



INDEPENDENT COMMUNITY  
BANKERS of AMERICA®

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## Community Banks and Housing Finance Reform

On behalf of the more than 5,800 community banks represented by ICBA, we thank Chairman Crapo, Ranking Member Brown, and members of the Senate Banking Committee for convening today's hearing on "Principles of Housing Finance Reform." We appreciate you taking up the critical policy challenge of creating a stable and enduring housing finance system to strengthen the American economy.

Attached is ICBA's recent white paper, "ICBA Principles for GSE Reform and a Way Forward," which we are pleased to offer as a statement for the record for today's hearing. Below is a summary of critical points made in the white paper.

### **The GSEs Have Facilitated Home Ownership for Decades**

For decades, American homeowners have benefited from the critical role Fannie Mae and Freddie Mac (the government sponsored enterprises or "GSEs") have played in helping finance homeownership. The GSEs have provided a steady, reliable source of funding for home mortgage lending through all economic cycles and in all markets. The GSEs have accomplished this by developing a strong liquid global market for conventional mortgage-backed securities (MBS), which enables the GSEs to attract funding worldwide. GSE securities trade with the same ease as U.S. Treasury debt. The GSEs operate as friendly aggregators and a source of capital for mortgage lending institutions of all sizes and charters.

Community banks depend on the GSEs for direct access to the secondary market without having to sell their loans through a larger financial institution that competes with them. The GSEs allow community banks to retain the servicing on the loans they sell, which helps keep delinquencies and foreclosures low. And unlike other private investors or aggregators, the GSEs have a mandate to serve all markets at all times. This they have done, in contrast to some private investors and aggregators that severely curtailed their business in smaller and economically distressed markets, leaving those community bank sellers to find other outlets for their loan sales.

### **Reform Should Preserve What Works, Draw Private Capital into the System, and Protect Taxpayers**

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.

As noted above, the current GSE secondary mortgage market structure has worked well for community banks by providing direct and equitable access, not competing at the retail level, and permitting community banks to retain mortgage servicing rights on the loans they sell.

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However, ICBA strongly supports secondary market reform measures that will prevent or significantly reduce the risk of devastating market failures that have hobbled our economy in the past. There is bipartisan consensus that there should be more private capital in the housing finance system. Private capital should come from multiple sources, not just the largest Wall Street firms. ICBA welcomes the return to a more balanced and less concentrated housing finance system with an appropriate role for portfolio lenders, originate-and-sell lenders, and small as well as large lenders. If implemented thoughtfully, such a system would reduce the moral hazard and taxpayer liability of the current system.

Reforms that would break up the GSEs or sell off their assets to large Wall Street firms would further concentrate the mortgage lending and the secondary market in a small number of megafirms. This would significantly increase the risk of another market failure.

ICBA's attached white paper provides a roadmap for reform that will preserve the role of community bank mortgage lenders, restore the safety, soundness, and financial stability to the GSEs, and ensure that Wall Street and the megabanks do not effectively capture the secondary market system to the detriment of borrowers and communities.

### **Recapitalization of the GSEs Cannot Wait**

It will take time to reach consensus on the many critical features of comprehensive reform legislation. Pending completion of that effort, FHFA should protect taxpayers from another bailout. ICBA urges FHFA to follow the Housing and Economic Recovery Act of 2008 (HERA) and require both GSEs to develop and implement a capital restoration plan, start to retain earnings and, over time, build capital to a level that adequately supports their operations and protects U.S. taxpayers.

### **Closing**

Thank you again for convening today's hearing. ICBA looks forward to working with this Committee to create a housing finance system that will support a robust and resilient housing market for many decades to come. We encourage all members of the Committee to read our attached white paper and discuss its principles with community bankers in their states.

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# ICBA Principles for GSE Reform and a Way Forward

In September 2008, the Federal Housing Finance Agency (FHFA) and the Treasury Department placed Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) into conservatorship. Described at the time to the public as a temporary “time out” to allow both companies to stabilize, the plan of those policymakers who put the GSEs into conservatorship was to release both institutions from this “time out” once they were financially sound again. More than eight years have passed, and a third administration has inherited these conservatorships. Unfortunately, Fannie Mae and Freddie Mac have less capital today than when they were placed under control of their regulator and the Treasury. Yet, both companies have returned to profitability and have worked through the majority of their defaulted loans, all while continuing to provide the liquidity to the housing market that’s been critical for its recovery from the worst recession in more than 80 years.

## **GENERAL POSITION ON GSE REFORM**

American homeowners have benefited from the critical role Fannie Mae and Freddie Mac have played in helping finance homeownership for decades. The GSEs have provided a steady, reliable source of funding for home mortgage lending through all economic cycles and in all markets. The GSEs have accomplished this by developing a strong liquid global market for conventional mortgage-backed securities (MBS), which enables the GSEs to attract funding worldwide. GSE securities trade with the same ease as U.S. Treasury debt and securities. The GSEs operate as friendly aggregators and a source of capital for mortgage lending institutions of all sizes and charters.

Community banks depend on the GSEs for direct access to the secondary market without having to sell their loans through a larger financial institution that competes with them. The GSEs help support the community bank business model of good local service by allowing them to retain the servicing on the loans they sell, which helps keep delinquencies and foreclosures low. And unlike other private investors or aggregators, the GSEs have a mandate to serve all markets at all times. This they have done, in contrast to some private investors and aggregators that severely curtailed their business in smaller and economically distressed markets, leaving those community bank sellers to find other outlets for their loan sales.

