarantee.

Sixth, the complexion of these entities' books of business must mirror that being generated by the primary market, in broad terms. They should not be able to service only certain slices of the market, or ignore some market needs in geographic areas or among demographic groups in favor of others. In principle this is similar to the current requirement that Fannie Mae and Freddie Mac consistently meet percent of business goals that reflect historical and trending shares of these segments in the primary markets.

Establishment of these requirements will serve no purpose if they are not rigorously enforced. The future system must include a robust, well staffed and resourced regulatory entity, either in existing institutions or *de novo*, to carry out this function. There should be sanctions for nonperformance, including loss of access to guarantees for future business, and entities should be required to provide data similar to that now provided by the GSEs to FHFA that can be made public in whole or in part, and examined by the regulator to track performance and compliance.

Q5: How should the housing finance system support sound market practices?

Insuring sound market practices must be a top priority of the future housing finance system. The recent past has sharply focused the dangers to individual consumers and to the financial system as a whole when sound market practices are abandoned. Innovation and flexibility are important and often positive components of a well functioning market system. True innovations increase access to credit and lower costs, enabling more families to realize the benefits of homeownership, and lenders to extend more mortgages with confidence. But "innovations" that put the interests of creditors and debtors at odds by rewarding origination volume at the expense of credit quality, or encourage fudging of critical credit information in order to boost financial product sales not only jeopardize consumers' well being. As we have seen, wholesale adoption of these practices ultimately undermines the well being of lenders, investors and taxpayers. Also, a new system must have better alignment between primary and secondary markets to support primary market policies that are aimed and driving sound/consumer oriented market practices.

Consistency

Oversight and regulation of mortgage finance market practices must be consistent and robust throughout the system, from originations and sales through securitization. Regulation must have vertical consistency, by insuring that bad practices are barred in every step of the mortgage transaction. There must also be consistency across all delivery channels, so that bad practices cannot develop in one and both pollute and outcompete others through faulty pricing and unscrupulous sales practices, as happened in the recent past.

Establishment of these requirements will serve no purpose if they are not rigorously enforced. The future system must include a robust, well staffed and resourced regulatory entity, either in existing institutions or *de novo*, to carry out this function. There should be sanctions for nonperformance, including loss of access to guarantees for future business, and entities should be required to provide data to the regulator that can be made public in whole or in part, and examined by the regulator to track performance and compliance.

Recent financial regulatory reform legislation has established an important set of groundrules for primary market mortgage origination that are long overdue. Together they form a foundation for consistent underwriting practices that should enhance credit quality and transparency for investors, borrowers and lenders. But these primary market reforms alone are not sufficient. There also must be uniform and consistent regulation at the secondary market level. A key feature of the future system should be *uniform* and *consistent* oversight of *any* issuer of securities backed by mortgages. There also must be much stronger oversight and regulation of the mortgages for which the government will provide insurance guarantees to insure that only well documented, safe and stable products are offered this coverage. Moreover, there should be broad restrictions on the assets that can be securitized and the capital, servicing and other requirements that issuers of securities outside a federal guarantee system must meet.

Risk Management

Innovation to meet consumer needs is an important part of an evolving and responsive mortgage credit system. Some of these innovations can be successfully migrated into wholesale lending channels and can

benefit the broad market. Others, however, are only useful to sophisticated, well capitalized borrowers who understand and can better manage the risks they represent. Hence, lower down payments for borrowers with low wealth but good credit and fully documented regular income were widely spread throughout the system in the 1990's, and there is ample evidence that they were successful for both lenders and borrowers. But other innovations, like "pay option ARMs," adjustable rate mortgages with initial teaser rates, negatively amortizing loans, balloon loans, stated income and/or assets and others were not. These features may be helpful to some limited number of borrowers in the right circumstances. Indeed, all of these features emerged from small niche markets where they were used to accommodate specific borrowers who had compensating factors – high wealth and assets, long standing relationships with the lender, irregular but consistent income – that offset the new features' risks. But when these features were rolled out to average borrowers and used to boost lending volume rather than accommodate small market segments, instability for both consumers and the system rapidly spread. There may remain borrowers who need and can benefit from such exotic innovations. The financial system undoubtedly will invent more as time goes by. But there should be strict requirements for lenders that offer such instruments to directly tie their interests to those of the borrower and investor by requiring that their compensation depends on the long term success of the debt.

The Frank-Dodd legislation establishes a requirement for 5 percent risk retention for all but a well defined basket of "qualified loans." Regulatory rule making will determine the eventual contents of this basket. This is a critically important foundation for more secure lending.

Another means through which to assure better risk alignment between lenders and consumers is to require that fee income also be dependent on the loan's success. The "originate to sell" model that now dominates mortgage lending depends on a supply chain that is paid through fees, usually some percentage of the loan balance. A critical weakness in this system is that as assets are moved through the system, each successive player is compensated for their step in the process only, without regard to the long term viability of the loan. Culture always follows compensation. If compensation is focused on production, the result will be to boost volume in whatever way possible. On the other hand, if compensation is focused on performance, there will be a much higher premium placed on the loan's credit quality and the ability of the borrower to pay it off. If fees at every step of the originations model were delayed in part based on loan performance, the industry's focus would shift to making loans that consumers are highly likely to pay.

