Responses to Questions on Housing Finance Reform Legislation, Senate Committee on Banking, Housing and Urban Affairs

By the Center for American Progress and Consumer Federation of America

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Thank you for the opportunity to submit responses to the questions developed by the Senate Banking Committee concerning housing finance reform legislation. These responses have been developed jointly by the Center for American Progress (CAP) and the Consumer Federation of America (CFA). CAP is a progressive, nonpartisan think tank, which also convenes the Mortgage Finance Working Group, a collaboration of experienced housing finance experts, affordable housing advocates, and leading academics. CFA is a nonprofit association of some 300 national, state and local pro-consumer organizations created in 1968 to represent the consumer interest through research, advocacy, and education.

Below, we respond to a number of the questions asked and issues raised. Because many of the questions relate to one another, we provide answers in paragraph format rather than question-by-question. We have also included suggested legislative language where appropriate. If you have any questions about our responses or wish to discuss them in more detail, please contact Julia Gordon at CAP or Barry Zigas at CFA.

Guarantee

How Much Private Capital?

The federal securities guarantee should function as a backstop to ensure securities buyers that they will receive the full principal and interest promised in the bond. This guarantee should stand behind private credit enhancers or guarantors. The public guarantor should set the level(s) of insurance required, and the level(s) should be flexible to allow for adjustments based on changing economic circumstances.

The depth of the private guaranty should be sufficient to cover any projected losses in the assets backing the security through complete business cycles, and the federal guarantor should set a benchmark for such coverage that takes into account experience of a sufficiently long period of time. Requiring too much coverage to protect against the very worst experience in market cycles will certainly protect the federal guarantor, but it also could constrain credit by increasing the cost of mortgages higher than necessary throughout most business cycles. On the other hand, the 2005-08 experience has demonstrated dramatically the consequences of having too little enhancement before the government is required to step in to assure continued liquidity and stability in the markets.

It is tempting to set these levels in legislation, but we believe this could needlessly hamper the federal guarantor's ability to adjust to changing market conditions. It also could constrain the system's ability to serve the full range of credit needs, including those of LMI borrowers and hard to serve markets, if it is set at too high a level. The mortgage origination provisions of the Dodd-Frank Act have re-established clear guidelines for mortgage lending. The requirement that creditors ensure that borrowers are able to repay the loans on the terms at origination should serve to reduce the volatility introduced into the mortgage system in the early 2000's through the introduction of unstable mortgage products that failed in records numbers and set off the financial crisis.

In answer to concerns that the public guarantor would give in to political pressure to set the levels too low, as arguably occurred when OFHEO was overseeing Fannie Mae and Freddie Mac prior to the crisis, we believe that the guarantor/regulator will be far less subject to these pressures if it is structured appropriately (see regulatory section below).

With respect to this issue, we recommend the following changes to S. 1217:

> p. 42, lines 20-21: strike this subsection (2) and instead permit the FMIC to set the percentage based on their assessment of what is required by subsection (1) above. "Is sufficient to meet the conditions of paragraph (1) above, and which shall be adjustable at the discretion of the FMIC to account for changing economic circumstances and the type of institution(s) standing in the first-loss position."

When would the public guarantor pay?

The federal guarantee on securities should kick in when private credit guarantors have exhausted their capital and are unable to cover losses in principal and scheduled interest to investors. The government's role should be to take over these payments to investors. We would expect the federal guarantor to seek other private insurers to take over such portfolios with the continuing federal backstop prior to expending government funds, but if this is not possible, the guarantor should use those funds to repay investors for cash flows stemming from defaulted loans.

We do not believe that legislation should provide any form of "stop loss" coverage to private credit enhancers/bond guarantors, such as the first 10 percent of all losses in a portfolio. This arrangement would be more akin to a co-insurance scheme, and we believe it puts the government at too much risk and reduces the economic discipline necessary to assure that the government's guarantee is truly a last-resort support. (It is also one of the reasons why we do not support providing a guarantee for private capital markets transactions, as we discuss below.) Private credit enhancers should be required to hold sufficient capital to cover losses on the total book of business that they guarantee, and should be required to exhaust their capital (become insolvent) before the government guarantee would apply. This requirement will ensure that shareholders and investors in primary market guarantors take sufficient care in extending their guarantees and hold sufficient capital to cover the complete portfolio of their guarantees.

Additionally, the system should be structured to limit as much as possible any implicit guarantee of the private credit enhancers themselves, or their shareholders or creditors, although if any guarantor becomes systemically important, it should be subject to the same requirements as any other SIFI in the event of its failure (and of course, in the event of widespread economic catastrophe, it is undeniable that the government will likely become involved – in other words, no matter what, the government owns the tail risk). This fee is for the benefit of investors in the securities themselves, and would provide sufficient capital to enable the federal guarantor to make good on its guarantee if necessary.

Bond guarantors will work better than private capital markets structured transactions

We strongly believe that first loss credit enhancement should be restricted to well-capitalized bond guarantors. We do not believe that the use of capital markets enhancement structures, such as senior/subordinated bonds or credit-linked notes, is consistent with the need for the government guarantor to have a clear and well understood level of capital standing in front of it. We fully expect bond guarantors to take advantage of capital markets reinsurance offers (not unlike the recent risk-sharing transactions undertaken by Fannie Mae and Freddie Mac) that would be assessed as part of the federal guarantor's responsibility to set appropriate capital levels for the primary credit guarantors.

