COMMUNITY
MORTGAGE
LENDERS
AMERICA

CMLA POLICY ON GSE REFORM
Time for Reform and Preservation

EXECUTIVE SUMMARY

The Community Mortgage Lenders of America (CMLA) has adopted a policy toward reform of Fannie Mae and Freddie Mac, (the Government Sponsored Enterprises or GSEs). The CMLA Board of Directors unanimously endorse a set of principles and reform actions that will ensure the viability of the GSEs and prevent severe market concentration with large national lenders at the expense of small and mid- sized mortgage lenders.

THE PRINCIPLES FOR AN EQUITABLE AND EFFECTIVE SECONDARY MORTGAGE MARKET

Convert the GSEs into public utilities. The GSEs should be regulated as public utilities with the guaranty fees they charge subject to approval by the Federal Housing Finance Agency (FHFA).

Market Liquidity. The GSEs were created to provide continuing liquidity to the mortgage market, during times of market stability and during times of extreme volatility. This historic role should continue to be embedded in GSE reform.

Codify and Preserve Conventional Lending. Non-conventional and sub-prime loans as well as lax underwriting standards were the primary cause of the housing crisis and both should remain off-limits to the GSEs.

Risk-Appropriate GSE Capital Standards. Risk-appropriate capital standards will ensure financial stability for GSEs and the market, minimizing disruption and market concentration, and averting another housing market crisis.

A GSE Model of Explicit Risk. CMLA believes the GSE model of “implicit risk” should be replaced with overtly stated explicit risk that would include fees paid by the GSEs for an explicit Federal backstop.

1629 K Street, NW
Suite 300
Washington, DC 20006

Reduce Market Concentration. GSE market participation is essential to the viability of small- and mid-sized lenders, to maintaining a diverse group of lenders to serve borrower home financing needs and to averting a market monopolized by large, national lenders.

Portfolio Flexibility. CMLA believes GSE portfolios are a valuable counter-cyclical tool that should be retained with regulatory oversight to ensure risk-free size and composition.

Proper Use of Guarantee Fees. CMLA believes that GSE guarantee fees should be rightly kept within the housing market and not used for other, unrelated purposes.

Risk Sharing. Any risk sharing done by the GSEs must be subject to regulatory oversight from FHFA. Risk sharing should be both upfront and back-end. Risk sharing opportunities should be open to a wide variety of qualified parties including small lenders, mortgage insurers and investors. The GSEs must be prohibited from discriminating against any class of risk sharing participant and must be required to offer equal terms to all risk sharing participants.

THE RIGHT APPROACH TO REFORM

CMLA believes there are a series of actions that will achieve the above principles for a sound secondary market. Most importantly many, if not all, of these measures can be achieved under existing law, without the need for further legislation. These measures would minimize market disruption and/or dominance and prevent a second financial crisis for the GSEs:

- **New GSE capital standards** sufficient to hedge front- and back-end risk sharing mechanisms, ensure GSE financial stability in extreme financial volatility, and reduce risk to the U.S. Treasury
- **FHFA should take appropriate action under the Preferred Stock Purchase Agreement (PSPA)** between the U.S. Treasury and the GSEs to rebuild GSE capital through retention of a portion of their earnings. An explicit backstop fee to the Federal government for the PSPA should be set.
- **Require appropriate underwriting standards** and GSE mortgage products that will maintain and expand access to credit for consumers, without subjecting consumers or the GSEs to undue risk
- **Require GSEs to serve lenders of all sizes** and nurture smaller markets to avoid market concentration that could lead to higher mortgage prices
- **Provide standardization** of origination documentation, servicing practices, securitization terms, and modification/foreclosure strategies to help protect consumers from faulty policies and procedures
- **Establish a GSE Rate Commission** to approve a guarantee fee in the model of a public utility, with funds retained in the housing industry for the protection of taxpayers
- **Regulate post-conservatorship executive compensation** to prevent excessive risk-taking by top executives

CMLA POLICY ON GSE REFORM

Time for Reform and Preservation

CMLA is the only Association solely dedicated to representing the interests of small- and mid-sized community based mortgage lenders. The CMLA's membership is composed of independent mortgage banking companies and community banks that finance home purchases for consumers. The GSEs are the lifeline for CMLA member companies. Unlike large banks, community lenders rely largely on the GSEs for liquidity to originate mortgages to serve the home financing needs of their borrowers. Thus equal access to the secondary market is essential for community lenders to offer mortgage products to finance their customers purchase of a home. While private loan purchasers have also provided access to the secondary market, tight credit and new regulations have significantly eroded, if not eliminated, this outlet.

