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On behalf of the

Community Home Lenders Association (CHLA)

House Financial Services Committee

Hearing on

"The Bipartisan Housing Finance Reform Act of 2018"

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee, I appreciate this opportunity to testify before you today.

My name is Don Calcaterra, Jr. I am the President of Local Lending Group, a community-based non-bank mortgage lender, headquartered in Troy Michigan. I am also Vice Chairman of the State of Michigan's Mortgage Industry Advisory Board. I appear before you today as the Vice President of the Community Home Lenders Association (CHLA).

CHLA is the only national association that exclusively represents independent mortgage bankers – also known as IMBs. CHLA members are small businesses, with single family mortgage lending and servicing as their sole or principal business line. Our Members are community-based, generally serving either local or regional markets.

IMBs do not pose risk to taxpayers, because, unlike banks and other depository institutions, IMBs do not enjoy an underlying FDIC or NCUA guarantee. Moreover, CHLA members – small or mid-sized IMBs -- are not large enough, individually or collectively, to pose systemic risk to our financial system.

As our testimony explains, IMBs have played a critical access to credit function in the decade since the 2008 housing crisis. IMBs have increased their origination of mortgage loans, serving low- and moderate-income, first-time, and minority borrowers, at the same time that banks have generally re-trenched from mortgage lending in favor of higher credit quality borrowers.

Therefore, as Congress contemplates GSE reform, it is critical to ensure that smaller IMBs continue to have full and competitive access to the GSE secondary market, in order to ensure competition and the resulting benefits to consumers that come with such competition.

Our testimony is divided into three main sections: (1) Small Lender GSE Concerns and Priorities, (2) Comments on the "*The Bipartisan Housing Finance Reform Act of 2018"* (hereafter referred to as the *"Hensarling/Delaney/Himes"* bill), and (3) "A Path Forward on GSE Reform" (CHLA's recommendations on next steps to complete GSE reform).

1. SMALL LENDER GSE CONCERNS AND PRIORITIES

IMBs Facilitate Access to Credit

In the aftermath of the 2008 housing crisis, many banks dramatically scaled back mortgage lending. For example, Bank of America terminated their correspondent lending business for smaller mortgage lenders. And many banks imposed credit overlays, even for government-insured FHA loans, limiting mortgage loans to only the highest credit quality borrowers.

In the face of this mortgage credit vacuum created by the bank pullback, IMBs stepped in to increase mortgage lending, particularly for first-time and low/middle income homebuyers. This was critical to the recovery of both the housing market and the economy. The reason for this is simple. **Mortgage lending is all that IMBs do. Unlike banks that reduce or restrict mortgage lending when it does not meet Return on Investment targets, IMBs keep lending.**

Historically, IMBs have consistently averaged over 50% of the FHA loan origination market. However, since the 2008 housing crisis, IMB market share of FHA loan originations has increased - from 57% in 2010 to 85% in 2016. And, IMB non-bank market share of Ginnie Mae issuance also increased in that same period – from 18% in 2009 to 78% in 2016.

This data reinforces the point that IMBs were the critical mortgage origination force that stabilized property values when the large banks generally curtailed their lending. It also shows that many IMBs began using GNMA to securitize FHA loans as banks left the correspondent business. GNMA is important because it is the primary source of funding for FHA loans. It is important to keep this in mind, as concerns are being raised that tightening of GNMA standards for IMB issuers could lead to a reversal of the pattern of the last 8 years – and could thereby reduce low- and moderate-income borrowers' access to mortgage loans.

IMBs also increased their share of GSE loans over this period, and now originate around half of all new Fannie Mae and Freddie Mac loans.

The implications for GSE reform are clear: Small mortgage lender access to the secondary GSE market is critically important, because IMBs have a long history of consistently providing affordable mortgage loans, particularly to low- and moderate-income borrowers, throughout all economic and housing cycles.

How Mortgage Lenders Access the GSE Secondary Market

The key to understanding small mortgage lender concerns about changes to our housing finance system is to understand how the system currently works, particularly with regard to GSE loans.

The process and components under which mortgage lenders originate mortgage loans is generally referred to as the "**primary market.**" In the case of GSE lending, Fannie Mae and Freddie Mac approve qualified seller/servicers, who are then eligible to originate and sell qualified loans to Fannie and Freddie. These seller/servicers underwrite and close mortgage loans in conformity with underwriting standards established by these two entities.

