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"Bipartisan Solutions for Housing Finance Reform"

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Good morning Chairman Johnson, Ranking Member Crapo, and members of the committee. I am Janneke Ratcliffe, a Senior Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill. I am also a member of the Mortgage Finance Working Group, a group of housing experts convened by CAP back in 2008 to chart a path forward for the mortgage market. The working group originally released our comprehensive "Plan for a Responsible Market for Housing Finance" back in January of 2011. [1] Since then, we have continued to offer comment on a variety of regulatory developments. While I will present recommendations from that plan, I speak only for myself today.

We are here today to discuss not just the future of the housing finance system, but the future of housing and economic opportunity for Americans. To quote from the Bipartisan Policy Commission, "restoring our nation's housing sector is a necessary precondition for America's full economic recovery and future growth."[2]

As technical as this debate can be, we encourage you not to lose sight of the ultimate impact of the housing finance system on households, communities, and the economy. Research and our lived experiences confirm the link between housing and economic opportunity in this country, from the importance of decent and affordable rental housing and the many benefits of homeownership to the central role of the housing economy on economic vitality.

What I want to stress, and what the BPC report articulates so well, is that much of the benefit derived from housing depends on the way in which housing is financed. That is why, since 1932,[3] the government has sought to foster a mortgage marketplace that is stable, safe, efficient and affordable. One visible hallmark of government's involvement is the long-term fixed rate mortgage. Partly as a result, homeownership has served as a crucial building block of a strong middle class in the 20th century.[4] The mechanisms have evolved over time and in response to crises, from the creation of the Federal Home Loan Bank System and federal deposit guarantees to the more recent bailouts of private institutions and the conservatorship of the Government Sponsored Enterprises. Now we have the opportunity to put in place a system that will serve the next generations even better than the systems that have preceded it.

The State of the Housing Market Today

As the market struggles to right itself, I suggest we remain mindful of the urgency and importance of the

task ahead. Our national mortgage market today is significantly smaller than it was in the early 2000s.[5] The homeownership rate has dropped from close to 70 percent to 65 percent,[6] and while the housing market's recent performance is heartening, we fear the fundamentals are not yet there for a robust, accessible and sustainable market to develop.

To start, approximately three quarters of mortgage originations in 2012 were refinances, not home purchases.[7] Among the purchases that are occurring, the National Association of Realtors estimates that investors represented 20 percent in 2012, high above their historic norm of 10-12 percent.[8] This investor presence may support housing prices and perhaps even inflate them,[9] but will not necessarily stabilize neighborhoods or pave the way for move-up buyers or homeownership in the future.

In the meantime, first-time homebuyers, young homebuyers and homebuyers of color – the future of homeownership in the United States[10] – have largely been shut out of the conventional mortgage market. The Federal Housing Administration backed financing for 46 percent of first-time buyers in 2012 and about half of home purchases obtained by homebuyers of color in 2011.[11] Homeownership rates for young people (ages 25-34) are among the lowest in decades.[12] This decline in homeownership has led to an increase in renters. With rents rising, this is only putting more pressure on the nation's renters, more than half of whom are "rent impoverished," or spending more than one-third of their income on housing.[13] These figures do not suggest well-functioning single and multi-family housing finance markets.

What's more, it has now been close to five years since Fannie Mae and Freddie Mac went into conservatorship. The GSEs are slowly deteriorating, with no clear plan for a restructured secondary market. In the absence of direction from Congress, the Federal Housing Finance Agency is unilaterally making significant policy decisions and investments. Some of these we support, and some we oppose. For example, of the decisions that have been disclosed by the agency, we agree that it makes more sense to invest in a single securitization platform for the mortgage giants rather than to retool the companies' own systems, while we strongly disagree with the decision not to pursue some form of principal forgiveness for delinquent loans or the decision to not fund the Affordable Housing Trust fund or Capital Magnet Fund. Other important decisions are not even to be found in the strategic plans, and are opaque to the public, such as decisions regarding how and when to extend credit to first-time homebuyers

But it doesn't matter whether we agree or disagree. What matters is that these decisions will impact American families broadly—whether they own their home, hope to become homeowners someday, or are seeking affordable rental options—and will lay the foundation for the shape of the market for many years to come. I believe these decisions are far too important to leave to one single agency whose deliberations largely take place behind closed doors, and whose officials are not elected, appointed, or confirmed.