CMLA's Board of Directors unanimously endorses a set of principles and reform actions that will ensure the viability of the GSEs and prevent severe market concentration with large national lenders at the expense of small and mid- sized community based mortgage lenders.

A PERSPECTIVE

The GSEs, Fannie Mae and Freddie Mac, were created by Congress to develop and support a secondary mortgage market by providing continuous liquidity to that market. As GSEs, these organizations were quasi-government agencies with a mandate to purchase a set goal of *affordable housing* loans. At the same time, the GSEs were publicly traded corporations with a mandate to deliver profitable returns to their investors. Importantly, this hybrid gave the GSEs an *implicit* Federal guarantee on their mortgage-backed securities and publicly issued debt. This implicit guarantee reassured investors and the returns to GSE investors were consistently strong for decades.

Fast forward to the early 2000s when subprime and non-traditional loans dominated the market, enabling borrowers to qualify for higher-balance loans. This robust market, in turn, drove home prices upward, creating unprecedented value appreciation in many markets across the country. This cycle came to a halt in 2007-08 as borrowers began defaulting in record numbers, the value of mortgage-backed securities began to tumble, and home prices declined, in many markets quite sharply. The GSEs experienced significant losses during this time period. At the height of the crisis, in September 2008, the GSE's regulator, the Federal Housing Finance Agency, (FHFA), in order to avert GSE defaults and an economic collapse, placed both GSEs into conservatorship. Simultaneously the Federal Government, acting through the Department of the Treasury, established a Preferred Stock Purchase Agreement (PSPA) with each GSE, which became a conduit for direct Federal financial assistance. Ultimately the Treasury infused $187.5 billion dollars into the GSEs and in turn received senior preferred stock carrying a dividend of 10 percent, which was subsequently modified to 100 percent of all profits earned by each GSE. In addition the Treasury received stock warrants granting them the right to acquire common stock of each GSE equal to 80% of the value of each company.

The GSEs have now been in conservatorship for over 7 years and the Treasury and Obama Administration officials have declared their intention to let the conservatorship continue, deferring GSE reform to the next Congress. That the GSEs regained profitability and returned more than $241 billion to the U.S. Treasury (vs. the $187.5 billion the Treasury infused into the GSEs) is seemingly irrelevant to policy makers. Thus, the GSEs will remain under the direct control of the FHFA, and the indirect control of the Treasury, for the foreseeable future.

The GSEs have continued to supply liquidity to the mortgage markets in conservatorship through access to U.S. and international capital markets. Millions of homes have been financed with mortgages acquired by the GSEs and bundled into securities sold to capital markets investors.

Congressional Progress to Date Congress has made progress in strengthening the regulatory oversight of the mortgage market. With the 2010 passage of the Dodd Frank law, Congress imposed a series of housing market reforms, including the creation of the Consumer Financial Protection Bureau (CFPB) and the imposition of the Qualified Mortgage (QM) regulation that created strong legal and regulatory incentives for lenders to offer only traditional, properly underwritten, mortgage products to borrowers.

These legal and regulatory reforms followed changes that were instituted by marketplace participants, the GSEs, lenders, and others. Marketplace participants turned away from the subprime and non-traditional mortgage products and lax underwriting standards that were emblematic of the run up to the financial crisis. Regardless of the Dodd Frank law the marketplace returned to the more traditional mortgage products and underwriting standards that existed prior to the run up to the crisis. The Dodd Frank reforms ensure that there cannot be a return to such questionable lending practices and products.

However, these same changes have considerably reduced access to affordable loans. More than 4 million qualified homebuyers have been locked out of the market an Urban Institute study has found. While regulatory reforms safeguard consumers and enhance market stability, first time and minority homebuyers in all income brackets are finding credit tight and loan qualification difficult.

The ability for small and mid-size mortgage lenders to continue providing financing depends on continued access to the capital markets through the liquidity and conduit function of the GSEs. To ensure continued access to credit, the housing finance market must provide ongoing availability of mortgage products and support underwriting standards that allow small and mid-sized community lenders to extend mortgage credit to all qualified borrowers.

