

*Testimony of*

**Christopher Dunn**

*On behalf of the*

**American Bankers Association**

*before the*

**Committee on Banking, Housing, and Urban Affairs**

**United States Senate**



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**June 28, 2011**

Chairman Johnson, Ranking Member Shelby, and members of the Committee, my name is Christopher Dunn, Executive Vice President and Chief Operating Officer of South Shore Savings Bank, South Weymouth, MA. I appreciate the opportunity to present the views of the American Bankers Association (ABA) on the future of government-sponsored enterprises (GSE) and particularly the access to the secondary market by community banks. ABA represents banks of all sizes and charters and is the voice of the nation's \$13 trillion banking industry and its two million employees.

The issue of GSE reform is a critical one for banks, particularly for community banks like mine, which use GSEs as the primary mode of access to the secondary markets. At South Shore Savings Bank, we have a proud heritage of commitment to the communities on the South Shore since 1833, with 13 branches and 187 employees. From a personal perspective, my entire career since 1972 has been in the mortgage lending business within the community bank world. I sold my first loans to Fannie Mae in 1974, so I know well the importance of secondary market access for smaller banks. Without that access, my bank could not be an active player in our primary mortgage market because our balance sheet could not support the demand in the market. Further, we would not be able to offer long term fixed rate loans due to the increased interest rate risk that this would create in the bank loan portfolio.

Over the course of the last year, ABA has gathered bankers like me to discuss the future of Fannie Mae and Freddie Mac and to consider an outline for a path forward. ABA has also engaged in discussions with regulators, which have helped us refine our views. In that process, ABA developed eleven principles to guide reform of the GSEs, which are attached to my testimony as an appendix. As Congress begins the next phase in shaping the future of the mortgage markets and the

government's role in them, I hope these principles, and the recommendations I will discuss below, will provide a base to build on.

ABA believes that the role of Fannie Mae and Freddie Mac should be reduced and transformed, enabling the private sector to shoulder more of the responsibility to assure an effective and efficient secondary mortgage market. In addition, the Federal Housing Administration (FHA) should return to its traditional role of serving first time homebuyers and other borrowers who may not qualify for conventional financing. The end goal we envision is a housing finance market in which more than half of mortgage finance occurs without federal secondary market guarantees of any type. An ideal goal might be to have 10 percent of loans in direct government guarantees like FHA and VA, 30 percent in well-regulated and mission-directed businesses that are privately owned and operated with a government backstop, and 60 percent with no government aid.

***The overarching principle is to ensure that banks of all sizes have access to secondary market financing.*** The ABA has not endorsed a specific structure for the GSEs and the private secondary market to achieve this going forward; finding the right mechanism will be challenging. In the meantime, however, there are significant actions that can provide a transition vehicle to reduce governmental involvement, foster private sector financing, and still assure equitable access to secondary markets for all banks.

Possible transitional structures for the GSEs or their successors include a well-regulated and controlled cooperative structure owned by the financing entities or a similarly-controlled secondary market utility that is publicly owned. Whatever structure is chosen will require significant control and direction of guarantee fees, mission, investor returns and potential taxpayer liability. Activities under that portion of the structure with government support or backstop will need to be confined to a controlled mission that is intended, among other things, to foster and accommodate development and expansion of purely private sector mortgage financing alternatives.

Rather than develop a single "silver bullet" solution to housing finance, it may be desirable to develop several sources which aid in the reestablishment of a private market. ***Multiple sources of liquidity for private market (including portfolio) lenders will lead to a more diverse and ultimately safer housing financing system.*** Thus, in addition to the creation of a successor entity or entities to the GSEs, policy makers may want to consider the creation of a well-regulated covered bond market, as well as enhancements to the Federal Home Loan Banks which would better help them continue to meet their mission of providing advances to private market portfolio lenders with minimal taxpayer exposure. It is also important to ensure that any actions taken with regard to

Fannie Mae and Freddie Mac do not harm or destabilize the Federal Home Loan Banks, which provide a key source of liquidity to our nation's banks, especially community banks.

Further, we would note that to fully protect taxpayers from additional losses, it will be necessary to impose similar reforms on the Farm Credit System, which continues to follow the discredited model of privatized gains and public losses which failed so badly in the housing sector. Without similar reforms to the Farm Credit System, it is only a matter of time until taxpayers again are put at risk.

That vision of transforming the GSEs and enhancing the role of the private sector may take years to attain, and goals can be better calibrated as we proceed. However, it is essential that we start taking incremental steps toward these goals, and trust in our ability to make mid-course corrections as we progress.