We also believe that the use of capital markets structures to provide primary credit insurance likely would undermine the TBA execution by requiring a level of disclosure for the subordinate bond holders that would reduce the homogeneity and fungibility of assets that are requisite for a deep and liquid TBA market. The TBA market provides multiple benefits to consumers, including the ability to lock in mortgage rates well ahead of closing on a loan. The standardization of the securities, the federal guarantee of repayment, and the limited amount of information available prior to the actual pooling of loans and issuance of TBA securities leads to narrow bid-ask spreads in a deep and transparent market. It also deepens the market for TBA securities through enabling them to be used by a wide variety of investors to hedge other trades, which in turn lowers costs by providing a constant demand for the securities.

For more details on our views on this area, please see Julia Gordon's QFR answer to Senator Corker, attached as attachment A.

Who would serve as bond guarantors?

We expect current mortgage insurance companies to emerge as bond guarantors, along with other existing and potential new monoline entrants using private capital to back large portfolios of mortgage securities. Given the systemic importance of the bond guarantees, requiring entities to manage this business separately from others, with dedicated capital if not separate corporate entities, would be expected. The federal guarantor should be able to identify capital specifically set aside for securities liabilities.

Moreover, the system should not be subject to shocks or weakness stemming from losses in other insurance or guarantee lines that entities might offer. For instance, heavy losses experienced by a property and casualty insurer because of natural disasters should not jeopardize an insurer's ability to stand fully behind its mortgage bond guarantees. The federal guarantor should be required to set capital levels for its counterparties, and should have robust examination and enforcement authorities.

While insurers are regulated at the state level, we believe it is both possible and appropriate for the federal guarantor, through the terms of its guarantee and contracts with primary credit providers, to establish, monitor and enforce its own requirements on all counterparties, including mortgage insurers Such requirements are not dissimilar to the covenants that investors in CDFIs can require of these entities above and beyond any independent credit risk capital that these entities hold against their liabilities. Such requirements would be ongoing and not just be limited to a simple initial approval.

We envision the federal guarantor will combine the roles of insurer and that of regulator. Given the exposure created by the federal guarantee, it is important that the guarantor be able to regulate the capital, ownership and operations of its counterparties. Separating the regulatory and insurance functions risks having a misalignment of focus between separate entities. We believe the experience of separate regulators established for Fannie Mae and Freddie Mac, with HUD responsible for "mission regulation" and OFHEO responsible for safety and soundness led to exactly this misalignment. Congress addressed this in combining the functions in FHFA in the 2008 HERA. We believe that a similar conflation of responsibilities is the right model for a future federal guarantor.

Regulatory Structure

Regulatory supervision for system safety and soundness will be a crucial part of a well-functioning housing finance system. Lax regulation and captured regulators in many ways led to the crisis we recently experienced, both in the housing finance system and the financial system as a whole.

Strong regulatory powers

For any new system, it is critical that the government have access to the full range of regulatory tools to supervise bond guarantors, issuers, and other counterparties, just as FHFA currently has. There needs to be a regulator with authority to examine and even take injunctive type action, similar to the FDIC's Prompt Corrective Action, or PCA, which can and should be done in coordination with the FMIC if the FMIC is not the primary regulator. Furthermore, any entity providing insurance of any type, whether loan or pool level, must be licensed as an insurer as well as meeting requirements and conditions set by the FMIC.

Additionally, one of the reasons we prefer bond guarantors over capital markets transactions is that we believe that effective oversight may be difficult to achieve in a system where issuers engage in diverse structured transactions. Initial "approval" of an issuer does not equal oversight, and in fact, may be counterproductive in that it may give a green light to subsequent actions that are unmonitored by the regulator. It will be much more effective to provide the FMIC with adequate tools, including the power to charter or license bond guarantors, and other counterparties have their own regulators with whom the FMIC can coordinate.

Agency governance

While we prefer a director to a board or commission, the most important priority is to ensure that there is representation within the FMIC leadership that understands the needs of homeowners. Leadership should include individuals with experience with consumer protection, affordable homeownership programs, and affordable rental housing. In the section below on consumer access, we discuss in more detail the need for an Office of Market Access and Office of the Homeowner Advocate within the agency.

Independent funding

We believe it's important for the public guarantor to have access to funding that is independent of the congressional appropriations process. In the past, regulation of the GSEs has been compromised due to the regulator's need to secure political approval. Under current circumstances, moreover, with the specter of government shutdowns and spending moratoria occurring more frequently, it would be best to insulate the operations of the housing market from congressional budget crises.

Second lien approval

We believe that first lien holders should be required to consent to simultaneous second liens that are originated at closing (piggyback loans). However, we would suggest an exemption for forgivable second liens, such as those offered by Housing Finance Agency "soft second" programs.

However, we do not think first lien holders should not be able to veto second liens originated after the initial closing. Requiring a first lien holder to consent to a subsequent second would be tantamount to prohibiting these loans. There is no question that piggyback seconds were a major problem for all concerned through the housing boom, but so were cash-out refinancings. Families should be able to use the wealth generated through homeownership to send a child to college, start a small business, or make home improvements that preserve or increase the home's value. And, if it is cheaper to do this through a home equity second lien, homeowners should not be forced to pay more for a new first lien cash-out refinance.[1]

[1] For a more expansive version of the answer, please see the responses to these questions submitted by the Center for Responsible Lending, et al.

Small Lender Access

Any new mortgage finance system must be available to the widest possible universe of mortgage originators. The new system will need to push against the natural tendency of the market to aggregate issuance functions into a relatively small number of very large institutions, which could shut out smaller banks, credit unions, and CDFIs that cannot or choose not to develop the warehousing, back office and other infrastructure necessary to manage a securities issuance capacity.

