

Housing Finance: The Community Bank Perspective

Chairman Crapo, Ranking Member Brown, members of the Committee, the Independent Community Bankers of America, representing community banks across the nation with more than 52,000 locations, appreciates the opportunity to provide this statement for the record in connection with today's hearing on Chairman Crapo's Housing Finance Reform Outline.

ICBA greatly appreciates Chairman Crapo's initiative. The Outline is a serious effort to address the significant challenges of housing finance reform, and we hope that it will advance this critical debate. ICBA strongly supports reform, but it is essential to borrowers and the broader economy that the details of reform are done right. ICBA looks forward to providing ongoing input on the impact of reform on community banks and their customers.

Recapitalization of the GSEs Cannot Wait

Before discussing the Chairman's Outline, we would like to highlight for this committee an immediate risk facing Fannie Mae and Freddie Mac (the government sponsored enterprises or GSEs), the mortgage market, and taxpayers. While there have been many improvements to the GSEs since they were placed in conservatorship 10 years ago, today both Fannie Mae and Freddie Mac are woefully undercapitalized and are putting taxpayers at risk of another bailout should there be a market downturn. Sadly, the GSEs have less capital today than they did when they were placed into conservatorship in 2008. ICBA has long urged the Federal Housing Finance Administration (FHFA) and the U.S. Treasury to end the destructive sweep of GSE earnings and require them to begin the process of recapitalization.

Specifically, ICBA urges FHFA to direct the GSEs to develop and file capital restoration plans, as required by the Housing and Economic Recovery Act (HERA), to provide a road map for the industry, taxpayers, and policy makers. The plans must detail the GSEs' capital framework, activities, milestones, and timeframe to achieve desired capital levels and specify the steps FHFA will take to approve the GSEs' eventual exit from conservatorship. These plans are critical for all stakeholders to ensure the process is transparent, with robust oversight by FHFA. Recapitalization cannot wait for legislative reform to occur. However, legislative reform can and should complement and support the recapitalization efforts by FHFA.

Community Banks and the Mortgage Market

Community bank mortgage lending is vital to the strength and breadth of America's housing market. Community banks represent approximately 20 percent of the mortgage market, but more importantly, our mortgage lending is often concentrated in the rural areas and small towns of this country, which are not effectively served by large banks. For many rural and small-town borrowers, a community bank mortgage loan is the only option.

A vibrant community banking sector makes mortgage markets everywhere more competitive, and fosters affordable and competitive interest rates and fees, better customer service, and more product choice. The housing market is best served by a diverse group of lenders of all sizes and charter types. More than 10 years after the beginning of the financial crisis, an already concentrated mortgage market has become yet more dangerously concentrated. We must promote beneficial competition and avoid further consolidation and concentration of the mortgage lending industry.

Fair Access to the Secondary Market

Secondary market sales are a significant line of business for many community banks. According to an ICBA survey, nearly 30 percent of community bank respondents sell half or more of the mortgages they originate into the secondary market.¹ When community banks sell their well-underwritten loans into the secondary market, they help to stabilize and support that market. Community bank loans sold to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are underwritten as though they were to be held in the bank's portfolio. Selling loans to the GSEs allows the community bank to retain the servicing on those loans, thereby keeping their relationship with that borrower. Loans that are serviced by locally based institutions tend to lead to better outcomes for borrowers and their communities. Many non-GSE secondary market investors require transfer of servicing when they purchase a loan.

While community banks choose to hold many of their loans in portfolio, it is critical for them to have robust secondary market access to support lending demand with their balance sheets. Selling mortgage loans into the secondary market frees up capital for more residential mortgages or other types of lending, such as commercial and small business lending, which support economic growth in our communities.

