June 17, 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, S.W.
Washington, DC 20410

Dear Secretaries Geithner and Donovan:

The Mortgage Bankers Association (MBA)[1] welcomes this opportunity to again outline our recommendations on the future of the U.S. secondary mortgage market. Since the credit crisis first hit, the Mortgage Bankers Association has consistently called for a thoughtful, thorough, workable response to the challenges faced.

In November 2008, MBA hosted a summit to bring together leading thinkers from industry, academia and regulators to discuss what fundamental elements would be required for a functioning secondary market. The discussion led to the MBA-issued report "Key Considerations for the Future of the Secondary Mortgage Market and the Government Sponsored Enterprises (GSEs)," which was released in January 2009.[2]

In March 2009, MBA released a set of guiding principles[3] embodying the key considerations discussed in the January report. The principles, outlined in "Principles for Ensuring Mortgage Liquidity," serve as a valuable tool in evaluating proposals for restructuring the secondary market.

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[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 2,400 companies, including 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] See Paper at MBA's Web site at the following URL: http://www.mortgagebankers.org/files/Advocacy/2009/KeyConsiderationsfortheFuture.pdf.

[3] See the principles at MBA's Web site at the following URL: http://www.mortgagebankers.org/files/Advocacy/2009/PrinciplesforEnsuringMortgageLiquidity.pdf.

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In September 2009, after considerable discussion and deliberation, MBA presented "Recommendations for the Future Government Role in the Core Secondary Mortgage Market,"[4] a suggested framework for government involvement in the single-family and multifamily secondary mortgage markets, with a particular focus on the roles currently played by Fannie Mae and Freddie Mac. These recommendations established a foundation for the current debate and have been integrated in many of the proposals that have since come forward.

MBA has testified before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (in September 2009) and the House Financial Services Committee (in March 2010), and has appeared in numerous industry, think-tank, media and other discussions on the future of the GSEs.

We are hopeful that this work will be of value to the Administration and Congress as you take up the important objective of rebuilding the secondary mortgage market.

MBA'S RECOMMENDATIONS

In developing the recommendations detailed here, the Mortgage Bankers Association sought a plan that would be a clear, concise and workable approach to ensuring liquidity in the secondary mortgage market. We believe the proposed framework carefully balances the government's ability to ensure liquidity with the need to protect taxpayers from credit and interest rate risks associated with mortgage finance.

In remarks to the American Enterprise Institute on March 22, 2010, on the topic of regulatory reform, Secretary Geithner cautioned "These are difficult issues and our legislators and their staffs often look to the financial industry for advice as they try to sort out what makes sense. This is important to get right but be careful whose voice you listen to." We agree. MBA members work in the secondary mortgage market every day, and hence understand it in a way that few others can.

The issues before us are too important and too complex to be taken lightly or to be developed or evaluated based on incomplete understandings, simplistic assumptions or vague generalities. That is a key reason MBA has devoted considerable time and resources to the task of evaluating various courses of action and their practicality. The recommendations presented here have been developed by MBA's Council on Ensuring Mortgage Liquidity. The Council has been studying these questions for the past 20 months, but most of the members of the Council and many MBA members have been working on them for their adult lifetimes. Our deliberations on these topics continue, and we would welcome the opportunity to come back and update you on our work.

Before describing MBA's recommendations through the questions below, let us highlight some key characteristics of our recommendations.

[4] See the recommendations at MBA's Web site at the following URL: http://www.mortgagebankers.org/files/Advocacy/2009/RecommendationsfortheFutureGovernmentRole.pdf.

First, MBA's recommendations are based on a key set of principles. MBA's Council on Ensuring Mortgage Liquidity took a deliberate approach to developing its recommendations, building from a set of key considerations to principles to the recommendations themselves. We believe this thoughtful approach is in evidence in the recommendations.

Second, the recommendations are grounded in pragmatism. They were developed by a council of industry practitioners who understand the capital markets and have perspective on what will and will not work. At this juncture, we cannot afford to pursue unworkable plans that do not take account of market realities.

Third, MBA's proposal is distinct in its focus on ensuring an efficient secondary mortgage market, its reliance on private capital and its insistence on multiple layers of protections for taxpayers. Keeping all three of these goals in mind is imperative.

1. HOW SHOULD FEDERAL HOUSING FINANCE OBJECTIVES BE PRIORITIZED IN THE CONTEXT OF THE BROADER OBJECTIVES OF HOUSING POLICY?

Housing policy begins with the premise that shelter, like food, is a basic human need. As such, a good and just society ensures that all of its citizens are able to attain at least a minimum standard in terms of their housing, and many families are able to do much more, achieving the American Dream of owning a home. U.S. housing policy, developed over decades, has consistently highlighted these objectives. These include:

- Bringing stability and affordability to the residential mortgage finance market (through Fannie Mae, Freddie Mac, Ginnie Mae, and the Federal Home Loan Bank System);
- Promoting homeownership (through FHA, VA, USDA, the mortgage interest deduction and downpayment assistance programs);
- Providing consumer protections to homebuyers and renters (through fair housing, truth in lending and other regulatory efforts) ;
- Providing subsidies to fill gaps between low-income households' incomes and market rents (through project- and tenant-based Section 8 and other programs); and
- Supporting and promoting the development and preservation of affordable housing (through HUD and other subsidy and grant programs).

All of these efforts are vitally important, and all are necessary to maintain a housing market that provides safe, decent and affordable housing to the American public. In the wake of the recent crisis, policymakers may choose to re-order or change the emphasis of these priorities to some extent. However everyone would agree they are all important.

The recent crisis in the housing finance system, and the federal conservatorship of Fannie Mae and Freddie Mac, have focused necessary attention on the federal role of bringing stability and affordability to the residential mortgage finance system. With $11.7 trillion in single-family and multifamily mortgage debt outstanding, the secondary

mortgage market has profound effects on families, communities and the economy as a whole.

The elemental objective of the federal government with regard to housing finance is to foster liquidity and stability in the market. Such stability accrues to all parts of the housing market, and is a prerequisite to the other housing policy objectives the government pursues. A stable mortgage market reduces subsidies that otherwise might be required, makes homeownership more accessible, reduces complexity for consumers, makes affordable housing development and preservation possible and is essential to helping homeowners and apartment renters overcome the effects of the current recession.