***Underpinning all of this must be workable and clear underwriting standards for all mortgage loans.*** We must get the underwriting standards correct today if we have any hope of transitioning to a stable system for secondary mortgage instruments. The current proposals defining a narrow Qualified Residential Mortgage (QRM) exemption from risk retention requirements fly in the face of workable and clear standards. ***In fact, should this proposal be adopted as proposed, it will surely drive many banks from mortgage lending and shut many borrowers out of the credit market entirely.*** ABA strongly believes that this rule should be substantially rewritten and re-proposed in a new form.

Not only is the proposal ill-conceived and will have long-term negative impacts on mortgage lending, but it comes at a particularly bad time with the housing market still struggling to recover. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, it is important that risk retention requirements be rational and non-disruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

In the remainder of my testimony, I want to focus on three key things:

- **The role of the government in housing finance should be dramatically reduced from its current level. Guarantee fees should be used to encourage private sector involvement.**
- **The transition to a private market should be carefully managed to protect taxpayers and ensure continued credit availability.**

- **New proposed mortgage rules on risk-retention are likely to drive many community banks out of mortgage lending and cut off mortgages to some borrowers.**

I will discuss all three of these points in turn.

## **I. Government's Role In Housing Finance Should Be Dramatically Reduced**

A private market for the vast majority of housing finance should be fostered and encouraged with an ultimate goal of a much smaller governmental role. Therefore, ABA proposes that the *government's role in housing finance should be focused primarily on ensuring stability and accessibility of the capital markets in the event of market failure.*

Direct government involvement may be necessary and desirable for the creation of affordable rental housing and to assist first-time borrowers or others who may not readily qualify for conventional financing. A well-regulated private market should be the desired financing source for the bulk of borrowers whose income and credit rating qualify them for conventional financing. We do strongly urge the continued federal guarantee of existing GSE debt and securities to ensure stability as the process moves forward.

Because of the trauma suffered by the financial markets and the borrowers they served during the recent financial crisis, it will be necessary to move toward a substantially private market in a cautious and well-considered fashion. A transition period taking a number of years will be necessary.

### ***Guarantee Fees Should Be Used to Encourage Private Sector Involvement***

ABA recommends that the primary mechanism for reducing government involvement (and for compensating the government for its ongoing support) is through adjustments to the guarantee fees (G-fees) paid to the GSEs (or their successors). *The current G-fees are too low* – the compensation being paid for what amounts to full government backing is simply not priced correctly. Raising the G-fee can do much to encourage development of the private market and to begin to repay the government for its current support. By "dialing up" the G-fees in an orderly and well-detailed manner, eventually the private market will find itself in a position where it is better able to compete with the GSEs for business.

With a high enough G-fee, *the private market will be able to price for risk in a fashion that allows for safe and sound investment and lending* at a rate that is comparable (and eventually better) than the rate charged by the GSEs. In the meantime, the increased rates for G-fees will help

to offset losses and assist in the repayment of the government's investment in Fannie Mae and Freddie Mac. This approach also allows for flexibility in the setting of guarantee fees, thereby ensuring a safety valve for housing finance in the event of private market disruptions.

*The other key mechanism for transition to a private market will be setting more reasonable loan limits for GSE purchases.* The current maximum loan limit of \$729,750 in high cost areas and \$417,000 in all other regions is dramatically higher than necessary for the purchase of a moderately priced home, especially in light of housing price declines nationwide. While some high-cost areas persist – and a recovery of the housing market will entail a hoped-for stabilization and recovery in home values – the conforming loan limits for most of the nation can be reduced. This will assist the development of a private market for loans outside of the conforming loan limits as a step to a more fully private market for all loans.

*Underwriting will also be an important mechanism,* but given the significant new underwriting requirements required by the banking regulators and by the Dodd-Frank Act, it would seem that the most important role played by the GSEs in this area for the foreseeable future is to ensure that uniform underwriting requirements are followed by all market participants selling to the GSEs or their successors. Under the Dodd-Frank Act, the current GSE regulator, the Federal Housing Finance Authority, will be among the regulators establishing underwriting standards and "safe harbors," so they will remain heavily involved with setting underwriting standards. As I mentioned in the introduction, getting the underwriting standards correct and consistent is the first and most important step toward any transition of the GSEs. I will cover this in detail in my third point below.

## **II. The Transition to a Private Market Should be Carefully Managed to Protect Taxpayers and Ensure Continued Credit Availability**

The critical question in creating a private market is how to mitigate costs as the transition is made. Any successor entity to the housing GSEs must provide market stability and liquidity, and be adequately capitalized. It is reasonable to expect that the users of that entity will contribute to capital or at least pay the full value and cost of any government guarantee, explicit or implicit. Similarly, any assumption of the hard resources of the existing GSEs by a private entity must occur in a manner in which the government recovers fair value for the assets acquired. In other words, the taxpayer should not subsidize the formation of privately-owned successors.