Since the 2008 housing crisis, Fannie and Freddie have significantly reduced their mortgage loan portfolios, with the great majority of loans sold and pooled into Mortgage Backed Securities (MBS) that are guaranteed by Fannie and Freddie. The activity of liquefying these mortgage loans into MBS is generally referred to as the "**secondary market.**"

Originated mortgage loans find their way into the GSE secondary market in two ways. The first is the **cash window.** Through the cash window, mortgage lenders sell loans or pools of loans directly to Fannie Mae or Freddie Mac.

The second option for execution into the secondary market is through **securitization of loans.** Mortgage lenders pool a group of loans qualified for the Fannie or Freddie guarantee and sell those loans into the secondary market through a securities broker/dealer. This can either be done directly by the originating mortgage lender or can be done by selling to an aggregator that buys different pools of loans and aggregates and securitizes such loans.

Generally, smaller mortgage lenders or lenders with smaller loan volume tend to use the cash window, while larger mortgage lenders tend to use the securitization option. However, mortgage lenders that securitize loans sometimes use the cash window option, particularly when the price is competitive with the securitization option.

It is our Members' experience that the securitization option is critically important to help ensure that the cash window option provides fully competitive pricing and execution. Thus, maintaining a strong, vibrant securitization execution option is not just important to lenders that securitize loans. It is also critically important for small mortgage lenders that use the cash window, and for consumers who benefit through increased competition in pricing and customer service.

Small Mortgage Lender Protections

CHLA strongly recommends that any GSE reform legislation include the following key features or provisions which are designed to protect small mortgage lenders:

1. Cash window that serves all of the market at competitive rates.

Fannie and Freddie currently play a critical role in providing a fully competitive cash window. One way to ensure this is continued is to preserve and recapitalize Fannie and Freddie, under a Utility Model that emphasizes their role in securitizing loans.

2 . Full and competitive access for small and mid-sized mortgage originators to securitize loans.

The best way to ensure access to credit at competitive rates for all qualified borrowers is to maintain the environment that currently exists, in which a wide range of mortgage loan originators can use broker-dealers to securitize their pools of loans.

3. No new charters should be authorized to carry out functions that Fannie Mae and Freddie Mac carry out.

GSE reform legislation should not charter any new entities to compete with the GSEs, particularly ones that could have any role in the primary mortgage loan origination market.

CHLA believes that it would be a mistake to create such new Too-Big-To-Fail (TBTF) institutions, particularly entities affiliated with FDIC-insured banks. The impact of authorizing new charters would be to grow the government, to increase the risk of a taxpayer bailout similar to what we experienced with TARP, and to expand the scope and burden of regulator(s) in monitoring both their financial safety and soundness and their conduct in the mortgage market.

The risk of increased financial concentration of chartering new TBTF entities is great. In a May 12, 2017 speech by FDIC Vice Chairman Thomas Hoenig, he noted that while the four largest U.S. banking firms in 1992 held roughly 14% of total industry assets, they now hold 42% of such assets – with $7 trillion in assets, roughly 38% of the U.S. gross domestic product. And, the 20 largest banks hold more than 60% of industry assets. Mr. Hoenig went on to note that the current size of these institutions has transformed banking in the U.S. and that these institutions dominate the industry and increasingly dominate our economy.

While we appreciate the desire to bring in more private capital into the GSE process, we believe this can be better accomplished through risk sharing (preferably on the back end), dispersed among a large diverse source of investors, than by giving large banks or investment firms a major new role in government-backed mortgages and creating a significant new financial risk related to that role.

Secondly, chartering Wall Street investment banks to compete against Fannie and Freddie could invite the same types of practices that we saw in the subprime crisis, with a race to the bottom on credit quality followed by taxpayer bailouts of these TBTF institutions during a crisis. The lesson we learned from that crisis is that when the TBTF institutions go too far and need a bailout, small lenders also suffer the consequences, from heightened regulations.

Third, regardless of the intent and language in GSE reform bills, the incentives for vertical integration are strong, and there is a risk that this will take place, as long as the vertically integrated Wall Street banks are permitted to have any role in being a guarantor. The simplest way to prevent this from happening is not to authorize new guarantors.