Securitization should first and foremost provide liquidity for fully documented, stable, long term fixed rate mortgages. These represent the most stable asset. Their performance has been significantly better, even in the downturn, than that of more "flexible" or "innovative" products. The size of the national MBS market and its importance as a part of an interconnected financial system is too important to be jeopardized by unstable and nonstandard products. The lenders best equipped to offer more exotic features should be portfolio lenders. Requiring that the risk-maker and the risk-taker are the same in such transactions should drive more careful underwriting. Securitization long has been a tool for raising capital for riskier financial products, and it can be a means through which new products and innovations are standardized, and through which prices to consumers are lowered. But without firm oversight and close regulation, the recent past demonstrates all too clearly how destabilizing such products can become, and how badly desire for market share and profit can distort credit risk management in private hands. Federal policy should emphasize the use of broad MBS liquidity for stable, fully documented products,

restrict government support only to such products, and closely limit securitization's use for any other products.

Safe Home Lending Is Possible

We know that many of the innovations that helped increase homeownership opportunities over the last decades are sustainable. These have helped many households gain access to the benefits that homeownership provides who otherwise would not have been able to do so. Education and outreach to consumers long neglected by mainstream home lending, counseling for first time buyers both before and after purchase, flexible sources of down payment like IDAs and community seconds, credit enhancements tailored to these features, and, most importantly perhaps, selective and careful expansion of credit criteria, all contributed to sustainable homeownership growth in previously underserved populations.

The key to successful lending to low wealth buyers has been stable products and fully documented underwriting. Self-Help's Community Advantage© lending program, initiated with Fannie Mae and the Ford Foundation in 1998, has shown that this kind of responsible lending can be done safely and soundly. What research on the program has shown, however, is that much depends on the mortgage product features consumers are offered, and the channels through which they are offered.[7] These lessons demonstrate that it is a mistake to blame low-wealth consumers for the financial conflagration from which we are still recovering. Rather, shoddy practices driven by exploitation and profiteering by an unregulated lending industry contributed not only to unsafe and unsustainable mortgages, but helped strip otherwise stable borrowers of their equity and self-sufficiency.

Other research also has shown that the prevalence of unstable, subprime products in a neighborhood can jeopardize the performance of otherwise well underwritten mortgages. The contagion effect of poorly regulated lending practices on conventional investments is thus magnified.[8]

The federal government has played an important role in the past in fostering innovations that helped expand safe lending practices. The FHA's creation in 1934 is the most vivid example of this. Throughout the following decades FHA has helped lead the market into other important areas, including reverse mortgages, and through Ginnie Mae, use of MBS to expand mortgage liquidity. In the 1990's, federal regulation of the GSEs' affordable housing goals not only helped increase their share of lending to targeted groups, but also used "bonus" scoring and other means to encourage their entry into specific submarkets. Over time the GSE charters were expanded to encourage their entry into energy efficiency lending, rehabilitation lending and reverse mortgages, and FHA used risk sharing partnerships with the GSEs and state housing finance agencies to bring more capital to affordable rental housing. We believe there is a continuing role for the government to play in fostering such innovation. Through sharing risk and other means, such as training, outreach and funding, the government should partner with secondary market entities to continue to find ways to increase access to responsible and durable mortgage capital for rental and ownership opportunities.

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[7] *Risky Borrowers or Risky Mortgages?* Lei Ding, et al., Center for Community Capital, UNC Chapel Hill, September, 2008 http://www.ccc.unc.edu/documents/HUD_Oct2008_final.pdf

[8] *Neighborhood Subprime Lending and the Performance of Community Reinvestment Mortgages,* Lei Ding, et al, Working Paper August 9, 2009, Center for Community Capital, UNC Chapel Hill http://www.ccc.unc.edu/documents/Neighbor.SubPrime.CRA.Mtges.8.09.pdf

Q 6: What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive or deceptive practices?

The most important element of effective consumer protection is a consistent and consistently enforced regulatory regime that covers every part of the mortgage finance supply chain, from originations through servicing. Increased and clearer disclosures to consumers at the sales end of the process; clear rules about what kinds of mortgages can be securitized through which channels, and how risks will be mitigated effectively; and robust requirements of servicers to actively help consumers who run into trouble find the best mutually possible resolution quickly are examples of the kinds of regulatory oversight that is necessary.

The regulation of the primary and secondary market should be mutually reinforcing. Capital markets should be available to products that are safe and stable for consumers. The objective should be to minimize bad actors and bad practices from infecting the system, as happened in the current crisis.

Consumer protection standards

The establishment of basic standards for mortgages and mortgage securitization is the foundation for effective consumer protection. Bad actors in the mortgage business were part of the problem that led to the financial crisis, but the willingness of investors to purchase securities backed by mortgages about which they had little information, and the seemingly insatiable demand for such instruments by Wall Street securitizers and their customers drove a self-reinforcing cycle of declining standards and ever more dangerous products.