A Bipartisan Way Forward

It is time to set a clear direction for the future state of the mortgage secondary market – one that considers the interests of all stakeholders, and does so in the context of broader, long-term considerations and priorities.

You've asked whether there is a bipartisan way forward on housing finance reform. There is. The Bipartisan Policy Center's housing recommendations are based on a view shared across the political spectrum that homeownership is a desirable option when viable, and that those who do not buy a home ought to have access to affordable, quality rental housing.[14] More specifically, this group agrees that the 30-year, fixed-rate product is the gold standard for a safe and sustainable mortgage market; that there is

a critical need for a reformed multi-family finance system to meet the demand for affordable rental; and that the system must provide access to safe and affordable mortgages for all creditworthy borrowers, including those of low and moderate income.

Perhaps most important, the bipartisan plan recognizes the need for the government to retain a guarantor role in the core portion of the GSE-supported market going forward. At this point, the Bipartisan Policy Center's reform plan is one of 18 proposals (including several bipartisan ones) that call for some explicit government support for the segment of the market traditionally served by the GSEs, while only a few plans propose no government role beyond FHA.[15]

In other words, while a couple of outlier proposals still call for withdrawal of all support, we see a very broad consensus emerging. It is time to move on from this question because ironically, until we do so, the government will continue to provide a 100 percent guarantee for the vast majority of mortgages.

The Commission's recommendation is a critical first step, but it is just a beginning. Now it is time to have a robust, in-depth conversation about how to structure the secondary mortgage market with an explicit, paid for and actuarially sound government backstop.

For these reasons, I'm very excited about today's hearing, and I hope it signals Congress's readiness to enter into a serious conversation about re-visioning our housing finance system.

Principles of a Responsible Housing Finance System

In 2008, the Mortgage Finance Working Group brought together experts to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. The Group's vision of a well-functioning and responsible market that protects taxpayers is grounded in five principles similar to those that underpin the proposal of the Bipartisan Policy Commission: liquidity, stability, transparency, access and affordability, and consumer protection.

Liquidity: The system needs to provide a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike. The capital markets have come to play an essential role in mortgage finance, but as the past decade so stunningly demonstrated, capital markets on their own provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times. These extremes can have a devastating impact on the entire economy.

Stability: Private mortgage lending is inherently procyclical. Stability for the market requires sources of countercyclical liquidity even during economic downturns. For families, stability means that they will not experience wild fluctuations in home values, allowing them to plan financially for their families, education, businesses, or retirement. Stability also requires sustainable products and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy.

Transparency: Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. Secondary market transparency

and standardization lower costs and increase availability, and are a fundamental precondition for the re-emergence of a private mortgage-backed securities market.

Access and Affordability: The lower housing costs produced by the modern mortgage finance system (before the recent crises) helped more families become homeowners, which enabled them to live in a stable community, to build equity, and to pass on assets to their heirs. Similarly, the government-backed mortgage finance system has provided developers of affordable multifamily rental housing with a source of long-term, fixed-rate mortgages, while the purely private market prioritizes market-rate rental housing.[16] The government guarantees, along with associated regulatory and consumer protections, confer significant benefits to households who can access it – and that should include all credit-worthy borrowers. Left to its own devices, participants tend to "cream" the market, leaving perfectly creditworthy lower wealth, lower income or minority segments underserved. With appropriate incentives and tools, these segments can be well-served, to the benefit of the entire system.

Consumer Protection: The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. As the current crisis has demonstrated, consumer protection is inextricably linked with financial institution safety and soundness. Along with regulators such as the Consumer Financial Protection Board, any structure supporting the nation's housing market must share a commitment to ensuring that the system supports rather than undermines the financial health of the consumer.

Basic Structure of Our Proposal

The Mortgage Finance Working Group's proposal creates a system that preserves the traditional roles of originators and private mortgage insurers, but assigns functions previously provided by Fannie Mae and Freddie Mac to three different actors: (1) issuers; (2) chartered mortgage institutions, or CMIs; and (3) a catastrophic risk insurance fund. Our plan seeks to use the least and most remote public guaranty necessary to leverage the greatest amount of private capital in a first loss position, which in turn will provide interest rate investors the assurance to fund long-term mortgages.

Issuers: Issuers are purely private entities that originate or purchase and pool loans and issue mortgage-backed securities (MBS).