CMLA believes the best, most effective and most expeditious solution is one already authorized under current law. The Administration, the Treasury, and the FHFA should act as authorized by the law that governs the GSEs, the Housing and Recovery Act of 2008 (HERA). As written and passed by Congress, HERA provides for recapitalization of the GSEs and a release from conservatorship once the recapitalization is achieved.

HERA created the FHFA with significant regulatory authority to ensure the GSEs are operated in a safe and sound manner. The FHFA under HERA has the ability to require the GSEs to purchase and/or securitize only well-underwritten traditional mortgage products. In addition FHFA may restrict the GSEs ability to invest in mortgage securities backed by non-traditional mortgage products or mortgage products that are not underwritten to strong standards. Both of these, particularly the investment in non-traditional mortgage securities, were major factors that led to the current conservatorship. The FHFA has also prevented the GSEs from extending favorable pricing of their mortgage products to their large lender customers. Most importantly, unlike the regulatory authority that existed before the 2008 crisis, HERA gives FHFA clear authority to place the GSEs' safety and soundness ahead of returns to shareholders.

In addition, HERA allows the Federal Government to continue providing the GSEs a line of credit from the Treasury through the existing PSPA, thus making Treasury the backstop to GSE securities and debt. In 2008, the GSEs, the Conservator, and Treasury authorized and agreed that the government could levy a periodic commitment fee which, set at a proper level, would pay for the existing Federal backing without Congressional involvement. Taking this action would remove the "implicit GSE backing."

CMLA believes a sensible and calculated reformation of the GSEs will result in continued liquidity and stability without an unnecessary disruption to the secondary market. That approach will also preclude dominance in the secondary market by large banks/servicers. CMLA is confident FHFA can -- through its regulatory authorities granted by HERA -- and should implement the following changes:

- Establish new capital standards for the GSEs that adequately cover both front- and back-end risk sharing mechanisms. Capital standards should be set to establish GSE financial stability even during times of extreme financial volatility and to reduce the risk to the U.S. Treasury as the ultimate financial backstop for the GSEs
- Permit the GSEs to immediately begin rebuilding capital through retention of earnings and
- Work with Treasury to set an explicit backstop fee to the Federal government for the continuing PSPA

- Maintain appropriate GSE underwriting standards and offer mortgage products that maintain and expand access to credit for consumers, without subjecting consumers to undue risk from poorly designed products or standards
- Continue to serve lenders of all sizes and nurture smaller markets to avoid market concentration that would lead to higher mortgage prices in the absence of the GSEs
- Continue to provide standardization of origination documentation, servicing practices, securitization terms, and modification/foreclosure strategies to help protect consumers from faulty policies and procedures
- Establish a regulatory mechanism to maintain and set a guarantee fee in the model of a public utility, with funds generated from the such fee to be retained by the GSEs for the benefit of taxpayers
- Regulate post-conservatorship executive compensation through a governing board to prevent excessive risk-taking by top executives

CMLA believes these steps would minimize market disruption, preclude market dominance by large lenders, and prevent a recurrence of the financial crisis experienced between 2006 and 2008.

Critically, and as noted above, the FHFA and the U.S. Treasury can – and should – act under their existing authority. Furthermore, it is highly unlikely a new Administration and a newly comprised Congress will take up GSE reform in the first year post-election. Thus, at a minimum there is 2 years before GSE reform can be reasonably expected. In the meantime, credit is tight for qualified borrowers, compliance costs (e.g. TRID) are escalating for smaller lenders that can least afford to absorb these rising costs, and an estimated 4 million – and growing – qualified borrowers are locked out of the market.

Principles for Meaningful GSE Reform

CMLA believes that GSE reform should be aligned with principles that support a robust, safe secondary mortgage market and homeownership for all responsible and qualified borrowers. With that litmus test, GSE reform will codify the GSE role as the primary source of liquidity in the U.S. mortgage market, enabling equitable access to the capital markets for all lenders, and expand access to affordable credit for underserved groups with the ability and willingness to achieve homeownership.

Standardization Reduces Costs

GSEs should ensure that the efficient and consumer-friendly nature of a standardized mortgage market is preserved. The GSEs currently provide a standard mortgage product, process and servicing process, which allow mortgage products to enter the secondary market without unnecessary delay or difficulty, thus resulting in an efficient housing finance model.