S. 1217 would require the FMIC to develop standards and guidelines that will reduce any artificial barriers to participation by smaller lenders. This includes the provisions in the bill that bar differential pricing of the federal guarantee based on either volume or the size of the issuing institution. It also requires the FMIC to "facilitate securitization of eligible mortgages originated by credit unions and community and midsize banks without securitization capabilities." We support these requirements.

Direct Access for Small Lenders is Crucial

It is important to understand that for many smaller lenders, the ability to retain servicing rights to the mortgages, and thereby retain contact with their customers, is critical to their business success. Yet most large commercial aggregators only acquire mortgages if they convey with the servicing rights, which provide both a source of long-term fee income and the potential for acquiring and cultivating customers for other purposes. The aggregators also make other demands on originating creditors, including integration of automated underwriting systems and other essential business processes that can limit the choices originators ultimately have in choosing among different products and secondary sales outlets. In the GSE system, Fannie Mae and Freddie Mac were able to use their portfolio capacity to purchase whole mortgages from smaller originators through the so-called "cash window," permitting them to bypass the aggregators.

The current draft of S. 1217 presents two completely different aspects of a future housing finance system, one that relies on independent issuers who may be organized in any number of ways, and another, parallel structure that would be governed as a mutual and benefit uniquely from its relationship with the FMIC, including what appears in Sec. 215(b)(2) to be a portfolio that would necessarily have an implicit, or even explicit, federal guarantee by virtue of this relationship.

We think it is important to explore possibilities for providing access for smaller lenders without setting up essentially a new GSE with an implicit federal guarantee. The suggestions are not mutually exclusive. One route would be to take advantage of the existing, mutually owned, Federal Home Loan Bank system for providing liquidity for smaller lenders. S. 1217 provides this option for each of the 12 regional FHLBs, but not a mandatory requirement. We support including provisions that would require the FHFA in its capacity as FHLB regulator, or its successor, to promulgate regulations that would require the FHLB system to provide this function, either through all banks, or through a selection of one or more of them that would serve this function for any member of any of the FHLBs. This route would have the further advantages of reestablishing an important role for the FHLBs and building on a well-established, well-regulated system that withstood the financial crisis in very good shape.

Alternatively, if the idea of a mutual is pursued, we believe there would be value in establishing the mutual for the purpose of aggregating and securitizing loans for all market participants, rather than having one system for independent issuers and another for smaller institutions.

We also note that there is nothing in S. 1217 that would prevent small lenders from creating their own mutual company to achieve the same objectives as the proposed new company. The bill does not provide any support for the idea that the new FMIC needs to house, fund or financially support this entity. The bill could easily direct the FMIC to foster such a mutual's start up and to facilitate its access to the federal insurance, without housing it within the FMIC.

Selling Technology to the Mutual

S. 1217 at Sec. 215(c) requires Fannie Mae and Freddie Mac to sell to the new mutual "…any function, activity, infrastructure, property, including intellectual property, platform or other object or service of an enterprise that the Corporation determines necessary…" This section seems to give the new mutual first bid on any or all of the current assets of the enterprises, without regard to the broader needs the FMIC will have for the same capabilities for its own oversight and management of the responsibilities S. 1217 envisions for it.

We believe it would be a mistake to hand all these assets directly to the mutual (if a mutual is set up). If this provision is not eliminated, it should at least be modified to give the FMIC the discretion to direct such a sale, taking into consideration the assets' value, and after determining that such assets are not necessary for the FMIC's proper functioning, and that their sale to another entity will not damage or compromise the FMIC's ability to carry out the functions assigned to it. Treating at least some of the GSE's assets at a public good, such as historical data, might also serve as an important part of the transition process and for encouraging new entrants.

The Importance of Automated Underwriting Systems

Small lenders benefitted significantly from the creation and availability of the automated underwriting systems (AUS) of Fannie and Freddie, which they were able to access on a loan-by-loan basis for a fixed fee. Loans that received a positive recommendation from these systems were then eligible for sale to the Enterprises, making them a commodity asset that could be sold to aggregators without requiring the originating institution to embrace any one aggregator's proprietary AUS.

The Committee should examine how to preserve access to such systems for smaller lenders in a future secondary market system. One alternative would be for the FMIC to acquire the current AUS and, as FHFA is doing now, develop a process through which they could be merged into a single engine that could be made available to any originator and provide a recommendation based on the FMIC's underwriting requirements. This would allow smaller lenders to gain approval for federally insured securities without having to either develop their own approved systems – very costly to do – or adopt any one aggregator's and therefore reduce their market options.

Single Security

Establishing a single security will both improve liquidity and limit the capture of the system by large issuers.

Consumer Access

The New System Should Serve All Markets at All Times

Any legislation overhauling the nation's housing finance system should have as its overarching purpose to provide liquidity, stability, transparency, and access to affordable credit for qualified borrowers across all geographies, housing types, populations, and mortgage balances within specified limits, including providing credit to traditionally hard-to-serve or underserved markets and supporting mortgages that further the purposes of the Community Reinvestment Act and other regulatory or statutory requirements for which primary market originating lenders are responsible.