Even those community banks that hold nearly all of their loans in portfolio need to have the option of selling loans in order to meet customer demand for long-term fixed rate loans. Meeting this customer demand is vital to retaining other lending opportunities and preserving the relationship banking model. As a community bank, it is not feasible to use derivatives to offset the interest rate risk that comes with fixed rate lending. Secondary market sales eliminate this risk. The ability to sell a single loan for cash, not securities, is critical because most community banks don't have the lending volume to aggregate loans and create mortgage backed securities, before transferring them to Fannie Mae or Freddie Mac. In addition, the GSEs won't appropriate data from loans sold to solicit customers with other banking products.

¹ ICBA Mortgage Lending Survey. September 2012.

Key Features of a Successful Secondary Market

The stakes involved in getting housing-finance market policies right have never been higher. Housing and household operations make up 20 percent of our economy and thousands of jobs are at stake.

ICBA's approach to GSE reform is simple: use what's in place today and is working and focus reform on aspects of the current system that are not working or that put taxpayers at risk. If reform is not done right, the secondary market could be an impractical or unattractive option for community banks. Proposals that would break up, wind down, sell or transfer parts of the GSEs' infrastructure to other entities would end up further concentrating the mortgage market in the hands of the too-big-to-fail players, putting taxpayers and the housing market at greater risk of failure. Further they run the risk of disrupting liquidity in the \$5 trillion housing market that community banks and homebuyers depend on.

Below are some of the key principles community banks require in a first-rate secondary market.

- ***The GSEs should be allowed to rebuild their capital buffers.*** As stated above, ICBA believes the first step in GSE reform must be restoring the GSEs to a safe and sound condition. Regardless which approach or structure reform takes, the existing system must be well capitalized to prevent market disruption or additional taxpayer support in the event of one or both GSEs requiring a draw from the U.S. Treasury during what's likely to be a lengthy debate and transition period to any new structure or system.
- ***Lenders should have competitive, equal, direct access on a single-loan basis.*** The GSE secondary market should continue to be impartial and provide competitive, equitable, direct access for all lenders on a single-loan basis that does not require the lender to securitize its own loans. Pricing to all lenders should be equal regardless of size or lending volume.
- ***An explicit government guarantee on GSE MBS is needed.*** For the market to remain deep and liquid, government catastrophic loss protection must be explicit and paid for through the GSE guaranty fees, at market rates. This guarantee is needed to provide credit assurances to investors, sustaining robust liquidity even during periods of market stress.
- ***The TBA market for GSE MBS should be preserved.*** Most mortgage lenders are dependent on a liquid to-be-announced (TBA) market that allows them to offer interest rate locks while hedging interest rate risk with GSE mortgage-backed securities (MBS) that will be created and delivered at a later date. Creating new GSE MBS structures or using customized capital markets structures that provide front end credit risk transfers, generally makes the resulting MBS "non-TBA."
- ***Strong oversight from a single regulator will promote sound operation.*** Weak and ineffective regulation of the GSEs enabled them to stray from their primary mission as aggregators, guarantors, and securitizers. As required by HERA, the FHFA must ensure the secondary market operates in a safe and sound manner so taxpayers are not put at risk. It is incumbent upon FHFA to ensure the GSEs are adequately capitalized commensurate with their risks and compliant with their primary mission.

- ***Originators should have the option to retain servicing, and servicing fees must be reasonable.*** Originators should have the option to retain servicing after the sale of a loan. In today's market, the large aggregators insist that lenders release servicing rights along with their loans. Transfer of servicing entails transfer of customer data which can be used for cross-selling. While servicing is a low-margin business, it is a crucial aspect of the relationship-lending business model, giving originators the opportunity to meet the other lending or financial services needs of their customers. Additionally, in general, consumers receive better service when their loans are serviced on a local level than when they are serviced by entities that did not originate their loan and are located out of their market area.
- ***Complexity should not force consolidation.*** Under the current GSE model, selling loans is relatively simple. Sellers take out commitments to sell loans on a single-loan basis and are not required to obtain complex credit enhancements, except for private mortgage insurance for loans exceeding 80 percent loan-to-value or other guarantees. Any future secondary market/GSE structure must preserve this relatively simple process for community banks and other small lenders that individually do not have the scale or resources to obtain and manage complex credit enhancements from multiple parties.
- ***GSE shareholder rights must be upheld.*** Any reform of the housing finance system must address the claims of GSE shareholders and respect the rule of law that governs the rights of corporate shareholders.