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 federal government should continue its commitment to the range of policy objectives outlined above. As outlined below, it should also provide clear and transparent support to the secondary mortgage market.

2. WHAT ROLE SHOULD THE FEDERAL GOVERNMENT PLAY IN SUPPORTING A STABLE, WELL-FUNCTIONING HOUSING FINANCE SYSTEM AND WHAT RISKS, IF ANY, SHOULD THE FEDERAL GOVERNMENT BEAR IN MEETING ITS HOUSING FINANCE OBJECTIVES?

Three principles lie at the heart of the answer to this question.

First, secondary mortgage market transactions should be funded with private capital.

Second, in order to promote uninterrupted market liquidity for the core of the mortgage market, the government should provide an explicit credit guarantee on a class of mortgage-backed securities. This guarantee should be paid for through risk-based fees.

Third, taxpayers and the system itself should be protected through limits on the mortgage products covered, limitations on the types of activities undertaken, strong risk-based capital requirements, and actuarially fair payments into a federal insurance fund.

The importance of housing in the economic and social fabric of the United States warrants a federal government role in promoting liquidity and stability in the market for mortgage debt; homeowners and apartment building owners must have consistent access to a stable source of mortgage credit.

The financial crisis proved that some form of government support is required to keep the mortgage market open during times of distress. More importantly, even in good times, investors will remember the experiences of the recent crisis. If they doubt their ability to sell mortgages during a crisis, they will be less apt to buy them outside of a crisis.

However, the size and scope of the U.S. housing market mean that, except in times of extreme duress, the federal government's role should be to promote liquidity for investor purchases of mortgage-backed securities, not to attempt to provide the capital for or absorb the risks itself.

A guarantee that aims to protect the entire market will be both less effective and less efficient than targeted support for the core of the market, those products that regulators determine should be available to borrowers at all times.

THE MBA PROPOSAL

The centerpiece of MBA's recommendation for federal support for the secondary mortgage market is a new line of mortgage-backed securities. Each security will have two components: a) a security-level, federal government-guarantee (GG) "wrap" which will in turn be backed by b) private, loan-level guarantees from privately owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs). The government guarantee will be conceptually similar to that provided by Ginnie Mae by guaranteeing timely interest and principal payments to bondholders and explicitly carrying the full faith and credit of the U.S. government.

These government guarantees would be supported by a federal insurance fund, capitalized by risk-based fees charged on the supported securities. In supporting their loan-level guarantees, the MCGEs would rely on their own capital base as well as risk-retention from originators, issuers and other secondary market entities such as mortgage insurers. Investors in the guaranteed mortgage-backed securities would face no credit risk, but would take on the interest-rate risk from the underlying mortgages.

MORTGAGE CREDIT GUARATOR ENTITIES (MCGEs)

The MCGEs will be privately owned, mono-line institutions focused solely on the mortgage credit guarantee and securitization business. This business encompasses both single-family and multifamily residential mortgages. The loan-level MCGE guarantee would be backed by private capital held by the MCGEs which would be overseen by a strong regulator. The MCGEs will be required to manage their credit risk by using risk-based pricing, originator retention of risk (such as reps and warrants backed by sufficient capital to support them), private mortgage insurance (PMI) and risk transfer mechanisms including other risk-sharing arrangements, to ensure that there is a strong capital buffer before the GG and insurance fund would come into play. Loans would not be included in a GG security unless they were guaranteed by a MCGE.

In most cases the MCGEs will own the loans underlying the GG securities they issue, and in the event of foreclosure could own the real estate collateral. The MCGEs will have standard corporate powers to raise debt and equity. Other than access to the

related GG security they could issue, none of the corporate debt or equity the MCGEs issue would be guaranteed, either explicitly or implicitly, by the federal government. The MCGEs must be sufficiently capitalized to weather all but the most extreme credit events, and should report regularly to the satisfaction of the GG, Treasury and the MCGEs' regulator.

The key mission of the MCGEs will be to guarantee and securitize mortgages through the program described. The MCGEs should therefore hold only a *de minimis* portfolio of mortgage assets. The portfolios' purposes would be to a) aggregate allowable mortgages for securitization, b) hold REO properties prior to disposition, and manage loss mitigation through foreclosure, modifications and other activities, c) incubate mortgages that may need seasoning prior to securitization, d) develop new mortgage products through a strictly limited level of research and development prior to the development of a full-fledged securitization market and e) fund highly structured multifamily mortgages that are not conducive to securitization.

The number of MCGEs should be based on the goals of a) competition, b) strong and effective regulatory oversight, c) efficiency and scale, d) standardization, e) security volume and liquidity, f) ensuring no one MCGE becomes "too big to fail" and g) the transition from the current government sponsored entity (GSE) framework. Initially, we would expect the number of MCGEs to be two or three. The regulator would have the ability to increase that number, through the granting of charters, as the market develops. Intense competition along a number of dimensions would benefit borrowers and the market as a whole. The market would also benefit from standardization of the MBS structure, so that investors can easily compare security offerings across MCGEs.

The existing system extended an implied federal backing to all the activities of Fannie Mae and Freddie Mac, including not only their mortgage guarantees, but also their portfolio investments, derivative counterparties and corporate bondholders. Some of those activities were clearly allocated insufficient capital, underpriced and under-supervised. In our proposal, the extent of federal backing would be greatly constrained, making explicit what is guaranteed and what is not, and establishing mechanisms to properly capitalize, price and supervise those activities.

It is important to note that while the mortgage-backed securities in this model would be guaranteed by the government, the MCGEs as institutions would not be. The corporate debt and equity issued by the MCGEs would be purely private. As with other firms, investors in MCGE equity and debt would accept the potential risk of failure and loss. For this reason, the MBA proposal recommends regulators charter enough MCGEs to establish a truly competitive secondary market, and to overcome issues associated with "too big to fail."

GOVERNMENT-GUARANTEED "WRAP" (GG)

The government guaranteed (GG) mortgage-backed securities (MBS) issued by the MCGEs would carry a guarantee of timely interest and principal payments, would explicitly carry the full faith and credit of the U.S. government and would be supported

by a federal insurance fund, funded by risk-based fees charged for the securities at issuance and on an ongoing basis. Due to similarities in responsibilities and likely structure, Ginnie Mae could potentially take on the responsibilities of the GG.