Chartered Mortgage Institutions (CMIs): Issuers will purchase credit insurance on MBS that meets certain standards from CMIs. These entities also will be fully private institutions, but will not be owned or controlled by originators. They will be chartered and regulated by a federal agency and their function would be to assure investors of timely payment of principal and interest on those securities that can qualify to be covered by the Catastrophic Risk Insurance Fund.

Catastrophic Risk Insurance Fund (CRIF): This on-budget fund would be similar to the FDIC's Deposit Insurance Fund, i.e., run by the government and funded by premiums on CMI-guaranteed MBSs. In the event of a CMI's financial failure, the explicit guarantee provided by the CRIF would protect the holders of qualified CMI securities. The government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs, and also establish reserving and capital requirements for CMIs that would be at higher levels than those presently held by Fannie and Freddie. In addition, the CRIF would regulate pooling and servicing standards to ensure a liquid market for the MBS and appropriate treatment of

delinquent loans to protect the fund and consumers.

Under our plan, there will be several layers of protection standing ahead of the CRIF: borrower equity, the CMI's capital, and in some cases private mortgage insurance. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss. And the CRIF would have to fail before any taxpayer funds would be required to meet the government's guarantee to security holders.

In addition, to provide tools that encourage safe and sound innovation and access, we propose establishment of a "Market Access Fund" which would support research and development, provide limited credit enhancements, and offset the costs of support services such as housing counseling. This fund would be supported by a per-loan contribution from all securitized loans, as the entire system benefits from the provision of prudent and affordable lending to enable more households to advance up the housing ladder. In addition, the Capital Magnet Fund and the National Housing Trust Fund, both of which were created in 2008 and intended to be funded by Fannie Mae and Freddie Mac, would become funds within the Market Access Fund.

Comparing our Proposal to Other Proposals

In your invitation to testify today, you identified the essential objectives policymakers should aim for as they seek to structure the future mortgage markets: the continued availability of the standard affordable long-term fixed-rate mortgage, equal access to the secondary market for all lenders, equal access for all qualified borrowers and market segments, availability of stable liquid and efficient funding for both multi-family and single-family housing, the protection of taxpayers, and the impact on economic recovery and stability.

A comparison of our plan with others illustrates several considerations for how to structure a well-functioning secondary mortgage market that achieves these objectives.[17] Our proposal is just one of many proposals, including the proposal of the Bipartisan Policy Commission, recognizing the need for government support of the core mortgage market. Although there are differences in the structural details, such proposals share the common principals of liquidity and stability that are required for a well-functioning housing system.

Preserve the standard affordable long-term fixed rate mortgage

The explicit government guaranty – even a remote one, such as our plan calls for – preserves the long-term, self-amortizing, fixed-rate mortgage, which maximizes affordability and economic security for the majority of American homeowners.

This type of mortgage, which is generally a 30-year, fixed-rate mortgage, provides borrowers with cost certainty regardless of market conditions. Adjustable rate mortgages expose borrowers to interest rate risk. Shorter-duration products with balloon payments that are designed to be refinanced every two to seven years expose borrowers not only to ordinary interest-rate risk, but also to the risks that they may not be able to refinance when they need to due to other adverse changes in market conditions.

Research conducted at the UNC Center for Community Capital confirms the important role that safe and sustainable products play in making homeownership work better for more households. A

longitudinal study of nearly 50,000 families, with a median income of around $35,000 who purchased homes in the decade leading up the bubble and bust, has found relatively low default rates, despite the fact that most of these borrowers put down less than 5% on their home purchase and about half had credit scores below 680. Although these borrowers would be very unlikely to get approved for a mortgage in today's tight market, they turned out to be good credit risks even through a major recession, and they even managed to build some equity at the median. These loans were prime-priced, fully underwritten loans, extended by banks around the country and sold to Fannie Mae.[18] Comparison with similar borrowers receiving adjustable-rate and other non-traditional loan features via the purely private market, who defaulted at rates three to five times as high, highlights the important role that good products play in reducing credit risk.[19]

Providing borrowers with that kind of stability also has benefits for the economy as a whole. Prior to the introduction of the major housing and finance reforms of the 1930s, the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. Mortgages were typically for a term of 5 years and depended on regular refinancing.[20] That system failed spectacularly when the Great Depression hit and half of all homeowners defaulted on their mortgage (although foreclosure rates remained lower than today due to the government's creation of the Home Owners' Loan Corporation).[21]

Without government involvement of some kind, the 30-year, fixed-rate mortgage is likely to be a product of the past.[22] Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.[23]

However, the fact that the purely private markets may be able to meet the mortgage needs of a small, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans. This argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a government backstop is small in comparison.[24] What's more, the jumbo market is enabled by the existence of the conventional market, as lenders need to compete with a product that wealthier borrowers could access with a larger down payment. The conventional market also provides transparent pricing information and benchmark prices and rates that the jumbo market can piggyback on.