ICBA's Way Forward

ICBA's approach to GSE reform is simple: Use what is in place today and is working and modify the parts of the current system that are not. Our approach has two parts: Reforms that can be accomplished administratively by FHFA within HERA and reforms that require Congressional action. These reforms are categorized below.

Administrative Reforms

- End the net worth sweep and retain earnings to rebuild capital.
- GSEs develop and file capital restoration plans with FHFA for approval.
- FHFA approves plans, directs the GSEs to implement.
- FHFA provides recapitalization plans to marketplace along with milestones and clear path to full recapitalization and eventual release from Conservatorship.
- FHFA and Treasury resolve PSPAs/ Dividend/ Commitment fee issue as well as any other covenants to PSPAs that may be needed to address any Treasury support /guaranty.

Legislative Reforms

- Provide the explicit government guaranty on the MBS.
- Permanent caps on GSE retained portfolios.
- Permanent elimination of preferential pricing/loan sale terms for lenders based on production volume or market share.
- Convert FHFA's governance structure to 5-member board rather than single Director.

- Change GSE charters to shareholder-owned financial utilities.
- Provide FHFA additional authority to regulate the GSEs as utilities.

ICBA Does not Support

- Chartering of additional guarantors or entrants who could access the GSE guaranty.
- Selling off GSE assets and intellectual property to other market entities.
- Use of GNMA platform or MBS structure.
- FHFA control or managing of GSE market share.

ICBA Concerns with Multiple Guarantor Model

Chairman Crapo's Outline provides for the chartering of additional guarantors that would be able to apply the government guaranty on MBS similar to Fannie Mae and Freddie Mac. The stated purpose of adding more guarantors into the system is to enhance competition in the secondary market by providing more choices for lenders when they sell their loans. Moreover, it has been argued that additional guarantors would reduce market reliance on the GSEs thereby shrinking their footprint. While encouraging competition sounds attractive, we are concerned that competition in this space would not be helpful and could even be dangerous. Below we describe some of our concerns with the multiple guarantor model.

There is robust competition in the *private* secondary market which aligns with the goal of increasing private capital. The private secondary market comprised of aggregators, REITs, portfolio lenders and issuers of private label MBS (PLMBS) offer a broad range of products and programs to the lending industry. These secondary market entities compete on price and credit, buying loans that may or may not be eligible for sale to the GSEs. Jumbo loans are a good example where the private market provides better execution than competing high balance loan programs of the GSEs. Additionally, the private market for non-QM and "just outside GSE guidelines" has developed and is quite robust. Competition should be in the private market where there is no government guaranty and taxpayers are not put at risk. Chartering additional guarantors to compete with the GSEs, as envisioned by the Chairman's Outline, would result in a degradation of credit standards as these entities compete to build market share to generate returns for their shareholders, likely culminating in an event similar to the housing market collapse of 2007. The only difference would be that now the government and the taxpayers would be obligated to support those MBS.

The current duopoly of the GSEs provides a more controlled level of innovation and competition within the confines of their statute and mission overseen by a strong regulator.

Multiple guarantors may *increase* taxpayer risk rather than reduce it. One of the primary goals of GSE reform is to protect taxpayers from having to bailout or step in to support the housing market in times of stress or if an entity fails. As proposed in the Chairman's Outline, the government would provide an explicit guaranty on the MBS issued by certain approved guarantors, including the GSEs. If any guarantor fails, the government would be obligated to continue to make the principal and interest payments on the MBS issued by the failed entity. The more chartered entities there are, the more likely it is that a failure will occur and that taxpayers will be tapped to cover the losses.