Finally, the creation of new charters designed to have the entities compete in areas such as pricing seems inconsistent with the concept of a Utility Model, and would appear to take the GSEs beyond the role of simply facilitating secondary market mortgage access.

4. All risk sharing should be done as back-end risk sharing.

To date, Fannie and Freddie have carried out the great majority of their risk sharing on a back-end basis – i.e., after GSE purchase of the qualified loan. This practice creates a broad competitive investment market for the risk sharing – and does not negatively affect small mortgage lender access. In contrast, up-front risk sharing could create significant risks for small lender access. Specifically, it could result in the risk sharing providers, particularly vertically integrated Wall Street Banks, engaging in anti-competitive practices, such as exclusively dealing with their bank lending affiliate or engaging in the practice of volume discounts.

Moreover, if up-front risk sharing becomes either an exclusive or dominant practice, it would create a chokepoint, where small lenders are not able to sell to the GSEs without delivering risk sharing at the same time. This threatens small mortgage lender access to the secondary market.

Finally, up-front risk sharing is much more likely to result in the re-aggregation of risk that could result from a small group of institutions or investors doing risk sharing on the front end. The simplest and most effective way to address this concern is to allow risk sharing only on the back-end, after loans have been delivered to the GSEs.

However, if Congress rejects this approach and elects to permit risk sharing on an up-front basis, it is essential that it not be allowed to be provided by any entity with any stake in primary loan origination, for reasons cited above. It should only be allowed by private mortgage insurers (PMIs) or other insurance-type entities. And, if allowed, protections must be in place to protect small mortgage lenders – including a ban on volume discounts, fully transparent pricing, and a requirement that the entity serve all qualified seller-servicers on a non-discriminatory basis.

5. Pricing, underwriting and variance parity.

The FHFA has substantially ended the anti-competitive, discriminatory pricing practices of the GSEs prior to conservatorship. Such a prohibition against differential treatment based on lender volume or size with respect to pricing should be made permanent, ideally through legislation – and applied to any entities authorized to compete with Fannie and Freddie. Non-discriminatory pricing should include G-fees, buy-up or buy-down grids, loan level price adjustments, credit risk transfers or any proxy for these. There should also be a prohibition against special underwriting deals and variances that put certain lenders at a competitive disadvantage and create unnecessary risk for the GSE's.

The GSE's – or any guarantors - should also be required to be completely transparent and publish all seller/servicers G-fees and related information. Finally, due process should exist for all small and mid-sized lenders, so that there is no discrimination based on charter or lender size or volume in areas such as reps and warrants.

2. COMMENTS ON HENSARLING/DELANEY/HIMES

Good Provisions in Hensarling/Delaney/Himes

There are many good provisions in this legislation from a small lender perspective, including:

- **Small Lender Access Provision [Section 116).** This section requires a Small Lender Access Program to facilitate a cash window for smaller lenders, including creating an option in which the loan originator can retain servicing.

- **Bright Line Distinction (Section 107**). This section prohibits credit enhancers or their affiliates from being a GNMA issuer of qualified MBS.

- **G Fee Pricing Parity (Section 103).** This section includes explicit language prohibiting "discrimination" by GNMA based on the "size or mortgage production volume of an issuer" – thus codifying G Fee parity with respect to GNMA fees.

- **Pricing Parity by Credit Enhancers (Section 105).** This section includes explicit language prohibiting "discrimination" based on the "size or mortgage production volume of an issuer" – thus codifying G Fee parity with credit enhancers and guarantors. This is a significant improvement over the provisions of the 2014 bi-partisan GSE reform bill that passed the Senate Banking Committee, which rejected calls by CHLA to prohibit volume discounts by such participants.

- **Approval and Standards for Private Credit Enhancement (Sections 104 and 105).** This section builds off of existing credit risk transfers (risk sharing) being done by Fannie and Freddie to off-load credit risk from taxpayers and to impose more market discipline – by requiring FHFA to regulate credit enhancers and credit enhancement standards.

Concerns About a GNMA Model

CHLA is sympathetic to the concept of using GNMA more in the conventional market. In fact, in the spring of 2014, CHLA developed and shared with GNMA its model legislation to require GNMA to conduct a pilot program in which 100,000 conventional loans would be securitized through GNMA, backed by a 100% incontestable guarantee from private mortgage insurance.

However, the concept of running a pilot is significantly different than transforming the entire GSE market over to a GNMA model. CHLA has a number of significant concerns about this approach.