As noted, any plan that maintains a government guaranty will give a broad class of investors the confidence to invest in the U.S. housing finance system at efficient, fixed rates. In our view, similar to the proposal of the Bipartisan Policy Commission as well as several others, this government guaranty needs only to cover the catastrophic level to serve this function as well as to support the TBA market,[25] provided there is sufficient standardization. Proposals that call for the investors to share in some tail risk are unlikely to achieve this end. On the other hand proposals that call for the government to take a larger share of the risk, for example through a single, government owned entity that takes both predominant and catastrophic risk (similar to the way the GSEs are functioning now, or FHA and Ginnie Mae combined) may result in marginally greater efficiencies to the extent that greater homogeneity drives greater liquidity. For example, even today, with full government support, Fannie Mae and Freddie Mac securities do not trade the same.

Ensure that both large and small lenders have access to secondary market finance to help ensure broadly

available access to credit in all communities.

A diverse lending market is crucial for ensuring broad access to credit for all borrowers and communities, including rural communities, communities of color, and communities that have been hard-hit by the recession. A secondary market that enables lenders of all sizes in all communities to offer mortgages on equal and well understood terms is one of the major beneficial functions of Fannie Mae and Freddie Mac that, going forward, the reformed system must retain and even improve on.

Our proposal recognizes the risks of building a system that favors large, well-capitalized banks (and their affiliates) and leaves small originators at the mercy of their larger competitors as to whether and under what terms they can access the government-guaranteed market. In our proposal, multiple chartered mortgage institutions (CMIs) would perform the predominant credit risk-taking function of Fannie and Freddie. These entities would enhance competition and ensure equal access by small lenders to the secondary market. Originating lenders would not be allowed to own a CMI, except as part of a broad-based mutually owned entity designed to ensure access at equitable prices to smaller lenders such as community banks, credit unions and community development finance institutions. In that context, and to assist in the achievement of public policy outcomes that may not coincide with the interests of private owners of CMIs, consideration might also be given to permitting CMIs established by government entities, such as housing finance agencies, individually or collectively.

Some proposals would explicitly allow banks and originators to perform the predominant credit risk-taking function. In a marketplace already characterized by extreme concentration of origination and servicing in entities that have both explicit government guarantees (on deposits) and implicit guarantee ("too big to fail"), this structure would only extend the large banks' market power and encourage the accumulation of risk with an implicit government guaranty. In effect it would be recreating Fannie and Freddie, except under the control of the largest originators. While proponents point to the Ginnie Mae model where originators are also issuers, they ignore the fact that the credit risk-taking function is not provided through Ginnie Mae or the issuers, but through FHA on a per-loan basis, universally available on equal terms. In the case where issuers themselves are determining the risk parameters and pricing for the predominant credit risk, such a transparent and level playing field will be hard to achieve.

Some of those proposals do identify this market power risk but would manage it administratively rather than structurally. Such plans would prohibit discriminatory pricing by issuers or credit-risk-takers. For example, the BPC plan calls for the Public Guarantor to set rules of the road that would prevent issuers (who are charged with choosing how to cover the credit risk) from creating "barriers using differential guarantee-fee pricing or other means to unfairly restrict or disadvantage participation in the government-guaranteed secondary market."[26] However, managing that risk administratively may be easier said than done.

By contrast, cooperatively-owned and "utility" models deliberately seek to equalize small lender access through structural mechanisms. At the far end of the spectrum, proposals that call for a single entity such as a nationalized secondary market would go even further to minimize this risk.

Ensure that all creditworthy borrowers and market segments have access to the mainstream housing finance system.