We strongly urge the Committee to adopt explicit language outlining the key objectives of a new system and outlining specific responsibilities for it. We recommend the following language to replace the purpose statement found on page 13, lines 9-15:

> (1) provide liquidity, transparency and standardization for mortgage credit, support a robust secondary mortgage market and the production and efficient trading of residential mortgage backed securities;
>
> (2) ensure broad and fair availability of credit for qualified borrowers across all geographies, housing types, mortgage balances within the limits set forth herein, and populations without interruption through complete business cycles;
>
> (3) provide liquidity for mortgages that further the purposes of the Community Reinvestment Act and other regulatory or statutory requirements for which primary market originating lenders are responsible and to support access to credit in traditionally hard to serve or underserved markets;

(4) provide a guarantee of the full and timely payment of principal and interest on securities backed by mortgage assets approved by the Corporation, and

(5) levy such fees as necessary to provide sufficient capital to fulfill the Corporation's guarantee obligations and to protect the taxpayer from having to absorb losses incurred in the secondary market during periods of economic stress.

Ideas for Ensuring the System Serves All Markets

For a variety of reasons, the mortgage market often serves those borrowers perceived to be the "easiest," most lucrative, or least risky borrowers at the expense of borrowers who are equally able to sustain homeownership but require more customization and consideration due to factors such as self-employment, nontraditional credit histories, the purchase of smaller homes, or living in certain rural or urban neighborhoods.

We see this phenomenon quite vividly today. Lenders are now requiring higher credit scores, larger down payments, lower debt-to-income ratios, and essentially refusing to lend in certain geographies, even if the loan might otherwise be profitable. Symptomatic of this trend, between 2007 and 2012 originations of prime home purchase mortgages fell 30 percent for borrowers with credit scores above 780 but fell 90 percent for borrowers with credit scores between 620 and 680.[2] As a result, the market is largely serving the most pristine borrowers, those seeking higher balance loans, and those in well-served locations. In other words, they are "creaming" the market.

For the new secondary market system to push against this tendency of the primary lending market, it should have a requirement that lenders provide a level playing field 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.

We suggest four ways for the system to meet this goal:

- Bond guarantors and issuers as a whole 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 guaranty.

- Bond guarantors and issuers for multifamily loans would be expected to demonstrate that at least 60 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.

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[2] Gov. Elizabeth A. Duke, "A View from the Federal Reserve Board: The Mortgage Market and Housing Conditions," Housing Policy Executive Council, Washington, D.C., May 9, 2013, available at http://www.federalreserve.gov/newsevents/speech/duke20130509a.htm.

- Bond guarantors and issuers 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 entities 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, areas hard-hit by foreclosures, and shortages created by special market conditions such as natural disasters. Substantial underperformance could lead to fines and possible loss of the ability to access the guaranty.

Office of Market Access

The structure of the FMIC outlined in S. 1217 include specific offices led by senior Directors to focus on various aspects of the FMIC's responsibilities. Notably absent from this list of key offices is one dedicated to assuring that the basic purpose of facilitating access to affordable credit to the widest possible universe of credit worthy borrowers and communities is achieved. As noted above, a major concern in any new system is that it be designed from the start to prevent a natural tendency by profit-maximizing entities to "cream" the market by concentrating on the most profitable and low-risk segments of the marketplace, *to the exclusion of others that are profitable and sustainable, but that require more effort and consideration.* Full disclosure of data demonstrating how different populations are served, and sensible and enforceable regulation requiring full inclusion of economically sustainable markets is required to assure this outcome.

Under a new system in which the federal government will be guaranteeing mortgage backed securities and setting the *de facto* standards for supplying capital to the mortgage system, it is imperative that ensuring this objective is a specific responsibility of the new federal guarantor. Experience has taught that subsuming this objective beneath specific mandates to support capital markets, protect investors and taxpayers, and reduce risk in the system, as S. 1271 does, leads to market failures for low and moderate income consumers and traditionally underserved communities.

Consequently, we recommend that the Committee require the creation of an "Office of Market Access" in any federal guaranty entity it designs. Suggested language for doing so:

> p. 103, line 14: insert new Sec. 233: Office of Market Access
>
> (a) ESTABLISHMENT: There is established within the FMIC an Office of Market Access, which shall be headed by the Deputy Director of Market Access.
>
> (b) RESPONSIBILITIES: The Office of Market Access shall ensure that the activities of the FMIC comply with the requirements of this Act with respect to ensuring the broad availability of sustainable mortgage credit to all geographies, housing types, mortgage

balances and populations in a safe and sound manner. Specifically, the Office of Market Access shall --

(1) ADMINISTER THE MARKET ACCESS FUND -- pursuant to the guidelines set out in section [XX], [etc.]

(2) PERFORM ANNUAL MARKET ANALYSIS – as part of the FMIC annual reporting process described in section [XX], the Office of Community Investment shall –

(A) Conduct an overall market assessment, including a needs analysis to identify priority and unmet needs in the housing finance market, identify areas that have been underserved by the market as a whole, assess the potential causes of these gaps and evaluate barriers to and opportunities for addressing those gaps.

(B) Examine the characteristics of all securities insured by the FMIC. This examination shall assess and compare the distribution and the terms of mortgage loans contained in the securities insured by FMIC during the previous year with respect to income and racial characteristics of borrowers or rental affordability, income and racial characteristics of census tracts, loan amounts, rural areas, lender size and type, affordable multifamily units, identified priority and unmet and underserved segments, and by risk characteristics of borrowers, across segments within FMIC securities and compared with the overall market as reported in HMDA for the previous 3 years for which data is available.

