July 21, 2010

The Honorable Timothy F. Geithner
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development
451 Seventh Street, SW
Washington, DC 20410

RE: Public Input on Reform of the Housing Finance System
eDocket Number: TREAS-DO-2010-001
eDocket Number: HUD-2010-0029

Dear Secretaries Geithner and Donovan:

The Mortgage Bankers Association (MBA)[1] wishes to augment its responses to the administration's questions regarding the future structure of the secondary market[2] with this supplemental comment on the role of housing goals in the new future secondary market structure. The reason for this supplemental comment is that it has been suggested in public debate and proposals from others that some variant of the current affordable housing goals requirements for Fannie Mae and Freddie Mac needs to be maintained in a new secondary market structure. MBA believes that a return to the type of housing goals required of Fannie Mae and Freddie would be inefficient and potentially an obstacle to achieving the required safety and soundness in the system. These goals played a significant role in distorting the mortgage market. Moreover, it has become clear that the mixing of a public purpose with the profit goals of private ownership did not work. Not only was the structure of mixing private gain and public risk fatally flawed, but the goals themselves were a flawed tool with which to seek to monitor and mandate the accomplishment of the public purpose mission. As we stated in our June 17 response to the administration's questions on the secondary market and the government sponsored enterprises (GSEs):

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 75 Fed. Reg. 77, 21146-21147 (Apr. 22, 2010).

> "The core mortgage finance market itself, and the role the government plays in it, should be neutral to and separate from other housing policy goals. Decisions of whether to promote rental or ownership, multifamily or single-family, or low-income or middle-income housing should be explicitly supported by specific policy decisions, actions and funding. Programs and/or subsidies to support these policies should supplement and complement, not distort or misalign, government efforts to provide stability and liquidity in the mortgage markets."

The MBA believes that there are more efficacious means of ensuring access to mortgage credit by credit-worthy borrowers. First and foremost, the goal of the MBA proposal is to maximize liquidity and therefore lower costs for all borrowers below what they would be without a functioning and efficient secondary market. Second, the MBA plan provides a mechanism for policymakers to raise funds for affordable housing programs that are transparent, accountable and precisely targeted. This mechanism is available to policymakers should they decide that the revenue for affordable housing should come from new mortgage originations rather than the taxbase at large. Finally, tools are readily available for policymakers to protect against any redlining of lower income areas, allowing them to detect and take remedial actions where denials of credit to an area are not justified by underlying economic and housing factors.

Housing Goals Are Conceptually Flawed

Under the housing goals that have been a part of the regulatory regime for Fannie Mae and Freddie Mac since the 1990s, a certain percentage of the loans purchased or securitized by the two firms were to be for housing for families with lower incomes as defined in relation to their area's median income. The housing goals have varied over time, both with respect to the goals percentage and the percentage of median income required to qualify a particular loan as goals eligible. While in theory the housing goals were meant to ensure that mortgage credit was made available to lower income individuals, in practice the goals had the effect of distorting the market for both single-family and multifamily lending.

The fundamental flaw of housing goals is that the distribution of credit-eligible borrowers is not equal across the income spectrum. While low income does not mean high risk and high income does not mean low risk, lower income borrowers generally have lower down payments and less financial reserves necessary to purchase and maintain a house. To illustrate the problem of housing goals, assume that the goals state that 50 percent of the loans must go to borrowers with incomes above the area median income level and 50 percent must go to borrowers below the area median income level. Also assume that 65 percent of families that would qualify for a mortgage under the credit rules established by the secondary market entity (called a MCGE in MBA's proposal) have incomes above the median income level and 35 percent of the families that would qualify have incomes below the median level. If every day the MCGE purchased an equal number of loans above and below the median income level, it would run out of credit-eligible borrowers below the median level long before it funded every credit-eligible borrower above the median income level. At that point the MCGE would have three choices:

1. Stop making loans to some credit-eligible borrowers simply because they made more money than the area median income;
2. Loosen credit standards to make more lower income borrowers credit eligible; or
3. Reduce the slope of the credit pricing gradient, in other words, distort the pricing of loans to dampen demand by stronger credit borrowers and increase demand by

weaker credit borrowers. This approach would essentially charge good credit quality borrowers more than their risk would justify and use the proceeds to subsidize higher risk borrowers by charging them less than their risk would justify.

While the first option has all of the problems attendant with any form of non-market credit rationing, the second option has even more dire consequences. The MCGE's credit standards would be carefully monitored by its regulator for safety and soundness. Any weakening of credit standards would put the whole housing finance system at risk. In addition, weakening credit standards for the purpose of increasing the number of lower income borrowers would not result in balancing the percentages. Any reduction in credit standards would also bring in additional higher income borrowers, preventing the MCGE from getting to the target allocation. Finally, forcing a change in the credit pricing gradient with housing goals could cause a repeat of the current housing collapse where credit risk was underpriced and borrowers were placed into houses when their overall economic situation could not sustain that mortgage over time. Another problem with housing goals is with the nature of an insurer and securitizer. A MCGE does not go out and originate loans – it can only securitize those loans presented to it by mortgage originators. Requiring a MCGE to securitize more loans for a specific segment of the population is the regulatory equivalent of pushing on a rope. Absent one of the market distorting actions already discussed, under-pricing risk or rationing credit to upper income borrowers, there is nothing an insurer/securitizer can do to meet explicit goals, even if by some miracle those goals do match exactly the total market's demand for mortgages for that MCGE's credit standards. A MCGE would be entirely dependent on what loans were offered to it by mortgage originators.