The GG would be responsible for standardization of mortgage products, indentures and mortgage documentation for the core mortgage market. Minimum regulated fees would be established for ongoing servicing, surveillance and reporting. This would ensure standardization and liquidity throughout the core market. Each MCGE would individually issue GG securities under this standardized regime. These securities would carry the GG security-level guarantee backed by the MCGE loan-level guarantee; accordingly, the MCGEs will have approved and insured the underlying collateral.

The mission of any federally related mortgage securitization and guarantee program should be explicitly limited to ensuring liquidity in the core mortgage market through the issuance and guarantee of mortgage-backed securities. This important mission should not be distorted by additional public or social housing policy goals. To the degree additional objectives and housing policies are desired, they should be pursued through FHA, VA, USDA, Ginnie Mae and direct federal tax and spending programs, which should be adequately funded and supported to meet these important objectives. Potentially, a surcharge could be placed on the insurance premiums to accumulate an affordable housing fund. This surcharge should be tracked separately to ensure that the insurance fund is actuarially sound.

While the full faith and credit of the U.S. government should mean there will not be a need for a liquidity backstop, in times of extreme market distress liquidity could be provided to the GG securities market through Treasury and/or Federal Reserve purchases of GG mortgage securities. As a result, there would be no need for the MCGEs' portfolios to take on the role of "liquidity providers of last resort."

MBA's proposal combines an acknowledgement that only a government guarantee can attract the depth and breadth of capital necessary for sustainable market liquidity through all economic cycles, with a reliance on private capital, insistence on multiple layers of protections for taxpayers and a focus on ensuring a competitive, efficient secondary mortgage market.

3. SHOULD THE GOVERNMENT APPROACH DIFFER ACROSS DIFFERENT SEGMENTS OF THE MARKET, AND IF SO, HOW?

The federally related securitization guarantee should support only "core" mortgage products with well-understood, well-documented risk characteristics. These would generally be drawn from:

a) "conventional" single-family mortgage products traditionally supported by the GSEs, including those currently eligible for "To-be-announced" (TBA) market funding; and

b) multifamily mortgage products that fit the GSEs' published underwriting guidelines, including affordable multifamily rental housing mortgage products.

Mortgage markets will evolve over time, so the system needs to be designed with sufficient flexibility. To ensure products, risks and capital are appropriately aligned, the definition of allowable products should be left to regulators, not legislated. Industry participants, the MCGEs and the GG should work with federal regulators to carefully review current product definitions and classifications and ensure maximum market transparency, efficiency and liquidity. New products proposed by the MCGEs would require approval from the regulator. Thus new product development would be measured, prudently regulated and conservatively responsive to market demands.

So as not to unduly promote one type of housing tenure or choice over another, financing for both single-family and multifamily, ownership and rental, low-income and middle-income housing should be supported. But the system should not extend beyond "core" residential mortgages. For example, the system should support the market for the financing of existing housing, but not for land acquisition, development and construction loans. The demand and supply drivers, risks and loss experiences of these loans warrant a different approach.

COMPLEMENTARY TO FULLY-PRIVATE AND FEDERALLY-ASSISTED PROGRAMS
Any model contemplating the roles currently played by Fannie Mae and Freddie Mac must also contemplate how those roles integrate with other public and private components of the housing finance system. The MCGE framework is not intended to be the entire market. It is meant to focus on a narrowly defined set of core mortgage products that should be available in all market conditions. There would continue to be key roles for FHA, VA, USDA and Ginnie Mae as well as for the Federal Home Loan Banks and the fully private market, particularly as such roles evolve in support of public or social housing policy goals and objectives.

Portfolio Holdings and Private Securitization – A portion of the market should always be operating outside of government supported channels. Depositories and other mortgage lenders hold whole loans on their balance sheets, funded with a mix of deposits, Federal Home Loan Bank advances, and other liabilities. There is also the potential that the covered bond market in the U.S. could grow substantially, providing another means of secured financing for mortgage assets. Finally, private label securitization of non-core products, while currently a minimal share of the market, will be essential going forward. The MBA proposal recognizes this and supports a re-emergence of the private model. It is anticipated the private market will expand and contract with consumer and investor appetites for different products.

Federal Support For Affordable Housing Finance – MBA's recommended framework also complements existing government funding channels that provide direct support for affordable housing finance, such as FHA, Ginnie Mae, VA and USDA Rural Development. Focusing government subsidies and other affordable housing programs through these channels minimizes market distortions and safety and soundness

tensions that existed in the GSEs today, while making government support and oversight more transparent, as befits such government expenditures.

4. HOW SHOULD THE CURRENT ORGANIZATION OF THE HOUSING FINANCE SYSTEM BE IMPROVED?

The re-establishment of the secondary mortgage market must address the fundamental deficiencies in the existing system. Diagrams found on page 20 present high-level views of the existing state and the target state for the core mortgage market. The key differences/improvements are outlined below. The most important distinction is moving away from an "enterprise-centered" housing finance policy, where support was focused on the individual companies Fannie Mae and Freddie Mac, to a "market-centered" policy, where federal government support is focused and concentrated on selected mortgage-backed securities, the largest source of mortgage credit.

Core Products – The GSEs had essentially unfettered discretion with respect to their credit standards, including the ability to purchase and guarantee higher risk subprime loans, low documentation loans and pay-option Adjustable Rate Mortgages, all now guaranteed by the taxpayers. MBA's plan would tighten the credit box limiting the loans that can receive federal support to a narrowly defined set of core products; the loans that are crucial to the continued operation of the market.

Nature of the Guarantee – The GSEs engaged in a number of activities and other investments outside of mortgage securitization, all of which are now guaranteed by the taxpayers. These include managing the interest rate risk associated with $800 billion mortgage portfolios, purchasing tax credit investments, and holding tens of billions of dollars of non-mortgage "liquidity portfolios." MBA's plan eliminates this by moving away from an enterprise-level guarantee to a security-level guarantee. Only the mortgage-backed securities issued by the new entities would carry any sort of guarantee, not the companies themselves.

Insurance Fund – The GSEs paid nothing for the implicit guarantee of their activities. The MBA plan makes explicit what is guaranteed and establishes an explicit, risk-based payment for that guarantee.