- **Recent GNMA Tightening Actions.** GNMA has recently taken numerous actions to tighten oversight of GNMA issuers, related to their counterparty risk. It is understandable that GNMA would impose stricter standards for the largest issuers, whose portfolios are more difficult to place. However, we are hearing reports that tightening actions are being taken for smaller issuers, which clearly do not pose the same level of risk. These include curtailing requests for commitment authority for issuers that meet all GNMA requirements and raising net worth requirements above posted levels.

- **Counterparty Risk Concerns Magnified under a GNMA Model.** As noted just above, GNMA already has stringent standards for GNMA issuance – especially in light of the fact that there is almost no credit risk to GNMA, in light of the 100% FHA guarantee that exists on the great majority of GNMA securities. The bill would potentially create significantly more counterparty risk from private guarantors and risk sharing entities, in comparison to FHA. It is also possible that guarantors will require loan originators to retain some credit risk on the loans they originate, or that originators will be required to contribute capital. As a result, instead of the more than 300 GNMA issuers that now exist, it is probable that only a handful of issuers would be able to issue these new GSE securities. This would significantly increase concentration among Too-Big-To-Fail entities, reducing competition and thereby harming consumers, harming smaller lenders, and increasing systemic risk.

- **GNMA Infrastructure.** GNMA does not have the staff to handle such a significant increase in volume. And, recent experiences in which Congress have failed to approve even modest $5 million to $10 million Administration proposals for GNMA staffing increases do not augur well that sufficient resources will be provided to carry this significant expansion of issuer oversight and new program responsibilities.

- **Transition Risk is Significant.** The bill envisions a significant transformation of our mortgage markets – with the creation of new securities, new guarantors, new risk sharing entities, and a new method for loan execution. This could create significant transitional risk, with dislocations to our mortgage (and housing) markets. The current system in which Fannie Mae and Freddie Mac purchases and securitizes loans works effectively and efficiently; the burden of proof for the need to significantly overhaul this approach should be very high.

- **Multiple guarantors Are Not Necessary and Could Harm Smaller Lenders.** The Hensarling/Delaney/Himes bill would proliferate a number of new guarantors, either to replace or co-exist with a restructured Fannie and Freddie.

  In July 2017 CHLA joined five other associations in testifying before the Senate Banking Committee on small lender concerns with respect to GSE reform legislation. During questioning, **all six associations opposed chartering new guarantors.**

  CHLA appreciates that authorization of new guarantors is done in the name of competition**. CHLA supports competition. However, we believe this should take place at the mortgage lender level and at the back-end risk sharing level. Guarantors should be operated under a Utility Model with the main role to facilitate access to the secondary markets.** CHLA's Senate testimony highlights the significant risks related to creating significant new entities at the guarantor level – including undermining the cash window, undermining the ability of small and mid-sized lenders to securitize loans, and pricing practices that discriminate against smaller lenders.

More Protections for Small Lenders Should Be Included

Finally, while CHLA is appreciative that the bill authors have incorporated a number of protections specifically designed to protect small lenders, GSE reform is extremely complex, and in practice, market forces and other factors could easily lead to outcomes which result in a

diminution of small lender access to both the cash window and the ability to securitize loans. We recommend more safeguards be put in place to protect against this, in the following areas:

- **No assurance that cash window will serve all the market at competitive terms.** It is not enough that a cash window exists. It must also provide: (1) fully competitive pricing, and (2) be sufficient in capacity to serve all interested small lender participants. Mechanisms should be put in place to review the effectiveness of the cash window, and to require further actions in the event the cash window is not working effectively.

- **Concerns that authorization of FHLB to provide cash window will leave out IMBs**. By statute, the FHLB can only serve depository institutions, and cannot serve IMBs. A concern would arise if the FHLB became the primary cash window source, which would therefore exclude IMBs. The legislation should either specifically permit IMBs to participate in a FHLB cash window or provide other assurances that a comparable cash window will be in place to serve IMBs.

- **Vertical Integration Protections Could be Strengthened**. Unfortunately, the language of Section 107, which is designed to create a bright line distinction between the primary and secondary markets and avoid vertical integration are inadequate. Merely prohibiting a credit enhancer or an affiliate from being an issuer does not prevent large Wall Street Banks from being an issuer and having a controlling or dominant role in a credit enhancer – and then using its market power and advantage in the secondary market to gain an unfair advantage or exclusive role to mortgage origination and issuance of qualified MBS. The language of Section 107 should be significantly strengthened to prevent this.