Assuring accountability for the performance of loans at all levels of the system is a sound way to enforce standards and rein in risky behavior. As noted in other parts of these responses, the originate-to-sell model allowed actors throughout the supply chain to emphasize production and sales. Sometimes this led to a reduction or total lack of concern with the actual creditworthiness of the loans themselves. This separates the interests of creditors and debtors. The strong originations standards in the Frank-Dodd legislation will go a long way to restricting these practices at the primary market level, and the risk retention requirements for non-qualified mortgages should increase the economic cost of financing them, appropriately so. The substance of the qualified mortgage exemption will be determined further through regulation. It remains important that the intent of Congress to seal off the mortgage originations space from practices that are unsafe for consumers is not watered down in the name of encouraging "innovation." As noted earlier, not all innovation is the same, and innovations that are primarily designed to boost sales, sales commissions and volumes while not paying careful attention to the loans' long term success are not desirable.

As noted earlier, we believe that access to the capital markets should be regulated and focused primarily on mortgages that are standard, fully documented, long term instruments that borrowers can afford to repay. Capital markets can act as an accelerant of new products and trends, whether they are safe for consumers or not, and this effect must be moderated through regulation *across the entire industry,* not only in the segments that rely upon federal guarantees.

Servicing

Another lesson of this crisis has been that the standard servicing model for mortgages is unsuited to carrying out large scale, efficient and equitable modifications when economic crises threaten large number of borrowers. While the initial flood of delinquencies was driven by bad products that placed consumers at risk, increasingly large percentages of the borrowers seeking modifications are doing so because they have lost jobs or are receiving reduced income because of cutbacks in employment. When the system most needed to be responsive, transparent and fair, it failed.

Servicing agreements in the future should be regulated and require that investors authorize cost effective and equitable work outs as a matter of course, and empower servicers to act on their behalf to do so. Servicers must be willing and able to work with borrowers to find the best solutions that are equitable for all parties when borrowers are having difficulty paying.

Foreclosure should be a last resort. While the industry argues that this is the economically worst outcome for them and therefore their last choice, recent experience suggests that even if it is the worst outcome financially it is not always the last resort. Either through law, regulation or both, servicers must be required to try in good faith to work out problem loans before initiating foreclosure. They must be able to assure that borrowers working with them in good faith do not find themselves subject to contemporaneous foreclosure actions.

Education is not a substitute

We strongly support effective consumer education to help prepare and support homeowners, especially those buying their first home. But education cannot replace effective consumer protections.

Effective disclosures that use simple, easily comparable measures also are an important, but not sufficient, tool. We strongly support the recent Federal Reserve Board's work on Regulation Z, and the extensive consumer testing that was used to determine the most effective means of providing information that was meaningful and useful for consumers when making decisions. But it is also important to note that many consumers will only finance a home once in a very great while, and therefore will not have an ongoing basis of experience to call upon when confronting a confusing and legalistic process. Moreover, some recent research has suggested that homebuyers begin considering their mortgage financing options only at the end of what can be a time consuming and intellectually and emotionally draining search for a home. At this stage in their journey, they are less likely to have the energy or time to devote to careful and informed examination of their financing options.[9] Many consumers, especially in minority and low income communities, rely heavily on so-called "trusted advisors" to guide them through the mortgage process. These individuals may be acting in the consumer's best interest, but not necessarily.

The combination of these stresses strongly argues for effective regulation of the mortgage finance supply chain, in addition to fostering and supporting effective consumer education.

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[9] "…according to a new Zillow Mortgage Marketplace survey(i) of 2,729 adults conducted on its behalf in April by Harris Interactive®. Borrowers report they are spending no more time researching a home loan today than they did in 2008 and those who obtained a loan in the past five years are soliciting fewer quotes -- an average of three quotes versus four in 2008…. borrowers who obtained a home loan in the past five years typically spent just five hours researching their options, which is unchanged from March 2008. Nearly one-third (31 percent) spent two hours or less." Zillow.com Media Room, April 29, 2010 http://zillow.mediaroom.com/index.php?s=159&item=201

Enforcement is critical

Regulations without enforcement offer scant protection to consumers in this complicated process. We are very pleased at the newly robust enforcement regime underway at FHA to weed out servicers and originators whose track record deviates significantly from norms across its insurance book.

Regulators must also have the flexibility and resources to act quickly when problems arise. The lack of action by financial regulators throughout the early 2000's, as predatory, subprime and Alt-A practices spread through the financial system, and the inadequacy of legislative remedies available to them helped to enable risky mortgages to proliferate and ultimately endanger the entire financial system.

The broad authority granted to the Consumer Financial Protection Bureau in the Frank-Dodd legislation is an important and welcome step. It is an opportunity for nimble and effective regulation of the primary mortgage market. Similarly robust regulation at the secondary market level also will be needed.