As noted previously, many of the benefits we associate with stable and affordable housing options stem

from the way in which that housing is financed. Left to its own devices, the market will tend to deliver the best loans where it is easiest to do so and to channel higher cost loans where borrowers are easier to exploit and have fewer options. Such cherry-picking practices result in the benefits flowing primarily to private shareholders and to a narrow group of advantaged borrowers, rather than the economy as a whole. To further the goal of access and affordability, CMIs in the new housing finance system would be responsible for providing an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- CMIs would be expected to mirror the primary market (roughly) in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct government insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to "cream" the market by securitizing limited classes of loans. (This approach relies on effective implementation of the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered; note that the Community Investment Act likely requires some updating for it to function optimally, and the federal banking regulators have been engaged in a lengthy process to do this.)

- CMIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.

- CMIs would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that are more robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.

- All CMIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters.

Like all other secondary market participants, CMIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Provide credit enhancement or other programs to serve those who cannot be served by purely private markets.

While rules against discriminatory lending and anti-creaming provisions, such as those we have proposed for CMIs, will help, they will not fill all the gaps left by a national history of discrimination and wealth disparities. These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending or were hit very heavily by the recession and unemployment. These neighborhoods most in need of capital to rebuild likely will be the last to get it from a private market left to its own devices. The Community Reinvestment Act is too limited in scope to be expected to generate the level of support required solely through banks' balance sheet lending.

However, many prospective homeowners and owners of rental homes who are not easily served by private markets demanding competitive rates of return can be well served with limited amounts of credit enhancement, or "risk capital." These borrowers inhabit a "grey zone" between fully private credit and fully insured credit through agencies like the FHA, VA and USDA's Rural Housing Services (RHS). During their most effective years, Fannie Mae and Freddie Mac generated some of this innovation through their own risk capital by relying on standard, fully documented loans; their large market shares; and broadly priced credit products, using limited pilots or trusted partners Banks subject to the Community Reinvestment Act also do some of this on a limited scale, both internally and through support of mission-oriented intermediaries such as Community Development Financial Institutions (CDFIs).

We therefore propose establishment of a Market Access Fund, which would have three broad functions:

- Provide support, both grants and loans, for research, development and pilot testing of innovations in product, underwriting and servicing geared to expanding the market for sustainable homeownership and for unsubsidized affordable rental.

- Provide limited credit enhancement for products that expand sustainable homeownership and affordable rental but that, without such credit enhancement, cannot be piloted at sufficient scale to determine whether they can be sustained by the private market, or, alternatively, are best served by FHA, VA and/or USDA or by the states.

- Provide incentive grants to encourage development of self-sustaining support services, such as housing counseling, that have proven effective in expanding safe and affordable homeownership, but that so far have not developed a sustainable business model that combines lender support, client fees and limited government and philanthropic subsidy.

We propose that the Market Access Fund be funded through a small (e.g., 10 basis points) assessment on all securitized mortgages, whether or not an issue receives a federal catastrophic guarantee. The fee would be structured as a "strip" from the mortgage coupon, in the same way that servicing fees are charged, and would continue for the life of the mortgage. This fee could be easily collected by the SEC on behalf of the Fund, or, if proposals for a single mortgage backed securities platform are implemented, by the platform.

The Fund should be on-budget, allowed to grow over time, and its credit activities subject to credit scoring. Using 2000 as a "normal" year for mortgage-backed securities issuance, a 10 basis point assessment would generate approximately $630 million annually while only costing individual mortgage borrowers a negligible amount – about $250, or about $20 per month, on a $250,000 mortgage. Assuming mortgage backed securities remain outstanding for an average of 4 years and MBS issuance remain at the 2000 level, by the fifth year after initiation, the fee would be generating a steady revenue of $2.5 billion.

By creating and using the Market Access Fund in this manner, all participants in the mortgage market will be contributing to the stability of that market and of the economy. That will be a marked contrast to the pre-crash system in which the so-called private market was able to use the credibility and stability of the US capital markets to simultaneously abuse lower wealth borrowers and communities and make huge profits.

In addition, the Capital Magnet Fund and the National Housing Trust Fund, both of which were created in 2008 and intended to be funded by Fannie Mae and Freddie Mac, would be relocated within the Market Access Fund. The National Housing Trust Fund allows the states to expand the supply of rental housing for those with the greatest housing needs. The Capital Magnet Fund enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact.