Portfolio – The large, highly leveraged investment portfolios of the GSEs had tremendous amounts of interest rate and liquidity risk, risk that in turn had the potential to compromise the credit guarantees. MBA's plan starkly limits the size and composition of the new firms' portfolios. Moreover, above and beyond the statutory and regulatory restrictions, the MCGEs would not have an economic incentive to build large portfolios. As the debt of the entities is explicitly not guaranteed, it is unlikely the entities could profitably hold portfolios or hit market returns-on-equity (ROEs) on required capital. Limits on portfolio size could be accomplished either through a hard cap or through a tiered capital requirement.

Chartering and Regulating – Even small reforms of the activities of the GSEs became mired in politics because their charters were established in law and controlled by Congress. The inability to charter new GSEs led to a lack of competition between the two firms. MBA's plan eliminates the Congressional charters and establishes chartering authority in the new regulator, similar to the Office of the Comptroller of the Currency and other bank regulators. The MCGEs' regulator should be strong, empowered and adequately funded. The regulator should have the power to adequately oversee the MCGEs, especially with regard to products, pricing and capital adequacy.

Mission – Similar to the problems with the dual mission assigned to Fannie and Freddie, their regulators have had a dual mission of promoting housing and regulating safety and soundness. MBA's plan removes HUD-type housing goals from the new entities so the new regulator can focus on safety and soundness.

TRANSITION

Any restructuring proposal must include consideration of, and measures to facilitate, the transition from the current to the future state. This is imperative because the market's condition is still quite fragile and even the most carefully deliberated plan could destabilize the market if implemented hastily.

A productive approach to the transition would be the use of a "good bank/bad bank" or "new-company/old-company" strategy. Fannie Mae's and Freddie Mac's intellectual and operational infrastructures and other assets that would be of use in the creation of two or more new MCGEs could be used as the basis of "good bank" or "new-co" MCGEs, while other legacy assets and obligations – including legacy portfolios, MBS obligations and corresponding assets – could be spun into "bad banks" or "old-cos" to be resolved.

Through this transition model, the infrastructures of the existing GSEs could be used as a foundation for new MCGEs, with the technology, human capital, standard documents and existing relationships that the GSEs have developed available to one or more MCGEs. Every effort should be made to transfer existing origination, servicing and other industry relationships from the GSEs to the new MCGEs so as not to strand originators and servicers with ties to the existing GSEs. Historical performance data and other information should be made available to the public, so that originators, the MCGEs, regulators, rating agencies, investors and providers of credit support can use this data to enhance the efficiency of the market.

The remaining assets and obligations could then be managed through a "bad bank" or "old-co" that would be charged with running-off and divesting the investment portfolios and managing the continued pay-off and pay-down of existing MBS and other obligations.

While many of these measures require legislation, there are actions that can be undertaken now to begin to lay the groundwork for the eventual transition.

During the boom, the GSEs, along with many other players in the industry, took on too much credit risk. As a result of the crisis, credit underwriting has become more conservative across the industry, including at the GSEs. Regulators can look to today's tighter standards to gain important lessons with regard to defining "core products" for the market going forward. Now is the time to focus the GSEs on this narrower range of mortgage products – fully documented and underwritten using conservative ratios. This core of the market is what needs to be protected throughout the country at all times.

In addition, many of the GSEs' unnecessary risks stemmed from their portfolio holdings. As originally proposed by former Treasury Secretary Henry Paulson, and as recently reiterated by Federal Housing Finance Agency (FHFA) Director Edward DeMarco, it is important to affirm plans to wind down the GSEs' portfolios to a *de minimis* level. FHFA should direct that effort, being cognizant of market conditions, and the supporting role that the portfolios could play in the near term.

Thirdly, efforts to clearly define the path to a new role for and form of the GSEs will have several benefits. The GSEs have built valuable infrastructures, relationships, and intellectual capital that the industry needs to retain. Ideally, we would envision the use of a strategy to retain the best people, processes, and infrastructure from the GSEs as we move to the new MCGE framework. Identifying and laying out a clear path forward will remove much of the current uncertainty, and ensure that the GSEs' structural, operational and human resources remain of service in some form for the present and the future.

5. HOW SHOULD THE HOUSING FINANCE SYSTEM SUPPORT SOUND MARKET PRACTICES?

The U.S. housing finance system could not have attracted the $11.7 trillion of mortgage debt outstanding without sound market practices. These practices have grown and advanced over the course of decades, and include practices ranging from credit reporting to automated underwriting systems to standard loan closing documents to the "to-be-announced" securities market to third-party data and service providers. The industry has continually advanced its practices, and will continue to do so. As the government re-defines its role in the market, key areas of influence will include those which follow.

Establishment of Core Market – Formal establishment of the core residential mortgage market will set a benchmark for consumers, underwriters, investors and others. For consumers, the presence of well-defined core mortgage products will provide a standard against which other products can be assessed. The core market will also provide considerable stability, ensuring that mortgage products of a known type will be available in all market conditions. For underwriters, the characteristics of the "well-documented, well-understood" mortgages of the core market will provide a known base for modeling and pricing risk. Variations would be considered a part of the non-core market and would operate outside of any taxpayer backstop. For investors, the core

market will establish performance and pricing standards for use in GG MBS investing, and against which other investment options can be judged.

Standardization – Building on the standardization brought to the market by the GSEs, federal regulation of the MCGEs and the uniform nature of the GG wrap will bring additional uniformity to mortgage market securitization practices. Structural differences that currently exist between Fannie Mae and Freddie Mac securities, for example in their remittance schedules, could be eliminated in the design of the GG mortgage-backed securities. Given the importance of the core market, the non-core market will also rely heavily on these GG standards. Additional standardization of the GG security instruments will provide greater liquidity to the MBS market. Standardization should not, however, reduce competition between the MCGEs in terms of differences in pricing, credit management, use of mortgage insurance to manage risks and other activities that will ensure a healthy, competitive marketplace.

Recognition/Acceptance of Risks – One of the most important practices of a successfully renewed secondary mortgage market will be the appropriate recognition and acceptance of the risks within the system. Borrowers, lenders, securitizers, investors and others must all recognize and accept the risks they control and/or take on. An elimination of the implied federal guarantee of the GSEs is a key step toward achieving this, as are attracting private capital to the MCGEs and a re-emergence of the fully private mortgage market.