## PRINCIPLES FOR GSE REFORM

- ***The GSEs must be allowed to rebuild their capital buffers.*** The first step in GSE reform requires the FHFA, the GSEs' safety and soundness regulator, to follow the mandates prescribed in the 2008 Housing and Economic Recovery Act (HERA), namely, to restore the GSEs to a safe and sound condition. Regardless of 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 must 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.
- ***Capital, liquidity, and reliability are essential.*** The GSEs must be adequately capitalized, liquid, and reliable enough to effectively serve the entire mortgage industry in all markets, at all times, including challenging economic circumstances.
- ***Credit risk transfers must meet targeted economic returns.*** The FHFA has required the GSEs to engage in ever increasing levels of credit risk transfers (CRTs). While these CRTs may help mitigate the amount of credit risk both the GSEs and taxpayers bear, these transactions also drain revenue away from the GSEs and expose them to operational risks. Additionally, CRT securities are currently illiquid and would likely dry up in times of market stress. CRTs, regardless of their form or structure, must reflect a real transfer of credit risk, minimize counterparty risk, be scalable, meet a targeted economic rate of return set by FHFA, and not encourage further concentration of the mortgage business in the largest banks.
- ***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 must 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 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 CRTs, 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 the FHFA to ensure the GSEs are adequately capitalized commensurate with their risks and compliant with their primary mission.
- ***Originators must have the option to retain servicing, and servicing fees must be reasonable.*** Originators must 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, consumers generally receive better service when their loans are serviced locally 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 or 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 assets must not be sold or transferred to the private market.***  
Assets such as the GSEs' automated underwriting technology, loan delivery portals, Common Securitization Platform, and multi-family housing businesses should not be sold or transferred to private market aggregators.
- ***The purpose and activities of the GSEs should be appropriately limited.***  
The resources of the GSEs must be focused on supporting residential and multifamily housing. They must not be allowed to compete with originators at the retail level, where they would enjoy an unfair advantage.
- ***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

Policymakers, industry stakeholders, think tank gurus, and politicians have weighed in on how to resolve this last remaining part of the Great Recession. There have been multiple papers and numerous legislative proposals, including some that have been attached to appropriations legislation, all seeking to end the conservatorship of the GSEs. Yet, the GSEs remain in conservatorship and subject to the net-worth sweep that is slowly bleeding away what little capital they have. This will eventually bring a day of reckoning for FHFA, the Treasury, and the housing market.

If asked about GSE reform, most mortgage lenders would say: fix what's wrong, let the GSEs recapitalize, regulate them, and release them from conservatorship. These mortgage lenders depend on the GSEs for access to the secondary market and do not want their options to sell or securitize loans controlled or dictated by a few large entities that also compete with them in providing financial services.

ICBA's approach to GSE reform is simple: use what is in place today and is working, and address or change the parts that are not. Our approach has two parts: (1) reforms that can be accomplished administratively by FHFA within HERA, and (2) reforms that will require congressional action.



## ADMINISTRATIVE REFORMS

- FHFA should end the net-worth sweep and, per HERA, require both GSEs to develop capital restoration plans. These plans would include continued use of credit risk transfers, provided they meet a targeted economic return threshold that balances GSE revenue and capital-building needs with prudent credit risk management standards.
- FHFA should review and approve those capital plans, establish prudent risk-based capital levels as required by HERA, and set reasonable timeframes and milestones for achieving re-capitalization goals.
- FHFA should monitor the GSEs' performance against their respective plans and release each GSE from conservatorship as they become well capitalized.
- The GSEs should complete construction of the Common Securitization Platform and issue their respective MBS from the platform. Ownership and management of the CSP should remain with the GSEs through the current LLC structure. Expanding access to the CSP to other entities should be up to the Common Securitization Solutions LLC board, with final approval by FHFA.
- Launch of the Uniform Mortgage Backed Security should be deferred until both GSEs are recapitalized and released from conservatorship.

## LEGISLATIVE REFORMS

- Congress should create a catastrophic mortgage insurance fund to be administered by the FHFA and funded through GSE guaranty fees. The size of the fund should be determined based on actuarial standards and should be similar to the FDIC's Deposit Insurance Fund. The fund would stand behind the explicit U.S. government guarantee of the GSE MBS.
- Congress should change the GSE corporate charters from the current government-chartered, shareholder-owned, publicly traded companies, to regulated financial utilities that are shareholder owned. All current shareholders should be able to exchange common and junior preferred GSE shares for a like amount of shares in the new structures. The Treasury should exercise its warrants for senior preferred shares of GSE stock and convert those shares to stock in the new structure. No dividends should be paid to any shareholders until the company is deemed well capitalized per its recapitalization plan by the FHFA. The Treasury should be required to divest itself from its shares once a company is well capitalized.

## CONCLUSION

GSE reform will be difficult, but it remains critically important to the future of the housing market and the U.S. economy, and HERA provides the road map needed to restore the GSEs to a safe and sound condition. ICBA is confident that a strong plan to improve their capital position, grow earnings, manage expenses and restore high-quality service and increased liquidity to the mortgage market will drive a more robust primary and secondary mortgage market. It will make the housing finance system safer and more sound, providing access to lenders of all sizes and the communities they serve.