Several other plans, including that of the Bipartisan Policy Commission, recognize the value of access and affordability in principal. There are plans that call for the secondary market entity(s) to maintain a portfolio – at a much smaller scale than Fannie and Freddie – for the purpose of funding niche and harder-to-securitize loans that expand access and affordability for single-family or affordable multi-family activities.

However, to our knowledge, no other plan spells out specific mechanisms for proactively ensuring broad access for all qualified, creditworthy households to the mainstream mortgage market, rather than to FHA. Other proposals call for all low- and moderate-income lending to be served through the FHA. This approach ignores the fact that much of this segment can be well and safely served by the core conforming conventional market, and that the primary market's conventional lending to such segments, through CRA and otherwise, depends on a reliable secondary market outlet. Instead, it would institutionalize a dual mortgage market, with less choice and higher costs for borrowers who would most benefit from access to the prime conventional market, and it would unnecessarily and inefficiently drive credit risk onto the government's balance sheet.

We argue that access and affordability objectives can be achieved whether the GSEs are replaced by numerous private credit-risk takers, a public utility, or a nationalized secondary market. That said, the more centralized the credit-risk-taking entity (s), and the more authority it has, the easier it is to align the delivery of the guaranty with broader housing policy objectives.

Provide access to reasonably priced financing for both homeownership and rental housing so families can have appropriate housing options to meet their circumstances and needs.

The need for affordable housing is growing more urgent for families in the United States. Over half of U.S. households spend more than 30 percent of their income on housing, and one in four U.S. households spends over half of its income on housing. We applaud the attention paid by the Bipartisan Policy Commission to the crisis in affordable rental housing for working-class households, a segment that is not effectively served today by either the government or the private market.

Our plan will address the affordability crisis by supporting broad access to affordable mortgage credit in the multi-family markets. The Mortgage Finance Working Group's plan uses a carefully deployed and targeted government guarantee to encourage private capital to bear risk ahead of the government for affordable multifamily finance as well. We envision that CMI's, most likely specializing in multi-family, would take predominant risk ahead of the CRIF for permanent financing. These CMI's would be required, on an annual basis, to demonstrate that 50 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of median income.

Some alternative proposals are silent on multifamily finance, or eliminate a government guarantee, or call for splitting the secondary market for multifamily off from that of the single-family market. But any responsible plan must address the critical gaps in financing for affordable rental properties, a goal which has gone too long ignored in US housing policy.

Protect taxpayers from unnecessary risk

The Mortgage Finance Working Group envisions a system that is capitalized with as much private capital at risk as possible while still serving the nation's housing needs. That will require federal government support, but only in a remote, catastrophic-backstop position, one that is well-buffered by several layers of private capital. The first layers of risk would be absorbed by owners' equity and, on lower-down-payment loans, by traditional private mortgage insurance. The next layer – what the Bipartisan Policy Commission refers to as the predominant credit risk – would be borne by private institutions specifically chartered for that purpose (CMIs). These entities would be regulated to hold adequate capital and reserves, and subject to strict standards for risk management. The next layer, which would be accessed only after failure of a CMI, would be covered by the Catastrophic Risk Insurance Fund, similar to the FDIC's Deposit Insurance Fund. This guarantee will be paid for by premiums set at rates designed to cover losses should a CMI fail. The government guaranty of MBS would be specific and limited to investments in qualified mortgage backed securities, and would not protect the shareholders or creditors for the CMIs.

At a high level, our plan is similar to the Bipartisan Policy Commission and several others that call for private capital in the predominant loss position with a fund standing behind that. Analysis presented by the Bipartisan Policy Commission finds that a 4 to 5 percent aggregate loss cushion would absorb credit losses in a scenario of the severity just experienced (with a 30 to 35% decline in house prices) (p56). This cushion is a massive increase over the old minimum capital requirements on Fannie and Freddie of .45% on credit risk.[27] All these plans recognize that mortgages would cost somewhat more, but estimate that the net effect will not be of a magnitude that would disrupt the market.

However, these plans differ as to the form that private capital would take. Some, like ours, call for specialized monoline institutions, while other plans envision a role for structured transactions. In my view, the institutional solution has significant advantages. It is easier to regulate and manage for safety and soundness, and it is more efficient at pooling and spreading risks. Structured transactions, to the extent that they cover a single or limited number of pools, cannot provide the benefit of a secondary market that can allocate risks and reserves across years, regions, lenders, and so on. The structured transactions approach also tends toward greater complexity and less transparency for purposes of pricing and regulation.