Adequate Capital – Allowing firms or individuals to take on risks without the appropriate capital to absorb those risks is not a sustainable basis for any market. While regulators can oversee transparency and some level of capital compliance, individual market participants also have a responsibility to assess the capital adequacy of the businesses with whom they transact. To protect taxpayers, regulators will need to closely monitor the capital of the MCGEs and of the federal insurance fund. The MCGEs and other market participants, with oversight from regulators, will in turn need to monitor the capital of the borrowers, lenders, insurers, servicers and others with whom they interact.

6. WHAT IS THE BEST WAY FOR THE HOUSING FINANCE SYSTEM TO HELP ENSURE CONSUMERS ARE PROTECTED FROM UNFAIR, ABUSIVE OR DECEPTIVE PRACTICES?

Consumers in the home mortgage lending market today receive inadequate protection from a patchwork of state and federal mortgage lending laws. In March 2009, the Mortgage Bankers Association proposed a new legislative framework to replace this patchwork and offer strong protections to consumers nationwide.[5] If enacted into law, these proposals would ensure consistent protections; greatly improve regulation of independent mortgage bankers and mortgage brokers; invigorate a fairer and more

[5] See MBA's Mortgage Improvement and Regulation Act on its Financial Regulatory Reform Web page of its Web site at the following URL:
http://www.mortgagebankers.org/IndustryResources/ResourceCenters/MIRAResourceCenter.htm.

competitive primary mortgage market; increase transparency; facilitate greater secondary market investment; foster a return to stability of the nation's financial system; and authorize significant resources to combat mortgage fraud.

Importantly, existing state and federal regulators would not be marginalized under the new structure. Instead, they would act as partners in developing lending standards and reviewing, examining and enforcing the uniform national lending standards in their jurisdictions.

Equally importantly, these reforms are focused on the primary mortgage market, where consumers make their mortgage decisions.

NEW REGULATOR

A new federal regulator should be created and made responsible for implementing uniform national standards for loan origination and servicing. The new regulator would also be responsible for regulating independent mortgage bankers and mortgage brokers in a partnership with state officials who will review compliance under and enforce the standards.

The new regulator would also be responsible for establishing national counseling and financial literacy standards including requiring mandatory pre-settlement counseling for some loans. The new regulator's activities should be overseen by an Oversight Board of the Secretaries of Treasury and Housing and Urban Development (HUD) and the Chairman of the Federal Reserve.

UNIFORM NATIONAL STANDARDS

Uniform national mortgage standards (UNMS) should include well-conceived substantive requirements and consumer protections to protect borrowers at the time of loan origination and during the servicing process. The standards would be based on new provisions developed by the Federal Reserve and legislative proposals from recent years. The standards also would include provisions developed by the Mortgage Bankers Association to make the process fairer for and more transparent to borrowers.

IMPROVING TRANSPARENCY

To increase transparency in the mortgage process, HUD and the Board of Governors of the Federal Reserve, in consultation with the new regulatory body, would be required to develop simpler, combined, coordinated uniform national consumer disclosures and information to empower consumers to better select their mortgage and navigate the mortgage process.

BENEFITS OF A NEW FRAMEWORK

The proposed new regulatory framework would offer tough, comprehensive protection for consumers and end the patchwork of state laws. It would also offer a steady stream of resources to effectively fund regulation and enforcement by state and federal regulators through assessments on regulated entities.

Actions such as these are appropriately targeted at the primary mortgage market – where consumers interact with mortgage brokers, mortgage bankers and other market participants. Consumer protection efforts that would attempt to work indirectly, through restriction of the secondary market, would be unnecessarily opaque and are unlikely to have the desired consequences. As Comptroller Dugan noted in a February 2, 2010, speech before the American Securitization Forum, "But while lax underwriting is plainly a fundamental problem that needs to be addressed, mandatory risk retention for securitizers is an imprecise and indirect way to do that, and is by no means guaranteed to work." He added, "Instead of going at the underwriting problem indirectly through 'skin-in-the-game' requirements, why not attack it directly?"

Consumer protections such as those outlined above are essential to an efficient, effective mortgage market and should be extended in the primary, not secondary, mortgage market.

7. DO HOUSING FINANCE SYSTEMS IN OTHER COUNTRIES OFFER INSIGHTS THAT CAN HELP INFORM U.S. REFORM CHOICES?

In a recent study prepared for a conference sponsored by Harvard's Joint Center for Housing Studies, Professor Michael Lea noted a number of factors that differentiate the U.S. and other housing finance systems. We highlight some of his findings here.[6]

Each country has a unique mix of culture, policies, institutions and traditions that affects its mortgage finance system and the ways it operates. Studying differences across a wide variety of alternative systems can yield important directional guidance with respect to the U.S. system, however, given these differences, we would argue against thoughts of any wholesale importation of a foreign system into the U.S.

The U.S. housing finance system has developed through both design and inertia. Multiple billions of dollars have been invested through the years by lenders and other market participants of all sizes in efforts to better manage the business within the context of existing institutions and market practices. Changes are necessary, but we must also be careful to preserve and protect market liquidity and other industry assets that have been developed with such great care at such great expense over the years.

Surveying international housing finance markets at a high level, one finds that other countries have been as successful as the U.S. in promoting homeownership and affordable rental housing with very different government roles and housing finance institutions. One also finds that most other countries appear to have housing finance systems that proved more durable through the most recent crisis than did the United States.

[6] "Alternative Forms of Mortgage Finance: What Can We Learn From Other Countries?" Dr. Michael Lea, San Diego State University.

In looking at other housing finance systems, there are four key issues on which to gain insights:

1) The role of long-term fixed-rate mortgages;
2) The extent of government support for the mortgage market;
3) The extent to which underwriting standards are captured in legislation or regulation; and
4) The impact of requiring recourse to borrowers.

THE ROLE OF LONG-TERM FIXED-RATE MORTGAGES

Since the Great Depression, homeowners in the U.S. have viewed the 30-year, fixed-rate, self-amortizing, prepayable mortgage as the product standard. Payments are predictable and borrowers are protected from fluctuations in interest rates. From the borrower's perspective, it is the simplest mortgage product available. If rates rise, payments are unchanged. If rates decline, borrowers typically have the option to refinance at no explicit cost.