(3) EVALUATE ISSUER AND BOND GUARANTOR PERFORMANCE – The Office of Community Investment will establish and implement a process for evaluating whether, and the extent to which, certain issuers and Bond Guarantors have performed with respect to the provision of broad availability of sustainable mortgage credit to all geographies, housing types, lender sizes, mortgage balances within the relevant loan limits, and populations. Such an evaluation will –

> (A) apply to any issuer or bond guarantor that, in the previous year, was responsible for 5 percent or more of all securities insured by the FMIC, and any other issuers or Bond Guarantors on a discretionary basis, and shall take into consideration –
>
> (1) The characteristics of loans in all securities insured by the FMIC for which that issuer or Bond Guarantor was responsible in the previous year, taking into account the factors considered in the Market Analysis and the safety and soundness of all such loans;
>
> (2) The extent of measures taken to assist borrowers to succeed as homeowners, including measures taken to assist borrowers experiencing financial or other distress;

(3) The effective use of Market Access Fund resources;

(4) Compliance with antidiscrimination and consumer protection laws; and

(5) Any other parameters that the Office of Community Investment believes are necessary to a complete and accurate evaluation.

(B) Provide for the submission by each such issuer or guarantor of a strategic plan for addressing unmet needs or underserved markets identified in the market analysis or other weaknesses identified in the evaluation.

(E) Establish a procedure for rating level of performance and applying incentives and penalties corresponding to levels of performance, except that the Office of Community Investment shall not evaluate the issuers or bond guarantors based solely on the volume of loans falling into particular categories.

We believe that an Office specifically tasked with identifying how well any federal guarantee is succeeding in meeting the broadest possible needs in the marketplace is critical. We stress that the office and the requirements for reporting with which it would be tasked is not intended to replicate the housing goals regime adopted for Fannie Mae and Freddie Mac in 1992. The approach we are recommending would build on sensible changes made to the Fannie and Freddie requirements in the 2008 HERA, which eliminated HUD's prior responsibility to set goals based on assumptions of future market outcomes. Like the 2008 amendments, the regime we have proposed would compare the overall system's outcomes and those of its largest customers against well-understood and documented trends in the primary market over time. It assumes that production in the secondary market system as a whole, and among the largest customers of a federal guarantee, will track the market well. Only in instances of persistent failure to demonstrate this would this proposed Office have the authority to work with the entity to identify causes of the discrepancies and strategies for overcoming them.

Furthermore, because no regime is fully effective without genuine enforcement tools, the FMIC should be empowered to reduce access to the guarantee by issuers that fail to demonstrate they are serving the whole market, and resist making changes in their approach to rectify this. This power should include excluding persistent non-performers from the insurance altogether.

The evaluation of both its overall activity and that of the largest issuers should be an integral part of the FMIC's reporting responsibilities. Hence we recommend the following changes to the proposed S. 1217:

p. 31, line 2: after "securities" insert "including the state and functioning of the TBA market and a detailed discussion of how it has provided these benefits across all income levels, races, ethnicities, genders, housing types, and geographical locations;"

p. 31, line 3: insert new subsection (F) "the Office of Market Access's review of issuers' performance against market standards for including for whom access to insurance has been limited or terminated as a result of the evaluations, and a report on the state and activities of the Market Access Fund [add other housing funds as well to the extent that HUD should be reporting on those;" [and renumber subsequent subsections]

p. 31, lines 5-9: end sentence after "market" and strike the remainder.

p. 31, line 12: after "housing market," insert "and access to mortgage credit by current homeowners and first time homebuyers and owners of rental housing,".

To ensure that issues of affordability and access receive sufficient attention and focus in the new entity, p. 39 line 15 should be changed as follows: before "availability" insert "broad" and before "credit" insert "sustainable" and after "credit" insert "to all geographies, housing types, lender sizes, mortgage balances within the limits set forth herein, and populations".

On p. 40, line 4: before "all geographic locations" insert "all qualified borrowers and"
This focus on ensuring access to credit also should be included in the goals against which the first loss credit providers are judged, and against which possible alternative means of providing that credit enhancement are measured. Hence, we recommend the following changes to the text of S. 1217:

p. 43, line 22: strike "consider how" and replace with "ensure that".

p. 44, line 3 and 4: replace "impacts" with "maximizes" and after "credit" insert "on equal and transparent terms".

p. 44, line 8: after "consumers" insert "representing a broad range of geographic locations, housing types, income and wealth categories, and racial and ethnic backgrounds".

p. 44, line 9: after "affordability" add "for borrowers across a broad range of geographic locations, housing types, income and wealth categories, and racial and ethnic backgrounds".

p. 44, line 11: after "alternatives" insert "that prioritize the preservation of homeownership when consistent with the interests of investors"

p. 44, line 12: replace "interacts" with "supports".

p. 44, line 15: strike "and" and insert new subsection, (vii) "promotes credit availability throughout business cycles, and".

This responsibility also should extend to the broader market regulation responsibilities of the FMIC:

p. 88, line 18: after “market” insert “, as long as such competition does not impair either safety and soundness or consumer protection”.

p. 88, line 22: after “market, insert “as long as such competitive pricing does not impair either safety and soundness or consumer protection”.

p. 88, line 23, after “and” insert “broad” and after “credit” insert “across all geographic locations, housing types, income and wealth categories, and racial and ethnic background and that there is a robust secondary market for credit extended pursuant to regulatory or statutory requirements for which primary market originators are responsible” [or “necessary to ensure that the purposes of the Corporation as laid out in this Act are met.”]

The Market Access Fund

While the mechanisms described above are essential, it will still be important to develop new tools that can help lenders serve all markets, especially those underserved markets suffering from a long history of discrimination and wealth disparities.