This efficiency is important to the industry in several ways:

- Enhances liquidity in the secondary market by ensuring investors that loans originated within stated parameters will meet widely-accepted standards and therefore enhance transferability in the secondary market

- Provides standard guides for loans and enables future rating agencies to better rate the risk associated with a group of loans, both of which allow the loans to be traded as a uniform group, more like stocks rather than individual loans with unique underwriting standards

- Bolsters fair lending goals by ensuring that all loans are processed and presented with the same standards, regardless of the status of the borrower

- Reduces geographic disparity in the loan process, and ensures that loans are available in all areas

- Enhances pricing processes because all similar loans will have the same risk associated with them, thus bringing speed and efficiency to the pricing process, a clear benefit to originators, borrowers, and investors of mortgage-backed securities

The GSEs have long sought to bring efficiency and fairness to the lending process through the use of standardization. Any future reform of the GSEs must preserve these important benefits.

LIQUIDITY IS NEEDED

Any modification to the GSEs should ensure that funding is accessible at all times and in all parts of the country, without delay or interruption and for purchase and refinance, as well as low-moderate-and middle-income markets. Pricing for similar products and credit scores should not vary between regions of the country.

These were the principles behind the creation of Fannie Mae in 1938 and subsequently Freddie Mac in 1971. These principles are still valid today. Without a dedicated source of liquidity for the mortgage market, liquidity will dry up during financial crises and the housing and mortgage markets come to a grinding halt, thus denying borrowers access to funding. During the financial crisis we saw this result occur in the non-conforming/jumbo market. Beginning in 2007, private capital was driven away from the market due to a lack of clear direction from Congress, political uncertainty, fear of future regulatory sanctions, and vague and uncertain regulatory guidance. As private capital evaporated, even creditworthy, fully qualified borrowers could not find affordable and acceptable loan terms outside of the limits of the GSEs. This condition persisted for nearly two years, with jumbo loans difficult to obtain and/or available only at prohibitive costs.

The 2008 Financial Crisis, the "Great Recession," was the most significant economic threat to the U.S. and the world since the Great Depression – which caused Congress to create the original, nonpolitical Fannie Mae in order to create a nationwide, liquid housing finance market. Because private capital is subject to stagnation or unavailability, the GSEs were given – and must retain – government sponsorship.

With the benefit of hindsight, it is clear the 2007-08 housing and financial crisis may have been as bad as the Great Depression had the Government not supported the GSEs. Indeed, the basis for creating the GSEs was sound, and eventually helped foster a healthy and active American economy. Although transparency has been lacking and public accountability was not held in check in recent years, liquidity for the mainstream borrower cannot be maintained by rendering the GSEs as either fully private entities, fully public agencies, or non- existent altogether.

Instead, the public/private partnership of the GSEs should be continued, albeit re-engineered to serve the true and important mission of the agencies: to assure funding sources are available for those meeting quality agency guides, without regard to geographic region, including low-, moderate-, and middle-income markets.

Protect Conventional Lending

Any modification to the GSEs should require the GSEs to avoid risky products and borrowers. Although the current regulatory structure indicates that the Federal government has taken definitive statutory and regulatory steps toward preventing a resurgence of risky or creative mortgage products, incentives may always remain for unscrupulous lenders to bend the rules or take advantage of unclear guidelines. The GSEs should not guarantee, fund, or purchase any products that present unusual terms or increased risk.

Traditional conventional mortgages have historically performed well. Although every borrower is subject to unexpected life events such as unemployment or sudden financial crisis, these traditional mortgages were not flawed from the outset, as many subprime originations were. Thus, the secondary market must ensure these safe loans are priced and supported appropriately via a robust securities overflow market/retained portfolios.

Make Risk Explicit

Any modifications to the GSEs should require some kind of explicit government backing for qualified mortgages. Long-term, fixed-rate mortgages were made possible through explicit government backing and a majority of homebuyers do not want the uncertainty of an adjustable rate mortgage. Instead, consumers prefer the certainty and affordability of long-term, fixed mortgages.

Yet most financial intermediaries will not assume the risk of hedging large sums of a long-term asset that can be pre-paid, such as a mortgage, with relatively shorter-term

funding (deposits and/or short term debt). Therefore, explicit government backing is essential to ensuring that long-term, fixed-rate mortgages remain commonly available.