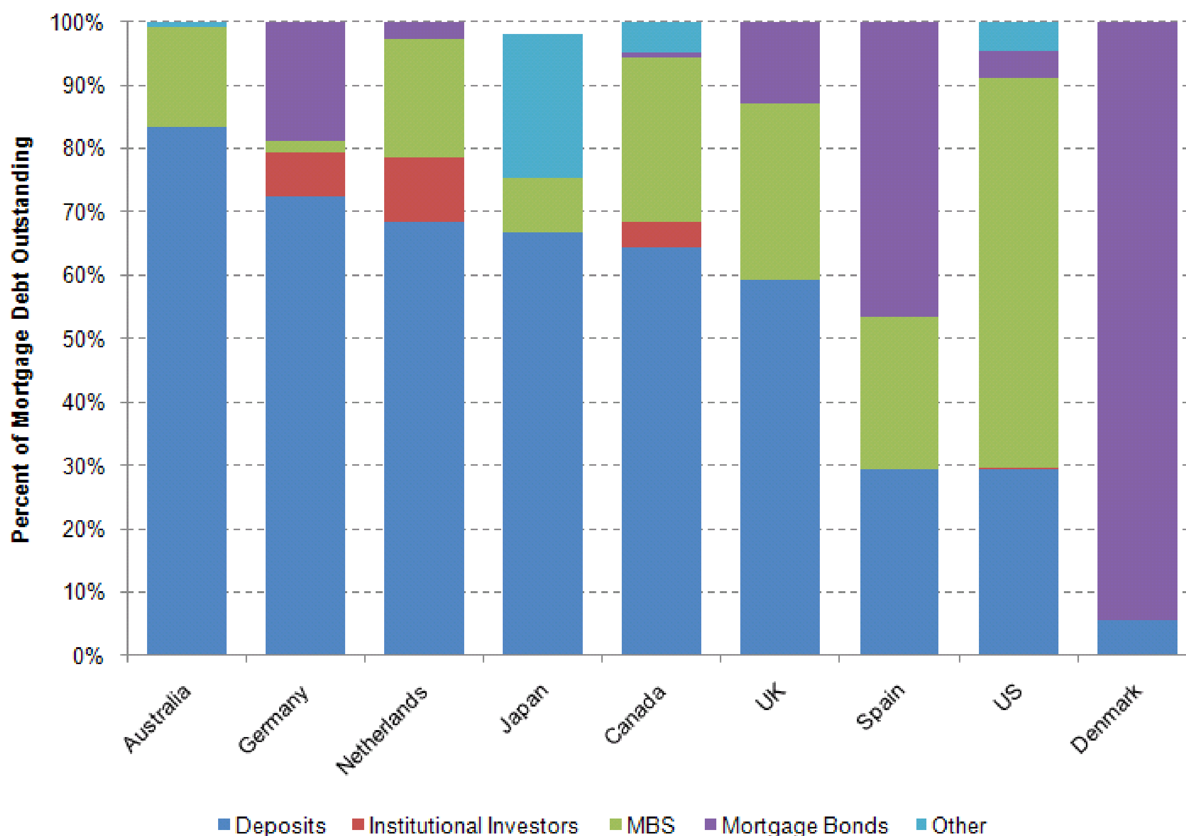
The share of U.S. mortgages that are 30-year, fixed rate mortgages fell during the boom – accounting for 65 to 70 percent of loans in the 2004-2006 period – but the market has reverted, and fixed-rate mortgages once again make up the lion's share of originations. But long-term fixed-rate mortgages are unusual elsewhere in the world. They used to be the dominant product in Denmark, but relatively low and falling short-term rates have led Danish borrowers to shift to medium-term (one to five year) fixed-rate loans in recent years. Rollover mortgages are the dominant product in Canada, Germany and the Netherlands. These loans have a fixed rate for up to five years (10 years in Germany) with a 25- to 30-year amortization period (briefly up to 40 years in Canada). At the end of the fixed rate period the rate adjusts to the new market rate. There is a substantial (as high as yield maintenance) prepayment penalty during the fixed rate period. A high proportion of Dutch loans are interest-only to maximize tax benefits. About one half of Japanese loans are convertible, meaning that after the end of the fixed rate term the borrower can select another fixed rate period or switch to a variable rate. Some Spanish loans are part fixed and part variable rate.

A key reason for the distinctions in products between countries is differences in funding. Deposit funding dominates in most countries, while the U.S. is unique in terms of the importance of securitization. Over 60 percent of U.S. residential mortgages have been securitized. The next closest countries are Canada, Spain and the UK with 24 to 28 percent securitized. Covered bonds are a more common funding mechanism in Europe.

Although thought of as consumer friendly, from the standpoint of an investor, the 30-year, fixed rate, self-amortizing, prepayable mortgage is actually a very complex product. Borrowers refinance when rates drop, transforming a loan with a nominal 30-year maturity to a short-term instrument. When rates increase, refinances disappear, extending the expected life of the loan. Banks and thrifts that fund themselves with deposits are not natural holders of 30-year, fixed-rate, prepayable loans, because they would inevitably be borrowing short and lending long.

Fannie Mae was created out of the Depression to begin a secondary market for these loans, and, it is fair to say, originators of fixed-rate loans have relied on the government-supported secondary market for these loans ever since. With the beginning of the U.S. MBS market in the early 1970s, it was discovered that investors were willing to bear the prepayment risk associated with these loans, so long as they were protected from the credit risk. From that point to today, with a few exceptions, most investors either did not have the capacity or the willingness to take on the credit risk, particularly given the uncertainty involved with systemic credit events such as the one we just lived through.

Developed Country Mortgage Funding



Sources: ABS, CMHC, EMF, FRB, Merrill Lynch, Europe, AU, CA, US 2008, Japan 2006

In order to maintain the availability and affordability of the 30-year, fixed-rate mortgage for middle-income Americans, the U.S. needs a vibrant secondary market where investors can focus on and manage interest rate and prepayment risks, while being shielded from the uncertainties surrounding mortgage credit risk. The experiences of other countries indicate that to accomplish this, there needs to be some level of government support for the secondary market.