In particular, the new system needs a means by which it can foster responsible mortgage product innovation; support the provision of affordable credit on responsible terms in hard to serve geographies; for products with more limited volumes that might otherwise be unattractive to private credit enhancers, lenders or securitizers; and ensure that the needs of the broadest possible range of creditworthy borrowers can be met at a reasonable cost.

During their most effective years, the GSEs 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).

To ensure that the new system has a similar capacity, we propose establishment of a Market Access Fund, which would have three broad functions:

- Provide support 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 support for products that expand sustainable homeownership and affordable rental but that 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 state housing finance agencies.

- 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 believe the Market Access Fund should be established separately from other existing affordable housing funds, and it is critical to change the language of S. 1217 to restore the Housing Trust Fund and Capital Magnet Fund to their original conception and income targeting as established through HERA.

Further, we think the Market Access Fund should be housed in the FMIC itself, where it would be administered through the Office of Market Access. Separating the funding for such activities and allocating it to another agency like HUD that would then be tasked with collaborating with the FMIC for this purpose is needlessly complicated. There is every reason to make sure that the FMIC can maintain its relations with other risk bearing counterparties on whom it is relying in issuing its insurance and control the terms, funding, evaluation and consideration of potential risk-sharing and credit enhancement arrangements with those counterparties.

Language establishing the Market Access Fund could look something like this:

SEC. 402. MARKET ACCESS FUND.

‘‘(a) ESTABLISHMENT.—There is established in the FMIC a Fund, to be known as the ‘Market Access Fund’, which shall be maintained and administered by the FMIC Office of Community Investment.

‘‘(b) DEPOSITS.—The Market Access Fund shall be credited with—

‘‘(A) the share of the fee charged and collected by the FMIC pursuant to subsection [XX] and

‘‘(B) any other such amounts as may be appropriated or transferred to the Fund.

‘‘(c) PURPOSE.—Amounts in the Market Access Fund shall be available to the FMIC to address the homeownership or rental housing needs of low-to-moderate income and underserved or hard-to-serve populations by—

‘(A) providing grants and loans for research, development and pilot testing of innovations in consumer education, product design, underwriting and servicing

‘‘(B) offering additional credit support for certain mortgages or pools of mortgages, such as covering a portion of the capital required for FMIC guarantee eligibility.

‘‘(d) EVALUATION. -- The Director of the FMIC shall provide, as part of the annual report to Congress, a full accounting of the performance and outcomes of grants, loans, or credit support programs funded by the Market Access Fund, including an evaluation of how each grant, loan, or program authorized under subparagraphs (A) and (B) succeeded in or failed to—

‘(I) meet the needs of certain populations, especially low-to-moderate income and underserved or hard to serve populations; and

‘‘(II) maximize the leverage of the public investment being made under each such subparagraph.

Capitalizing the Market Access Fund, Housing Trust Fund, and Capital Magnet Fund

Title IV of S. 1217 establishes a new “affordable housing allocation” in the form of a fee levied on all securities receiving insurance through FMIC. We strongly support this provision in Section 401, but believe it should be extended to all mortgage backed securities.

In particular, we support assessing on all mortgage backed securities (not just guaranteed securities) a 10 basis point annual user fee (i.e., a “strip”) that would be used to support the Market Access Fund and the two funds created under HERA – the Housing Trust Fund and the Capital Magnet Fund. These funds each use a different mechanism to serve very different housing purposes and would be administered, respectively, by a separate office within the FMIC, HUD and the Treasury’s CDFI Fund.

p. 123, lines 15-20: strike and replace with: "charge a fee of 10 basis points for each dollar of the outstanding principal balance of all mortgages collateralizing securities, which fee shall be collected in a manner similar to the guarantee fee and paid into the fund on an annual basis; and"

Office of the Homeowner Advocate

Generally speaking, the secondary market has little contact with homeowners, who largely interact with primary lenders. However, particularly as we are aiming to design the best possible system, we believe it makes sense to provide an interface between the individuals and families being served. Hearing the voices of those being served by the system will help serve as an early warning system if markets are not being served or if servicing requirements are not being followed. Moreover, an office devoted to the “end user” of the system will help rebuild the trust that consumers lost in the housing finance system as a result of the crash.

To this end, we suggest the creation of the Office of the Homeowner Advocate. This idea is loosely modeled on the Internal Revenue Service’s National Taxpayer Advocate.

p. 104, after line 8: insert new office:

> "The Corporation shall establish an Office of the Homeowner Advocate to receive complaints from homeowners, homeowners' representatives and other designated third parties concerning their mortgage originator or servicer. The Homeowner Advocate shall have the authority to investigate, including but not limited to the right to obtain information, documents, and records, in whatever form kept, from the lender or servicer, and to resolve disputes between any homeowner and the originator or servicer of a loan insured by the Corporation."

Servicing Standards and Oversight

The failure of mortgage servicers to prevent unnecessary foreclosures was a key reason for the devastation wrought by the collapse of the housing boom. In short, servicers routinely foreclosed on homes when foreclosure was not only unnecessary, but neither in the best interest of the investor or the homeowner, in large part because the way servicers are compensated gives them an incentive to pursue foreclosures over modifications.

Once a loan is in default, servicers must choose to foreclose or modify. A foreclosure guarantees the loss of future income, but a modification will also likely reduce future income, cost more in the present in staffing, and delay recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers.[3] For servicers, the true sweet spot lies in stretching out a delinquency without either a modification or a foreclosure. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. Delinquency also boosts the monthly servicing fee and slows down servicers' largest non-cash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing.[4] Finally, because foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool, waiting to foreclose or modify postpones the day of reckoning for a servicer, although of course delay can cost a homeowner the opportunity to obtain a modification.