It is not realistic to imagine that there is capacity within the financial services industry to fully capitalize a new entity in the near term, or to take on the debt of the existing GSEs. *It is our*

*recommendation that income from increased G-fees be used to begin building capital, to repay the Treasury, and to better protect taxpayers.*

This could be facilitated by cordoning off the troubled assets of Fannie Mae and Freddie Mac into a segment of the enterprises which would remain in need of federal support while being wound down. Ultimately, the troubled assets of the GSEs may have to be separated into a "bad bank" structure and the remaining losses realized. However, as the economy recovers some troubled assets may yet be salvaged and losses recovered. The new book of G-fee business, which would consist of guarantees for securitized pools of high quality mortgages – with higher G-fees going forward – should provide healthy returns that support government payments and absorb some or all of the potential bad asset losses.

The resulting healthy guarantee businesses should be managed and regulated in a manner intended to dramatically shrink their market share, and also to establish incentives for growth of purely private mortgage finance alternatives to fill that market share. This most likely will require that the successors initially be managed under a public utility model under government control. Subsequently, the government can exit its controlling interest by spinning the successors to private ownership as cooperatives or through public offerings, further recouping its investment. If these smaller private successors retain some form of government guarantee, which we believe likely, a continuation of the public utility regulatory model will be necessary to ensure capital requirements and G-fee pricing necessary to compensate the government, protect taxpayers, and prevent leveraging of the government guarantee in a manner that discourages growth of private sector, non-guaranteed mortgage markets. To be clear, this is not the only possible approach, but we believe this offers a path from the current environment of federal support for the mortgage markets to a more realistic and sustainable private sector driven mortgage market.

### **III. Proposed Mortgage Rules Will Harm Creditworthy Borrowers And Drive Community Banks From The Market And Must Be Revised**

ABA has grave concerns that the risk retention proposal issued by the regulators will drive many banks from mortgage lending and shut many borrowers out of the credit market entirely. Responding to widespread objections from consumer groups, banks, and Senators and Congressman, the regulators extended the comment period from June 10th to August 1st. While more time for commenting on such a far-reaching regulatory proposal is welcome, *what is really necessary is for the rule to be substantially reconsidered and re-proposed.*

It is true that the proposal's immediate impact is muted by the fact that loans sold to Fannie Mae and Freddie Mac, while they are in conservatorship, escape risk retention. However, once the rule's requirements are imposed broadly on the market – should they be adopted – they would likely shut out many borrowers entirely and act to destabilize the housing market once again. Since it is also the stated goal of both the Congress and the Administration to end the conservatorship of Fannie and Freddie, and since ending the conservatorships and the related GSE exemption would expand the proposal's negative impact, it is important that risk retention requirements be rational and non disruptive when they are applied broadly to the market. The rule as proposed does not meet those tests.

Therefore, ***ABA urges Congress to ensure that the regulators revise the risk retention regulation before it is imposed on the mortgage market broadly.*** Specifically we recommend:

- A. Exemption from risk retention provisions must reflect changes in the market already imposed through other legislative and regulatory change, and
- B. Risk retention requirements should be conformed to GSE underwriting standards.

I will explain each of these recommendations in more detail:

***A. Exemption from Risk Retention Provisions Must Reflect Changes in the Market Already Imposed Through Other Legislative and Regulatory Change***

In the Dodd-Frank Act, Congress determined that some form of additional risk retention was desirable under certain circumstances to ensure that participants in a mortgage securitization transaction had adequate “skin in the game.” The goal was to create incentives for originators to ensure proper underwriting (e.g., ability to repay) and incentives to control default risk for participants beyond the origination stage. There have already been dramatic changes to the regulations governing mortgages and more are pending with new “ability to pay” rules. The result is that mortgage loans with lower risk characteristics – ***which include most mortgage loans being made by community banks today*** – should be exempted from the risk retention requirements, regardless of whether sold to Fannie Mae and Freddie Mac or to private securitizers.

Exempting such “qualified residential mortgage” loans (QRM) is important to ensure the stability and recovery of the mortgage market and also to avoid capital requirements not necessary to address systemic issues. However, ***the QRM as proposed is very narrow and many high-quality loans posing little risk will end up being excluded. This will inevitably mean that fewer***

*borrowers will qualify for loans to purchase or refinance a home.* Instead, the QRM definition should closely align with the proposed “Qualified Mortgage” (QM) definition promulgated by the Federal Reserve Board. The QM definition (as proposed) focuses on a borrower's ability to repay and allows originators to measure that ability with traditional underwriting tools. The proposed QRM rule, in contrast, takes most underwriting decisions away from originators in favor of rigid loan-to-value and other targets.

