

Wanted: An Independent And Strong GSE Regulator

The chairman of an independent mortgage bankers alliance calls on the Congress to put new responsibilities into the agency overseeing Fannie and Freddie.

By Scott Stern



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The government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – play a crucial role in ensuring that independent mortgage bankers can rely on a stable and affordable supply of mortgage capital to loan to borrowers, in good times and bad. The GSEs are also an important business partner in the development of technological innovation and new products that lower costs and expand choice for borrowers.

Additionally, the GSEs help establish a level of standardization in the industry in mortgage underwriting and delivery, which makes for an efficient and cost-effective marketplace and helps maintain a high level of borrower protection.

The vital role played by the GSEs in our housing finance system demands strong safety and soundness regulation to ensure their long-term ability to fulfill their market functions.

Independent mortgage bankers unwaveringly support the creation of an independent, well-funded regulator such as embodied in H.R. 1427, the Federal Housing Finance Reform Act of 2007, introduced by Chairman Barney Frank (D-Mass.).

The regulator must have the tools necessary to supervise the financial stability, safety and soundness and mission-related activities of Fannie Mae and Freddie Mac. Investing the regulator with muscular authority to review and enforce GSE operating standards and mission compliance is important to maintaining confidence in the enterprises and in our housing system.

At the same time that we support a strong regulatory regime, we believe it is vital that legislation in no way diminish the role of the GSEs in the housing finance system. The current volatility in the mortgage sector demonstrates the value of the stability that the GSEs bring to the marketplace. As James B. Lockhart, director of the Office of Federal Housing Enterprise Oversight (OFHEO), recently stated, in times of uncertainty in the market, “we need strong GSEs and a strong regulator.” Fannie Mae and Freddie Mac are the “firewall” that safeguards the nation’s housing finance system – and borrowers – from market shocks and excessive volatility by providing

confidence in the mortgage capital markets.

During the past five years, as risky mortgage practices have exploded in the private market – putting both borrowers and investors at risk, the GSEs’ conventional, conforming market has remained stable and steady – minimizing risks to lenders and borrowers alike.

In 2000, interest-only and payment-option mortgages amounted to only 2% of the market. However, by the first half of 2006, these types of non-traditional mortgage products represented approximately 40% of all loan originations.

Similarly, in 1998, sub-prime lending represented about 5% of the marketplace. By 2005, subprime borrowing was about 20% of the market. Meanwhile, the GSEs and the Federal Housing Administration saw a concurrent decline in their market share as borrowers flocked to products with low initial payments that masked high costs and increased risk.

In recent months we have seen the beginning of the fallout – for borrowers, lenders and the mortgage market – from lax underwriting standards and credit policies.

With the mortgage market undergoing rapid change, the function of the GSEs in ensuring a stable marketplace that keeps the flow of credit open without putting borrowers in high-risk loans is more important than ever.

We believe it would be a dramatic mistake for Congress to pass legislation that directly or indirectly enabled a regulator to diminish the one sector of the housing finance system best shielded from market uncertainty.

Indeed, as the marketplace returns to a more traditional market, the GSEs will need regulatory flexibility to respond to the lender and borrower

need for safe new products to fill the void left in the wake of contraction of the subprime and nontraditional markets.

During the last Congress, independent mortgage bankers supported H.R. 1461. We believed H.R. 1461 would establish a world-class regulator for the GSEs and ensure the on-going safety and soundness of the enterprises. While we supported the overall approach of that bill, and extend that support to H.R. 1427, we also had some concerns regarding the following specific provisions.

GSE portfolio limits

Independent mortgage bankers oppose efforts to arbitrarily restrict or diminish GSE portfolios, or to impose a “systemic risk” or market-size test on the portfolios. Such limitations introduce a significant risk of uncertainty into the housing finance system.

Dependable access to mortgage capital is a vital part of the business of independent mortgage bankers. GSE portfolio investment has provided ongoing stability to the secondary mortgage market and enabled the ability of the GSEs to ensure a reliable capital supply.

GSE portfolios are large and do carry risk. But we agree with President Reagan’s former budget director James Miller, who suggested that “the best way to address this issue is to ensure they operate safely and soundly and cover their risks through adequate hedges and capital.”

The regulator, as originally created by H.R. 1461, has strong powers to monitor the GSE portfolios, without the blunt instrument of portfolio reduction. The enhancements reflected H.R. 1427 would further strengthen the powers of the regulator to monitor, and if necessary, adjust portfolios. The proposed language would not, in our analysis, permit the regulator to make adjustments based on the size of the GSEs or an evaluation of systemic risk, and we strongly support making those limitations explicit.