CMLA believes the prior model of "implicit risk" did not work well and recommends that some form of explicit premiums be submitted to the Federal government in return for the secondary market structure that allows the proper hedging of these assets. These premiums represent an additional source of income for the GSEs to repay their debt to the American taxpayers, after which time they could be held by their regulator as a buffer against future downturns.

REDUCE MARKET CONCENTRATION

Any modifications to the GSEs should refrain from returning us to the pre-2008 situation of market concentration among a limited number of originators/servicers and should instead encourage participation among a wide variety of parties.

Small lenders serve a valuable local market niche, and help grow local economies. They should be encouraged to obtain secondary market and liquidity directly from the GSEs and not through their larger, direct competitors. This would create a vibrant, competitive housing finance market that will provide consumers with a range of lending choices. The reality is many Americans prefer to deal with locally based institutions with local community leadership. Thus, the secondary market should preserve these locally owned and run institutions, which maximize consumer care and choice while keeping costs low.

Market concentration leads to dangerous reliance on the dominant banks and creates a lack of innovation and stifling of customer service. The post-crisis mortgage market has been characterized by a de-concentration of the mortgage origination market, with small and mid-sized lenders accounting for over a 40% share of all originations. A significant factor in this de-concentration was the decision by the FHFA to require the GSEs to eliminate discounted pricing previously granted to large lenders. That discounted pricing gave large lenders a competitive advantage in the marketplace, which they used to establish dominant market share positions. The current marketplace features a wide variety of lenders, offering a broad array of choices to consumers for fulfilling their home financing needs. Any GSE reform should preserve and enhance the marketplace diversity we currently enjoy.

ENCOURAGE PORTFOLIO FLEXIBILITY

Any modification to the GSEs should include an option that grants the GSEs and their participants the flexibility to hold mortgages in portfolio in order to keep prices from rising during market contractions. The size of these portfolios should be limited and strictly regulated by the FHFA as a measure to be utilized by the GSEs only during times of market contraction.

The GSE portfolios, as mandated by the PSPA with the U.S. Treasury, have shrunk in recent years on a path to eventual elimination. We believe the GSE portfolios can be valuable counter-cyclical tools that should be retained for use at appropriate times.

REQUIRE THE PROPER USE OF GUARANTEE FEES

Any modification to the GSEs should maintain the integrity of mortgage risk-based pricing while at the same time repaying American taxpayers in total for past economic support. Accordingly, income derived from the guarantee fee should be retained in the industries, which created it – the housing and mortgage finance industries.

CMLA opposed Congress' 2012 decision to fund a two-month payroll tax holiday through higher GSE guarantee fees. That legislation set a new precedent for using the mortgage market's price hikes to fund unrelated parts of the federal budget. While the independent regulator had signaled that prices were increasing, these price hikes should have been used to re-price credit risk and repay taxpayers for their assistance into the U.S. mortgage market.

The legislation not only raised mortgage costs while doing nothing to help repay taxpayer assistance to the GSEs, but also raised long-term costs should the rating agencies downgrade the GSEs' debt. Further, this two-month band-aid saddled the American borrower with thirty years of increased debt, thus hindering the housing industry for 30 years to come. This mistake would be exacerbated should Congress return again to this ill-advised funding solution as it nearly did with the 2015 Federal Highway bill.

CMLA supports appropriate and risk-related adjustments of guarantee fees provided that the income derived from the fee is used within the housing industry to price credit risk accurately and help repay taxpayers for their investment in the GSEs. CMLA strongly opposes the transfer of this income into the general U.S. Treasury for unrelated purposes.

SETTING APPROPRIATE CAPITAL STANDARDS FOR THE GSES

The entry of the GSEs into conservatorship clearly demonstrated that the GSEs were undercapitalized for the risks contained on their balance sheet. In large measure mortgage market reforms and stronger regulatory oversight by FHFA on GSE assets and underwriting standards have addressed this capital/risk imbalance. However the issue remains of what GSE capital standards should be once reform is accomplished and the GSEs are released from conservatorship. These capital standards must take into account the unique role played by the GSEs, their status as government sponsored enterprises, the Treasury backstop provided through the PSPA and the fact that the GSEs are mono-line businesses.