3. A PATH FORWARD ON GSE REFORM

It is important to acknowledge that almost all needed GSE reforms have already taken place. These all but ensure that there will not be a return to the practices that led to conservatorship, or a return to the old system of private gain, public loss. Completed reforms include

1. **Ability to Repay (QM).** A major factor in the GSEs' conservatorship was their purchase of no doc (Alt A) loans. With adoption of QM, no doc loans are a thing of the past.

2. **Credit Risk Sharing.** The GSEs have been doing risk sharing on over 90% of new loans, and to date have transferred $50 billion in credit risk to third party private entities.

3. **Portfolio Wind Downs.** The significant interest rate risk that the GSEs were exposed to before 2008 has largely been eliminated with a major winding down of their portfolios.

4. **Strong Regulator.** The 2008 HERA legislation replaced a weak regulator (OFHEO) with a strong regulator (FHFA) that has focused on effective, proactive regulation.

5. **Taxpayer Compensation for Federal Guarantee.** The pre-2008 deal in which GSEs had an implicit guarantee without compensating fees has been replaced by a full profit sweep under the PSPA – and an expectation of fair guarantee fees under GSE reform.

6. **Common Securitization Platform (CSP)/Common Security.** FHFA is engineering a CSP and single security - to create a more uniform, competitive securitization process.

The one major reform that has not been completed is the recapitalization of Fannie Mae and Freddie Mac, building capital in the GSEs in order to absorb losses and protect taxpayers. This is not because Fannie and Freddie have not been profitable or financially stable. They have paid back their initial taxpayer advance and generated an additional $85 million in profits. However, because of the arbitrary profit sweep under the Preferred Stock Purchase Agreement, Fannie and Freddie were not allowed to retain any profits, except for the tiny $3 billion buffer that FHFA permitted a year ago. Unfortunately, this buffer is insufficient to cover the normal types of earnings variations and accounting adjustments that typically take place.

Therefore, FHFA should immediately increase this buffer to a more reasonable level – e.g to a .5% net worth level for both Fannie and Freddie.

Secondly, the 2008 HERA legislation, under which the GSEs were taken into conservatorship, clearly spells out the authority of FHFA to require Fannie Mae and Freddie Mac to develop a capital restoration plan to show how they could emerge from conservatorship, consistent with the capital standards FHFA is now developing. Development of such plans does not commit them to carry them out. However, as legislators contemplate different GSE reform options, this Committee and the broader public GSE reform debate would benefit from understanding the specifics about how and how long it would take for Fannie and Freddie to be recapitalized.

Therefore, CHLA reiterates its call for FHFA to direct Fannie Mae and Freddie Mac to develop a capital restoration plan.

Third, CHLA continues to support Congress adopting comprehensive GSE legislation. This would be the preferred resolution, both to try to achieve consensus and to address outstanding GSE issues that will likely require legislation, such as:

- Adopting a federal backstop of qualified GSE loans, either through a guarantee of qualified mortgage backed securities (MBS) or a Line of Credit.

- Codifying FHFA's administrative requirement of G fee parity - and extending this to guarantor and risk sharing practices.

- Extend the QM patch (scheduled to expire in 2021) with any appropriate modifications - so that FHFA can continue to set its own QM parameters for the GSEs.

- Retaining, but making any appropriate adjustments to housing goals, Duty to Serve, and the Housing Trust Fund/Capital Magnet Fund - in order to ensure that the GSEs use their federal backstop to focus on low- and moderate-income borrowers and underserved markets, and to prevent them from using that backstop to cherry pick only the best loans.

However, it has been 10 years since Fannie and Freddie went into conservatorship and Congress has, to date, been unable to adopt comprehensive reform legislation**.** Ten years is long enough. Inevitably, there will be an economic downturn, and as Director Watt has warned, there would be negative consequences of a Treasury draw caused by Congress' continuing failure to act.

Therefore, if it becomes clear by some time in 2019 that Congress will once again be unable to enact GSE legislation into law, Treasury and the FHFA should move forward to re-privatize and recapitalize Fannie and Freddie – using the Capital Restoration Plans that HERA authorizes and CHLA is calling on FHFA to require.