Beyond the loss mitigation failures, servicers also have routinely overcharged homeowners and investors for routine activities such as insurance and default servicing fees. For example, overcharging for lender-placed insurance (also called force-placed insurance), as well as placing that insurance when not necessary, often pushed borrowers who were otherwise making their

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[3] A fuller treatment of servicer incentives may be found in Diane E. Thompson, "Why Servicers Foreclose When They Should Modify and Other Puzzles of Servicer Behavior" (Washington: National Consumer Law Center, 2009), available at http://www.nclc.org/issues/general-mortgage-servicing-policy-analysis.html.

[4] [4] *See, e.g.,* Ocwen Fin. Corp., Annual Report (Form 10-K) 30 (Mar. 12, 2009): ("Servicing continues to be our most profitable segment, despite absorbing the negative impact, first, of higher delinquencies and lower float balances that we have experienced because of current economic conditions and, second, of increased interest expense that resulted from our need to finance higher servicing advance balances. Lower amortization of MSRs [mortgage servicing rights] due to higher projected delinquencies and declines in both projected prepayment speeds and the average balance of MSRs offset these negative effects. As a result, income . . . improved by $52,107,000 or 42% in 2008 as compared to 2007").

monthly payments into default and foreclosure. There is ample evidence that servicers have received kickbacks from insurers, made force-placed insurance a profit center through "commissions" to servicer affiliates, and entered into captive reinsurance schemes with servicer affiliates.[5]

For this reason, the new housing finance system should build in standardization, accountability, and transparency concerning servicer compensation and contractual obligations. We believe this goal can largely be accomplished through the pooling and servicing agreements or their equivalent. A standard agreement or contract should be used for all securitizations that take place through the public utility platform being discussed.

While the Consumer Financial Protection Bureau has established loss mitigation regulations for all servicers that offer loss mitigation, it serves as a floor, rather than a ceiling, for any individual contracts with servicers. As the GSEs do under current practice, the new system can therefore improve in some ways on the CFPB's rules.

For example, such a standard agreement can establish the core principle that servicers must offer loss mitigation and that they should act in the best financial interest of both investors and borrowers, particularly that they should keep homeowners in their homes rather than foreclosing when doing so would return the greatest value to investors. It can also require servicers to refrain from initiating a foreclosure or taking additional steps to pursue a foreclosure when loss mitigation negotiations are (the practice of pursuing loss mitigation and foreclosure simultaneously has been one of biggest drivers of unnecessary foreclosures), and prohibit servicers from having any financial interest in force-placing insurance other than the coverage provided by the insurance.

Holding Modified Loans

One structural concern is how best to provide servicers with flexibility in modifying loans. Ginnie Mae does not have the ability to hold loans, which requires servicers themselves to purchase loans having payment difficulties out of the pass-through securities and then attempt to re-securitize them. As a result, servicers have a strong incentive to do very shallow modifications at current interest rates and 30-year terms to fit into new Ginnie Mae pools. Fannie and Freddie, on the other hand, have been able to offer modifications that are both more affordable and sustainable because they can buy loans out of pools and hold them in their portfolio, where it is easier to reduce interest rates and/or extend loan terms. While we do not anticipate a repeat of the type of foreclosure crisis that has just passed, we believe it's important to consider whether servicers, bond guarantors, or the FMIC should have the ability to hold modified loans, at least for some period of time, instead of resecuritizing them immediately.

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[5] [5] Letter from Benjamin Lawsky, New York Superintendent of Financial Services to New York State Insurance Commissioners , "*Reforming Force-placed Insurance,*" April 5, 2013, available at http://www.dfs.ny.gov/about/press2013/Force-Placed_Letter.pdf.

Servicing Transfers

Transferring the servicing of a loan is often necessary, either because the original servicer is failing to perform adequately or for various other reasons. In the new system, it will be important to clarify when the regulator or bond guarantor can make the unilateral decision to transfer servicing "for cause" and without continuing to compensate the original servicer. Bright line criteria will limit exposure to litigation over the transfer.

Underwriting

In general, we strongly support leaving underwriting policies to the discretion of the federal guarantor. Setting such standards in the statute – whether for down payments, DTI, credit history, or loan characteristics – unduly restricts the guarantor's ability to respond to the market, adjust as experience dictates, and to foster responsible innovation to reach populations that may be harder to serve with traditional underwriting guidelines.

No Hard-Coded Down Payment Requirement

S. 1217 would require a minimum down payment of 5 percent for any mortgages backing securities insured by the FMIC. We strongly oppose this requirement, and believe it would unnecessarily and unfairly restrict credit to low wealth borrowers who have been shown to be good credit risks with strong performance even through the most recent extreme credit cycle.

While down payments do make a difference in loan performance, other factors, such as product type, delivery channel, quality of servicing, credit history and overall debt loads have far greater effects. A January 2012 report by the University of North Carolina's Center for Community Capital and the Center for Responsible Lending[6] found that down payments have relatively less effect than other underwriting factors on loan defaults of standard, fixed rate prime loans with full documentation, but a very large impact on access to mortgages by low wealth borrowers.

An arbitrary legislative requirement for a 5 percent down payment will eliminate many credit-worthy borrowers from the FMIC universe of covered loans. In the study cited above, between 7 and 30 percent of the borrowers who had such mortgages originated in 2000-2008 and were current on them in 2012 would been excluded from the market if a down payment of between 3 and 10 percent had been required.