Finally, the negative impact of the GSE housing goals on the quality of the Federal Housing Administration (FHA) portfolio should not be underestimated. To the extent the GSEs reduced credit standards in an attempt to meet housing goals, many of the goals-driven loans they purchased or securitized would have been made anyway but with FHA insurance. The GSEs did not, however, take on all of the loans that FHA would potentially have insured, just the less risky loans. The absence of risk-based pricing at FHA exacerbated the problem by allowing the GSE to offer better pricing than FHA could offer to the less risky group of FHA borrowers. This left FHA with a riskier overall portfolio, artificially distorting its book of business.

Historical Problems with the Housing Goals in Practice – Public Policy or Public Relations?

MBA's proposal on a new secondary market structure eliminates the tools the GSEs were able to use to meet their housing goals, tools that helped distort the market. The most important change is the elimination of large portfolios in the new MCGE structure. Nevertheless, it is legitimate to ask why Fannie Mae and Freddie Mac were able to meet their housing goals over the years, even after the goals were raised in 1998 to levels that no longer reflected the distribution of credit-eligible borrowers, and yet housing goals are specifically excluded from the MBA proposal. The answer is that while the goals are often viewed as goals for single-family mortgages, the goals were most often met through the purchase or securitization of multifamily mortgages, or the purchase of the AAA-rated tranches of private label residential mortgage-backed securities (RMBS) or commercial mortgage-backed securities (CMBS) that contained either subprime or multifamily mortgages. The GSEs would often pay up for these securities, subsidizing yields below what the risks of the securities would have justified.

These practices distorted the market in several ways. First, the demand by the agencies for multifamily loans was driven by the volume of single-family business. In years of heavy single-family refinance volume, the agencies were voracious purchasers of multifamily loans, driving down yields and driving out other traditional lenders. In other years, appetites would diminish and rates would climb. This whipsawing of rates on multifamily loans that appeared detached from underlying market conditions distorted the multifamily market.

The second way the market was warped was through the goals-driven purchase of private label mortgage-backed securities supporting subprime and Alt-A mortgages. The GSE capital rules are such that the GSEs could purchase these securities at a 40 to 1 leverage ratio because they would purchase only the AAA-rated pieces. Because the GSEs had lower capital requirements than other leveraged purchasers and needed the housing goals credit to subsidize their prime single-family business, they drove down yields on the securities and helped underprice the credit risk for subprime and Alt-A loans. The effect was the creation of liquidity for these subprime securities that would not have otherwise existed and forcing other investors in private label mortgage securities into the lower-rated tranches.

Finally, the degree to which the GSE housing goals distorted the multifamily market through the CMBS market should not be ignored. Many CMBS deals were specifically constructed with a certain percentage of multifamily loans so as to attract GSE investment in the AAA tranches of those bonds. The result was that there was strong pressure to deliver multifamily loans into these CMBS transactions that would make the AAA tranches eligible and attractive for GSE purchase, thus lowering the pricing of these loans and general credit standards. It is no surprise, therefore, that multifamily loans packaged into CMBS securities are now the worst performing group of multifamily loans.

Regardless, purchasing of securities for meeting housing goals would not be an option for the MCGEs because they would not be allowed to hold portfolios under the MBA proposal.

What Has Changed Since Housing Goals Were Introduced?

While housing goals are an imprecise and counterproductive tool for attempting to achieve national housing objectives, they were a reflection of what was available to policy makers when they were first introduced. Much has changed since then. For example, the coverage of the Home Mortgage Disclosure Act (HMDA) data has been expanded to cover a much larger share of the market and the information collected as part of HMDA have been expanded. These data are used by regulators and others to ascertain where lending is and is not taking place with much more precision than can ever be achieved with the housing goals. While some outside observers often misuse the data by equating the income data in HMDA with risk, the professionals in the financial regulatory agencies know how to analyze and interpret the data. Applying this proven model to the regulatory framework of the new MCGEs is far preferable to a return to the distortions created by housing goals.

What is the MBA Proposing Instead of Housing Goals?

The MBA believes that the primary source of delivering support for government housing policy should be through FHA. FHA is the best mechanism for determining the tradeoff between the social benefits of providing loans to riskier borrowers and the longer-term costs to taxpayers. As has already been noted, housing goals already create a conflict between the mission of FHA and the mission of the GSEs and tended to increase the risk in the FHA portfolio. The MBA believes that the structure it is proposing for the payment of explicit fees to the government in exchange for explicit guarantees on mortgage securities can be augmented by charging an additional fee to provide a source of funding for various housing programs. In addition to the fees paid to support the regulator, pay for the guarantee and paid into the insurance fund, an additional fee could be paid into a fund administered by a governmental entity to subsidize various housing programs. The advantage of such a fee is that its costs can be explicitly measured and it can be deployed in a much more efficient manner than anything that might be achieved with housing goals. The central question is whether policymakers expect that support for affordable housing should come from mortgage borrowers or from the taxbase at large.

Finally, if the expectation is that housing goals in some way protect against redlining of certain neighborhoods, active oversight by regulators of credit models, both the design and the results of those credit models, is the best method for detecting redlining. Housing goals are a weak and imprecise tool for this purpose. For example, imagine a hypothetical case that one of the GSEs had decided to redline lower income neighborhoods of “City A,” that is, apply much tighter standards in those neighborhoods than it applied elsewhere. Under the housing goals system, it could make up the shortfall by purchasing more loans in “City B,” “City C,” or some other city, but nothing that would help “City A.” Under the MBA’s proposal, the regulator would have the power to oversee in detail the workings of the various credit models to ensure that if credit standards needed to be tightened in certain areas, that tightening was done for reasons that were economically justified.

The MBA appreciates the opportunity to continue to provide its perspective on the complex topic of rebuilding the secondary market for mortgages.

Regards,

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