THE EXTENT OF GOVERNMENT SUPPORT

The U.S. is unusual in its reliance on mortgage guarantees and government-backed mortgage institutions like the government sponsored enterprises. The market share of

government-backed institutions in Canada and Japan is significantly less than that of the U.S. And unlike the experience with Fannie Mae and Freddie Mac, none of the other international, government-backed institutions have experienced exceptional losses or required government capital injections. None of these institutions takes on significant interest rate risk as they have limited or no portfolio accumulation, and none has a formal affordable housing policy mandate.

Although the U.S. had an unprecedented run-up of house prices during the past decade, it was not alone. Many Organisation for Economic Co-operation and Development (OECD) countries had greater house price increases between 2000 and 2006 than did the U.S. But the magnitude of the U.S. house price fall has been greater than other countries. For example, Australia and the U.S. were the first of the bubble countries in which house prices fell, but the Australian housing market has since recovered.

Comparing the housing finance system in the U.S. to those of other countries shows that despite the high level of government support, the U.S. system has performed worse during the crisis. Furthermore the U.S. system has not produced higher rates of homeownership or levels of use of mortgage debt than are seen in many other countries.

DIFFERENCES IN UNDERWRITING STANDARDS
In light of falling house prices in most countries, lenders across the world are requiring larger downpayments. The use of 100 percent loan-to-value (LTV) loans, common in a number of countries before the crisis, has largely disappeared. Swedish maximum LTVs have declined from 95 percent to 85- 90 percent and the average LTV in the UK has fallen from 80 to 75 percent. In the Netherlands, 80 percent of lenders reported tightening in early 2009 as did 65 percent in the U.S. In response to the crisis, affordability criteria have been tightened and all loans are now fully documented.

It is clear that the decline in underwriting standards inherent in subprime lending was responsible for extending and accentuating the housing boom in the U.S., worsening the housing bust and creating the spark that triggered the financial crisis. No other country experienced a similar decline in standards, yet many others have seen a tightening of standards parallel to that in the United States.

THE IMPACT OF REQUIRING RECOURSE TO BORROWERS
An important feature of most developed country housing finance systems that would reduce credit risk for lenders, investors and the government is recourse to borrower income and non-housing assets. Research in Europe has found that the propensity to default in the face of an adverse income shock is closely related to the punishment incurred by doing so, which in turn depends on the legal framework. Recent U.S. research suggests that recourse decreases the probability of default when a borrower has negative home equity.

LESSONS LEARNED

Each country has a unique housing finance system that aligns with its culture, institutions and history. While no system can be fully transported from one nation to another, the shared experiences provide important lessons. First, the 30-year, fixed rate, self-amortizing, prepayable mortgage requires some level of government support for the secondary mortgage market. Second, the level of government involvement in the U.S. housing finance market has exceeded that of other countries, with no appreciable impact on homeownership rates or performance through the most recent crisis. Third, international underwriting standards have already been tightened in response to recent experience, largely at the volition of lenders. Finally, enforcement of "skin-in-the-game" for borrowers is an important element of successful housing finance systems.

ADDITIONAL QUESTIONS TO BE CONSIDERED

CORPORATE STRUCTURE

In early discussions of the future of the GSEs, former Treasury Secretary Paulson, Federal Reserve Chairman Ben Bernanke and others laid out a spectrum of options for future models – ranging from a fully private to a fully public model. It is important to note that these discussions tend to focus less on what the successors to the GSEs should do, and more on how and by whom they should be owned.

As outlined above, MBA's deliberations began by defining "what they should do." Building on this set of activities, a number of points on corporate structure and ownership become clear.

First, the fully private model would be unable to attract the depth and breadth of capital needed to fund the U.S. housing finance system through all market environments. At the end of the day, the U.S. government would still be expected to provide some level of backstop, for which it would have had no advance control, oversight or funding. We concluded this to be unacceptable.

Second, it will be important that any system utilize the private market, and its ability to assess, price and manage risk and efficiently operate within a known set of constraints. While we believe it is essential for a portion of the market to have a government guarantee to retain liquidity, it is also essential that private capital be at risk to ensure that lending is efficient, effective and responsive to market conditions. Additional concerns about capacity, funding, responsiveness and political distraction make it clear that a fully-government-based system would not be optimal.

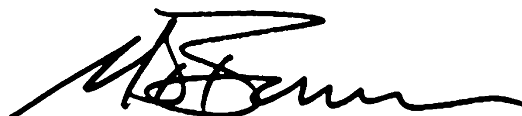
Our conclusion is that any ownership system going forward must be able to attract private capital to serve as a buffer and reserve against losses. To do that, it must provide a competitive return on equity and debt capital. It must also ensure that those private investors shoulder the vast majority of risks. Stock ownership and cooperative ownership could each achieve these goals.

CONCLUSION

We appreciate the careful consideration the administration is giving to these important issues. The recent credit crisis and recession have made clear that the strength and stability of the U.S. mortgage finance market is critically important to individual households and communities as well as to the economy at large. The reintroduction of private capital; focused, limited government support of the core mortgage market; and taxpayer protections as outlined above are essential elements of a reinvigorated system.

The topics discussed here are sometimes contentious, often complex, and always important. Thank you for the opportunity to share our insights.