Of course, for all these private-risk-capital proposals, one big unknown is whether and at what terms adequate private capital will be available. Under plans that call for a smaller role or no role at all for private capital, this question is of course less important.

Promote economic recovery and housing market stability

A healthy mortgage secondary market is required for a healthy economy. This is true both with regard to shorter-term economic stability, and long-run stability.

In the short term, uncertainty about the future state will continue to dampen lending activity, creating a self-fulfilling drag on recovery. At the same time, though, our tentative recovery would be derailed by disruptions to the current state. The Bipartisan Policy Commission calls for a congressionally adopted model coupled with a "dynamic, flexible transition" for winding down the GSEs and moving toward the new model. The transition may take five to ten years, and it can be eased by building the new model on the valuable infrastructure currently residing with Fannie and Freddie. This approach will help the market recover and transition to a new normal.

We also must keep our eye on long-term economic stability, which derives from appropriate government support of financial systems. While our plan calls for private capital to bear all but tail risk, we also recognize that the more central a role is played by private capital, the more instability is introduced. Private capital is inherently procyclical, meaning that it tends to be plentiful and cheap during good times and scarce and expensive during downturns, thus inflating bubbles and deepening downturns. While this is a challenging problem, we suggest that there are two keys to solving it.

The first is to build in countercyclical capability in an intentional and effective way, through a series of dials that can be adjusted in times of economic stress when private capital simply flees. In addition to ramping up FHA activity, the other moving dials could include regulatory interventions and a shift in split of risk bearing. Our plan explicitly does not provide a guaranty for the GSE's historical portfolio function. Instead, we envision that in times of economic crisis, a government guarantee of a specific class of senior debt (similar to the limited FDIC bank debt guarantee program of 2009) could accomplish this without reinstating the implied US government guarantee of all CMI debt.

The second key to countercyclicality is to recognize that what is done in good times is just as important as what is done in times of stress. Adequate reserving and building up of capital is critical and can best be achieved using institutional risk taking solutions (rather than structured transactions). Regulatory discipline around pricing and risk management also needs to be imposed on the private market, and should be the charge of a strong regulator.

In any event, the future state model should prioritize what is in the best interest of the overall economy over the long run. These decisions should not be left to a conservator, who has a substantively different mandate.

Comparison to a completely private market

A completely private market alternative is one where all credit risk is borne by private capital. (Technically, the source of funding for all mortgages is "private," but most of it relies on some form of government credit guarantee in the event of default.)

As the Bipartisan Policy Commission report documents, financing America's housing requires some ten trillion dollars; attracting adequate capital without a government backstop at that scale would surely be challenging. Commercial banks and savings institutions, which have federal deposit insurance and, for larger institutions, implicit "too big to fail" backing, only constitute a quarter of this debt, and according to the report, "there is simply not enough capacity on the balance sheets of U.S. banks to allow a reliance on depository institutions as the sole source of liquidity for the mortgage market."[28] Today, the more purely private market is funding less than 20 percent of the rest.[29]

A completely private market would mean a smaller market and a riskier one, and one that would not meet the fundamental requirements of stability and liquidity to support a robust housing market in this country. History has shown us that a housing finance system that relies on private risk-taking will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and the American family. Moreover, completely private proposals would not achieve stability and, in fact, would expose taxpayers to even more risk from boom-bust cycles such as the one that triggered the financial crisis and that was fueled by recklessness in the private market.

Importantly, even a well-regulated private market would predominantly offer loans with shorter durations and higher costs, while the long-term fixed rate mortgage would not be available under terms affordable to most families.[30] Likewise, rental housing would be less available to working families and would cost

more, even as there is growing demand for it.

Finally, there is the fact that, as demonstrated by the recent financial crisis, the government has demonstrated that it will step in to prevent a systemic financial collapse regardless of structure. Even champions of a pure-private solution admit, that if that is the case "explicit guarantees with some taxpayer protection may be better than implicit guarantees with no protection."[31] They go on to suggest that "taxpayers should evaluate all proposals for continuing guarantees with their eyes wide open and do what they can to reduce the extent to which they are unwittingly exploited in the future."[32]

We could not agree more. It is time to get to work on devising a system that provides the benefits of government insurance with minimal risk to taxpayers through the structuring of a stable mix of public and privately administered credit insurance.