For example, for the loan to qualify for QRM status, borrowers must make at least a 20 percent down payment – and at least 25 percent if the mortgage is a refinancing (and 30 percent if it is a cash-out refinance). Certainly, loans with lower loan-to-value (LTV) ratios are likely to have lower losses if in default, and we agree that this is *one* of a number of characteristics to be considered. However, the LTV should not be the only characteristic for eligibility as a “Qualified Residential Mortgage,” and it should not be considered in isolation. *Setting the QRM cutoff at a specific LTV without regard to other loan characteristics or features, including credit enhancements such as private mortgage insurance, will lead to an unnecessary restriction of credit.* To illustrate the severity of the proposal, even with private mortgage insurance, loans with less than 20 percent down will not qualify for the QRM.

ABA strongly believes that creating a narrow definition of QRM is an inappropriate method for achieving the desired underwriting reforms intended by Dodd-Frank.

### ***B. Risk Retention Requirements Should be Conformed to GSE Underwriting Standards***

The proposal presented by the regulators will make it vastly more difficult to end the conservatorship of Fannie and Freddie and to shrink FHA back to a more rational portion of the mortgage market. As noted above, under the proposed rule, loans with a federal guarantee are exempt from risk retention – which includes loans sold to Fannie Mae and Freddie Mac while they are in conservatorship and backed by the Federal government. FHA loans (as well as other federally insured and guaranteed loan programs) are also exempt. Since almost 100 percent of new loans today being sold are bought by Fannie and Freddie or insured by FHA – and as long as these GSEs can buy loans without risk retention – it will be dramatically more difficult for private securitizers to compete. In fact, the economic incentives of the proposed risk retention strongly favor sales of mortgages to the GSEs in conservatorship and not to private securitizers. Thus, *this proposal does not foster the growth of private label securitizations that would reduce the role of government in backing loans.*

Equally important is the fact that the conservatorship situation is unsustainable over the long term. Eventually, these narrow and restrictive rules would apply to a much, much larger segment of the mortgage market. After the conservatorships end, even fewer borrowers will qualify for QRM mortgage loans, and the risk retention rules make it less likely that community banks will underwrite non-QRM – but prudent and safe – loans. Some community banks may stop providing mortgages altogether as the requirements and compliance costs make such a service unreasonable without considerable volume. ***Driving community banks from the mortgage marketplace would be counterproductive as they have proven to be responsible underwriters that have served their borrowers and communities well.***

Instead of exempting the GSEs from risk retention, the QRM should instead encompass most if not all of the low risk loans being underwritten today and purchased by the GSEs. If a loan meets those requirements (which we anticipate will evolve to conform with any new QM definition) and is thus eligible for purchase by the GSEs, it should also be exempt from risk retention requirements. Conforming the QM, QRM and GSE standards will set the foundation for a coherent and sustainable secondary mortgage market.

The imposition of risk retention requirements to improve underwriting of mortgage loans is a significant change to the operation of the mortgage markets and must not be undertaken lightly. ABA urges Congress to exercise its oversight authority to assure that rules adopted are consistent with the intent of the statute and will not have adverse consequences for the housing market and mortgage credit availability. Setting logical, consistent, and workable underwriting standards is the foundation upon which GSE reform must be built.

## Conclusion

The task ahead will not be easy. Fannie Mae, Freddie Mac and the Federal Housing Administration currently constitute the vast bulk of available financing for the American mortgage market. It is imperative that reform be ***cautious***, in order to avoid inflicting further harm on an already fragile housing economy, ***but deliberate***, in order to move away from the current situation of full federal support for the long-term. We must not wait, but start the process now. I hope that these recommendations and the eleven Principles for Reform which are appended to this statement are helpful to you in this process. The American Bankers Association stands ready to assist in any way possible.

## **Appendix**

### **Principles for Mortgage Finance Reform**

The eleven principles developed by the ABA GSE Policy Committee and endorsed by the ABA's Government Relations Council are:

1. The primary goal of any government sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to the primary mortgage market for low- and moderate-income families.
2. In return for the GSE status and any benefits conveyed by that status, these entities must agree to support all segments of the primary market, as needed, in all economic environments.
3. Strong regulation, examination and authority for immediate corrective action of any future GSE must be a key element of reform.
4. Any GSE involved in the mortgage markets must be strictly confined to a well defined and regulated secondary market role and should not be allowed to compete with the private, primary market.
5. Any reform of the secondary mortgage market must consider the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of FHLBanks or access to advances by their members.
6. GSEs must both be allowed to pursue reasonable risks, but the risk/reward equation must be transparent and more rigorously defined and regulated.
7. GSEs must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.
8. A better alternative to "skin in the game" is the establishment of strong minimum regulatory standards to assure sound underwriting for all mortgages, regardless of whether they are sold or held. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.
9. Accounting and regulatory changes should be developed to more appropriately reflect and align securitizations with underlying risks. True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures.
10. Affordable housing goals or efforts undertaken by the GSEs should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects.
11. GSEs must provide for fair and equitable access to all primary market lenders selling into the secondary market through the GSEs.