Sincerely,



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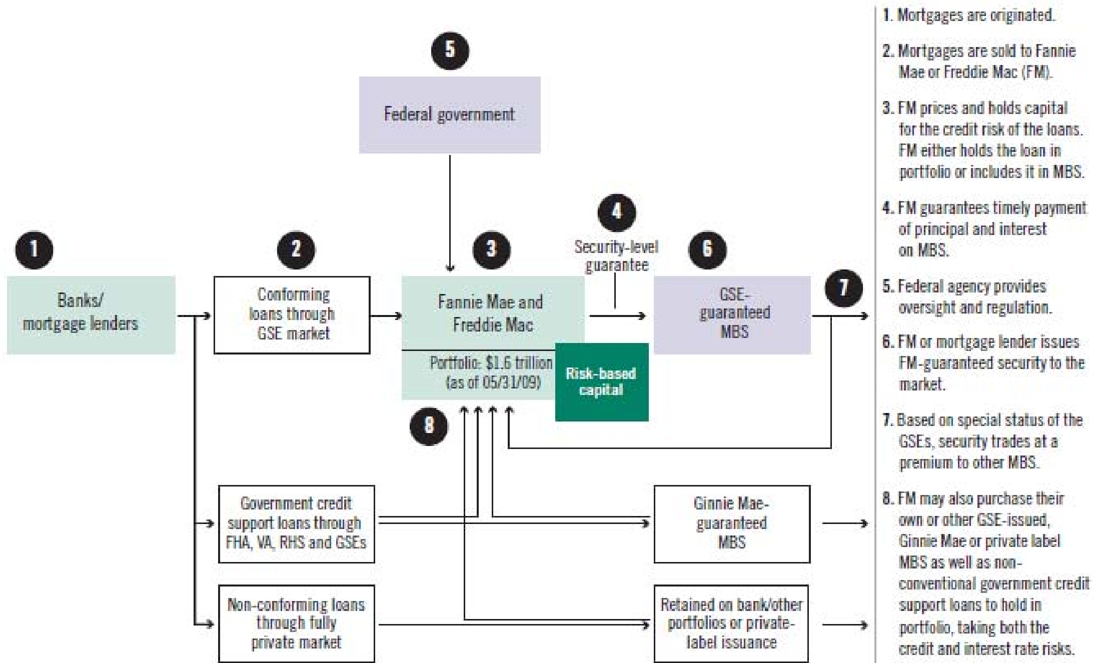
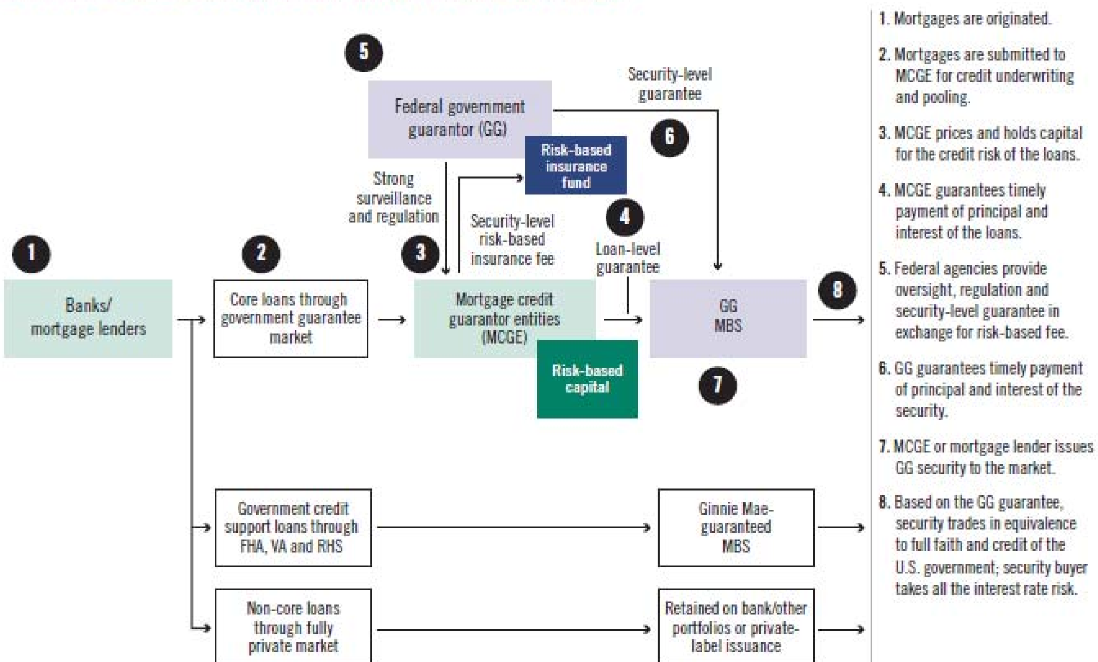

HIGH-LEVEL VIEW
CURRENT STATE: FANNIE MAE, FREDDIE MAC AND THE SECONDARY MORTGAGE MARKET
Federal government
Banks/ mortgage lenders
Conforming loans through GSE market
Fannie Mae and Freddie Mac
Portfolio: $1.6 trillion (as of 05/31/09)
Risk-based capital
Security-level guarantee
GSE-guaranteed MBS
Government credit support loans through FHA, VA, RHS and GSEs
Ginnie Mae-guaranteed MBS
Non-conforming loans through fully private market
Retained on bank/other portfolios or private-label issuance
1. Mortgages are originated.
2. Mortgages are sold to Fannie Mae or Freddie Mac (FM).
3. FM prices and holds capital for the credit risk of the loans. FM either holds the loan in portfolio or includes it in MBS.
4. FM guarantees timely payment of principal and interest on MBS.
5. Federal agency provides oversight and regulation.
6. FM or mortgage lender issues FM-guaranteed security to the market.
7. Based on special status of the GSEs, security trades at a premium to other MBS.
8. FM may also purchase their own or other GSE-issued, Ginnie Mae or private label MBS as well as non-conventional government credit support loans to hold in portfolio, taking both the credit and interest rate risks.


HIGH-LEVEL VIEW
TARGET STATE: POTENTIAL ROLE OF THE FEDERAL GOVERNMENT IN THE CORE SECONDARY MORTGAGE MARKET
Federal government guarantor (GG)
Risk-based insurance fund
Security-level guarantee
Strong surveillance and regulation
Security-level risk-based insurance fee
Loan-level guarantee
Banks/ mortgage lenders
Core loans through government guarantee market
Mortgage credit guarantor entities (MCGE)
Risk-based capital
GG MBS
Government credit support loans through FHA, VA and RHS
Ginnie Mae-guaranteed MBS
Non-core loans through fully private market
Retained on bank/other portfolios or private-label issuance
1. Mortgages are originated.
2. Mortgages are submitted to MCGE for credit underwriting and pooling.
3. MCGE prices and holds capital for the credit risk of the loans.
4. MCGE guarantees timely payment of principal and interest of the loans.
5. Federal agencies provide oversight, regulation and security-level guarantee in exchange for risk-based fee.
6. GG guarantees timely payment of principal and interest of the security.
7. MCGE or mortgage lender issues GG security to the market.
8. Based on the GG guarantee, security trades in equivalence to full faith and credit of the U.S. government; security buyer takes all the interest rate risk.