Multiple guarantors threaten liquidity in the current system and TBA market. The vast liquidity of the GSE

secondary market depends on the TBA Good Delivery status of the GSEs' MBS. In June both GSEs will begin issuing the Uniform Mortgage Backed Security or UMBS. The key change is that the UMBS will co-mingle loans from both GSEs which will help increase the overall liquidity in the MBS market. However, in order to maintain this liquidity, the GSEs will be required to maintain near perfect alignment of programs and underwriting guidelines to keep pre-payment speeds of their respective loans/securities nearly identical. FHFA and the GSEs have agreed to a very intensive monitoring process to ensure security performance remains aligned. Adding loans into the UMBS from additional guarantors would make this process even more challenging and would likely lead to the loss of the Good Delivery TBA status. This in turn would harm community banks and other smaller lenders more than the large national aggregators and banks.

Finally, given the high levels of capital that would be required to be a guarantor, only the largest financial entities would be able to form, capitalize, and run a guarantor which would further consolidate the mortgage market with Wall Street and the too-big-to-fail banks.

Problems with Using GNMA

The Chairman's Outline proposes to create a new class of MBS which would be backed by conventional, not government insured, loans and would be "wrapped" by the Government National Mortgage Association (GNMA) to achieve the explicit government guaranty on the MBS. GNMA currently provides this guaranty on MBS backed by FHA/VA and USDA rural housing loans, all of which are insured or guaranteed by the government. This would be a completely new class of MBS. While this sounds like a novel way to obtain the explicit government guaranty on conventional MBS issued by the GSEs, there are major hurdles to implementing this idea. These include:

- GNMA, with less than 200 staff, is critically under-resourced, overly reliant on outside contractors, and subject to the appropriations process. The agency can barely support the 400 approved issuers and servicers and its current \$1.5 trillion book of business. Contrast that to the GSEs nearly 3000 approved seller-servicers and \$5.4 trillion book of business supported by nearly 8,000 staff. Being subject to the appropriations process will create uncertainty and could put taxpayers at risk due to operational failure. Current issues with prepayments, liquidity, and concentration of GNMA servicing rights highlight some of the flaws of the GNMA model.
- GNMA is an issuer model not a guarantor model. Obtaining sale treatment on conventional loans with private risk sharing would be very expensive. As stated above, GNMA currently provides a guaranty on the MBS backed by loans where the government assumes most if not all of the credit risk. While GNMA doesn't assume or manage credit risk, it does manage counterparty risk and liquidity risk but doesn't acquire or guaranty the loans themselves. Issuers of GNMA MBS get sale treatment of their loans because the government assumes the credit risk. The Chairman's Outline is unclear how this model would work with conventional loans. However, to achieve sale treatment would require very deep credit support from a guarantor which would be very expensive to achieve making the price execution to the lender uncompetitive. It's also unclear how the servicing contract would work as the GNMA servicing contract is very different than the GSE servicing contract and not as attractive to community banks and others as evidenced by the small number of approved issuers/servicers, most of which tend to be larger non-bank servicers.

Closing

Whatever course housing finance reform takes, the worst outcome would be to allow a small number of mega-firms to mimic the size and scale of Fannie and Freddie under the pretense of creating a private sector solution strong enough to assure the markets in all economic conditions. Moral hazard derives from the concentration of risk, and especially risk in the housing market because it occupies a central place in our economy. Any solution that promotes consolidation is only setting up the financial system for an even bigger collapse than the one we've just been through.

The GSEs must not be turned over to the firms that fueled the financial crisis with sloppy underwriting, abusive loan terms, and an endless stream of complex securitization products that disguised the true risk to investors while generating enormous profits for the issuers. These firms must not be allowed to reclaim a greater systemic risk profile in our financial system.

ICBA is pleased to see a robust debate emerging on housing finance reform. A number of serious proposals have been put forth to date – both from within Congress and from outside – all of which combine promising features with others that warrant additional consideration and reworking.

Thank you again for the opportunity to submit this statement today. It is critically important the details of reform are done right to ensure community banks and lenders of all sizes are equally represented and communities and customers of all varieties are served.