Once the specific safety and soundness concerns leading to a portfolio adjustment are addressed, the limitation should be lifted.

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Reducing GSE portfolios does not shrink overall risk. The risk is simply reallocated to other financial institutions, which may have fewer tools to manage risk than the GSEs, yet carry the same perception of government support.

On March 2, 2007, Moody's introduced a new methodology to measure government support for large financial institutions in the event of institutional distress. For example, in assigning a 98% probability of government support for JPMorgan Chase, Moody's stated that, "Due to the importance of these operations to the U.S. financial system, the potential disruption to the financial markets from any failure or default by such an institution would be massive, and for this reason Moody's assigns this virtually certain support assumption."

Likewise, Citibank received a 98% probability of government support, Bank of America received a 95% probability of government support, Wells Fargo received a 70% probability of government support, and Wachovia received a 70% probability of government support.

Regulatory authority over capital

We support the authority of the regulator to adjust minimum capital ratios. However, we believe H.R. 1427 should clarify that any adjustment in minimum capital must be specifically tied to safety and soundness concerns identified by the regulator through a deliberative and transparent process. Once the conditions change or the problems are rectified to the regulator's satisfaction, minimum capital should return to the statutory level.

The requirement for a safety and soundness finding before minimum capital is adjusted is consistent with a desire to balance the new regulator's enhanced authority over capital with Congressional guidance on how such authority is to be used.

The United States has a long-standing policy of federal support for the housing sector through the activities of the GSEs. Unbridled regulatory authority over capital presents the risk that the historic commitment to housing could erode through shifting regulatory attitudes toward the federal role in housing.

By linking capital adjustments to safety and soundness findings, Congress will ensure the

regulator can adequately supervise the financial stability of the GSEs without substituting the regulators' judgment on matters of fundamental national housing policy.

Conforming loan limits

Independent mortgage bankers support the provision in H.R. 1427 to increase the conforming loan limits in high cost regional markets. This provision offers significant benefits to families living and working in high-cost housing areas.

The inability of the GSEs to purchase loan products from high-cost areas has contributed to a high concentration of loan products that federal banking regulators consider to be risky for borrowers and lenders. The nontraditional guidance issued last year by the regulators is expected to reduce the availability of such loan products. Increasing the GSE loan limit in these areas will enable lenders to continue to extend credit to prospective homebuyers in high-cost markets, with less risk exposure for both the borrower and the lender.

In addition, because FHA and Veterans Administration (VA) loan limits are limited by the GSE conforming ceiling, an adjustment to the GSE limit in high-cost areas will also expand borrower access to the government programs which have experienced significant declines in high-cost markets.

Some have suggested that regional mortgage limits would create operational difficulties in the mortgage industry. While our members would welcome easy-to-implement statewide limits, we do not believe the challenge of managing regional limits is a reason not to support increased conforming loan limits that would benefit borrowers in high-cost areas.

Program approval

Independent mortgage bankers caution against overly restrictive program approval requirements and oppose a "bright line" test for new GSE products and programs.

The bright line test proposed by GSE competitors would hamper competition in the marketplace by making it harder for independent mortgage bankers to work with the GSEs to lower costs and increase choices for consumers.

The GSE charter authorizes Fannie Mae and

Freddie Mac to operate in the secondary market for mortgages. The GSE reform debate has generated much discussion about the need for a clear delineation between the primary and secondary mortgage markets.

As "on-the-ground" mortgage bankers, we are puzzled by the suggestion of ambiguity about the reach of GSE activities. The distinguishing feature of the primary market is loan origination. Under their charter, the GSEs may not originate loans. A brighter line than the existing prohibition on loan origination would be hard to draw.

Some GSE activities, such as the deployment of automated underwriting (AU) systems, enable lenders to improve the process of loan origination. The fact that a GSE process or technology assists a loan origination does not mean that the GSEs are engaged in primary market activity. And the value of such activities can be significant.

For example, by providing a universal and portable underwriting decision, the GSE AU systems increase competition by permitting lenders to fund and sell loans to the best pricing in the market, whether directly to the GSEs or to a large aggregator.

From the borrower perspective, the GSE systems have lowered costs and sped approvals by enabling lenders to determine in seconds, rather than in days and weeks, whether a loan meets requirements for purchase in the secondary market.

Addressing the issues that we have outlined will help ensure that final legislation passed by the House will preserve a viable, long-term business model for the GSEs to carry out their secondary market and affordable housing functions in safe and sound manner that maintains confidence in the world's most successful housing finance system.

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