Conclusion

From the 1930s through the end of the last century, the United States enjoyed a vibrant, stable, housing market that evolved to provide liquidity for mortgages in all parts of the country through every business cycle. The system was not perfect, but it contains valuable lessons for us as we look to rebuild. By applying those lessons to meet the goals outlined in this testimony, we have the opportunity to build a mortgage market that is fair, accessible, affordable, and fiscally sound, one that works better for more households and communities than ever before.

Thank you for inviting me to talk about the work my colleagues and I have done and I would be happy to answer any questions.

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[2] Bipartisan Policy Center Housing Commission, "Housing America's Future: New Directions for National Policy," (2012), available at http://bipartisanpolicy.org/library/report/housing-future

[3] See the Federal Home Loan Bank Act, Pub.L. 72–304, 47 Stat. 725

[4] Bipartisan Policy Center Housing Commission, "Housing America's Future"

[5] US Department of Housing and Urban Development, "US Housing Market Conditions Historical Data," available at http://www.huduser.org/portal/periodicals/ushmc.html

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[7] US Department of Housing and Urban Development and US Department of Treasury, "The Obama Administration's Efforts to Stabilize the Housing Market and Help American Homeowners," (2013), available at http://portal.hud.gov/hudportal/documents/huddoc?id=HUDJanNat2013SC_FINAL.pdf

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[9] Susan Berfield, "What Crash," Bloomberg Businessweek (March 2013)

[10] George S. Masnick, Daniel McCue, and Erick Belsky, "Updated 2010-2020 Household and New Home Demand Projections," Working Paper W10-9 (Harvard Joint Center for Housing Studies, 2010), available at http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/w10-9_masnick_mccue_belsky.pdf

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[12] HUD, "US Housing Market Conditions Historical Data"

[13] United States Census Bureau, American Housing Survey

[14] Bipartisan Policy Center Housing Commission, "Housing America's Future"

[15] For a summary of plans, see John Griffith, "The $5 Trillion Question: What Should We Do with Fannie Mae and Freddie Mac?" (Washington: Center for American Progress, 2013), available at http://www.americanprogress.org/wp-

content/uploads/2013/03/NewGSEReformMatrix.pdf

[16] Ethan Handelman, David A. Smith, Todd Trehubenko, "Government-Sponsored Enterprises and Multifamily Housing Finance: Refocusing on Core Functions," (Washington: National Housing Conference, 2010), available at http://www.nhc.org/media/files/NHC_GSE_core_functions_v8_2_101001.pdf

[17] For a side by side comparison and links to 22 plans, see matrix on CAP website at http://www.americanprogress.org/wp-content/uploads/2013/03/NewGSEReformMatrix.pdf

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[23] Peter Wallison, "Going Cold Turkey," (Washington: American Enterprise Institute, 2010), available at http://www.aei.org/outlook/economics/financial-services/housing-finance/going-cold-turkey/

[24] Bryan J. Noeth and Rajdeep Sengupta, "Flight to Safety and U.S. Treasury Securities," The Regional Economist 18 (3) (2010):18–19 available at http://www.stlouisfed.org/publications/re/articles/?id=1984; see also Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," August. 31, 2007, available at http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm

[25] The TBA, or "To be Announced," market is a type of futures market for mortgage-backed securities that allows lenders to provide consumers with interest rate forward commitments or "locks" on their mortgage interest rates before the final mortgage is signed and sealed. For more information on the importance of the TBA market, see Mortgage Finance Working Group, "A Responsible Market for Housing Finance"

[26] Bipartisan Policy Center Housing Commission, "Housing America's Future," p. 57

[27] This was the minimum statutory capital requirement for off balance-sheet obligations, with a 2.5% minimum for on-balance sheet assets; the regulator could and on occasion did require an additional factor (at its highest, +30%). The GSEs were also subject to risk-based capital requirements, but these were often lower than the statutory requirement.

[28] Bipartisan Policy Center Housing Commission, "Housing America's Future," p. 39

[29] Center for American Progress calculations based on Federal Reserve "Mortgage Debt Outstanding" data, available at http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm

[30] Richard K. Green, Testimony before the Senate Banking Committee, "Housing Finance Reform: Should there be a Government Guarantee?" September 13, 2011, available at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=56068079-9c03-40d4-b36a-72913d3850b4

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[32] Ibid.