What's more, a perverse consequence of prohibiting the new conventional market from permitting low down payment lending will be that these risks will be shifted entirely to the FHA,

[6] Roberto G. Quercia, Lei Ding, Carolina Reid, *Balancing Risk and Access: Underwriting Standards for Qualified Residential Mortgages*, Center for Responsible Lending and UNC Center for Community Capital (Revised March 5, 2012)

where the US Government bears *all* of the credit risk, rather than sharing it with private credit enhancers as envisioned in S. 1217.

Do Not Restrict the New System to QM Loans

We oppose writing a requirement into law that would restrict a federal guarantor to only QM loans, and instead suggest leaving the establishment of criteria for eligible loans up to the FMIC. Both for underwriting and down payment requirements, we prefer to avoid hard-coding specific numerical underwriting standards in legislation because they are hard to adjust and would leave the guarantor with too little flexibility to respond to the market.

In this case, the mortgage reforms adopted by the Dodd Frank Act and being implemented through regulations by the Consumer Financial Protection Bureau (CFPB) have reestablished basic requirements for lenders that should restore a broad market standard of safe and sustainable mortgages. By requiring lenders to make loan decisions based on a the borrower's ability to repay, making them liable for this determination, and providing a safe harbor for compliance with this requirement through the Qualified Mortgage (QM) definition, these regulations will largely preclude the type of underwriting (or lack thereof) that helped lead to the crisis.

Additionally, while we expect most loans receiving federal support will be QM loans, it is widely anticipated that the QM safe harbor definition will exclude some safe, sustainable lending, especially to low-to-moderate income borrowers. We emphatically do not support federal guarantees for loans that are poorly underwritten or documented, but serving all markets fairly may well require some lending that meets the Ability to Repay standard but does not meet the QM safe harbor exemption. Restricting the guarantor's flexibility in statute will foreclose such efforts, which we believe could be detrimental to LMI borrowers and communities.

Finally, we do not anticipate that purchasing non-QM loans will render the FMIC unduly vulnerable to legal liability. The FMIC itself is neither originating nor purchasing loans, so even the limited amount of assignee liability contained in the Ability to Repay rule will not run to the FMIC. If the financial exposure of an issuer is of concern, the fact is that Ability to Repay rules in the past have not spawned significant amounts of litigation, as they are very difficult to prove and given the statutory limitations on damages, not particularly lucrative.[7]

Loan Level Credit Enhancements Can be Helpful

Loan level credit enhancements through mortgage insurance or other risk-sharing approaches are a responsible and well-understood risk mitigant. Congress has long required Fannie and Freddie to obtain some form of loan level credit support for higher LTV loans. We would expect the guarantor to follow a similar path. While we are concerned with legislative provisions that empower specific commercial enterprises, like mortgage insurers, for services that consumers

[7] [need cite to CRL memo]

must pay, we also acknowledge that such supports can make credit both more accessible and, in the long run, more affordable if they are structured and priced fairly.

Counseling Can Also be Helpful

Homeownership counseling has been shown to play a positive role in supporting improved mortgage performance, particularly for first-time, low-wealth borrowers. Post-purchase counseling also has been proven to reduce servicer and investor costs and to improve modification outcomes for distressed borrowers. It would be appropriate for the statute to encourage the guarantor to include homeownership counseling, when provided through certified nonprofit agencies, as a potential compensating factor in overall underwriting.

We also would encourage the guarantor to explore more sustainable models of compensation for pre-purchase counseling, including allowing charges for such service paid by a borrower to be included as a mortgageable expense. We see no functional difference between charges for services like home inspection and appraisal and counseling when it comes to allowing the expenses to be rolled into a mortgage.

The guarantor could also consider encouraging revenue from the servicing strip on guaranteed mortgages to be available as a revenue source for post-purchase counseling for borrowers experiencing difficulties making their monthly payments. Counselors at present obtain support from servicers, but this is on a case-by-case basis. Making such services an explicit expectation for servicers of federally guaranteed securities and identifying it as one of the eligible and expected uses of the servicing fee could encourage a more stable and durable business model for counseling agencies who currently have to rely on an uncertain mix of public, private and philanthropic support.

Single Securitization Platform

We have conceptually supported the building of a common platform for securitizing GSE loans, although at present the lack of public information about how this work is proceeding makes it difficult to know if we support what is actually happening, and we're concerned that building this platform now, before we know what the future system will look like, will foreclose options going forward.

That said, we certainly support the use of such a platform under any regime that emerges next. Any platform should be structured as a government-owned utility, which would fit into the FMIC-based system that is being contemplated by S. 1217. Such a platform offers clear advantages for a federal guarantor, including a single collection point for mortgage and securities data; standardized pooling and servicing agreements that would bring more uniformity and consistency to the treatment of consumers and investors; and lower costs for issuers. We believe public, or quasi-public in the case of FMIC, ownership will encourage the most open architecture, promulgation of common standards, and lowest cost of operations.

We are confident that such a platform could attract and retain the necessary personnel and build the requisite technology to keep the system robust.

We also would suggest developing incentives for other securitizers to use the platform even if they do not purchase a federal guarantee on their securities. Broad use across both guaranteed and purely private securities will help provide standardization and improve investor confidence in the securities.

Transition

It will be critical to ensure adequate funding for affordable housing during transition. We suggest the following language to do so:

> p. 36, lines 12-13: strike "not exceeding the amount".
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> p. 36, line 13: after "sufficient" insert "to contribute to the National Housing Trust Fund and Capital Magnet Fund immediately, to contribute to the Market Access Fund until the FMIC begins issuing insurance, and to".
>
> p.38, line 2: add "including funding of the National Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund"