NATIONAL COMMUNITY REINVESTMENT COALITION NCRC

Regulatory Comments

Comments to:

US Department of Treasury and
US Department of Housing & Urban Development
Regarding Reform of the Government
Sponsored Enterprises (GSEs)

Submitted by
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July 21, 2010

Docket No: TREAS-DO2010-0001
HUD-2010-0029

RE: Public Input on Reform of the Housing Finance System

To Whom it May Concern:

The National Community Reinvestment Coalition (NCRC) appreciates this opportunity to formally convey our position on the future of the Government Sponsored Enterprises (GSEs), the regulation of the housing finance system, and the role of government in the finance system. We applaud Congress and the Administration for their work on enacting the most significant reform to our financial system since the Great Depression. Yet, as this request for comments indicates, the work on reforming our financial system is far from complete and must include reform of the GSEs.

NCRC is an association of more than 600 community-based organizations that promotes access to basic banking services, including credit and savings, to create and sustain affordable housing, job development, and vibrant communities for America's working families. As such, our member organizations have witnessed first-hand the economic and social devastation wrought by foreclosures and the current recession. Careful thought in crafting meaningful reforms to the GSEs, the housing market, and to the regulatory framework is a critical step in developing a reform package that will contribute to sustainable housing finance and blunt the severity of future crises.

Role of Existing Government-Sponsored Enterprises: Return Fannie Mae and Freddie Mac to Public-Private Status

The housing finance system needs hybrid secondary market institutions in order to promote stability, liquidity, and access for traditionally underserved populations. While a revamped Fannie Mae and Freddie Mac should not be reconstituted as the same Government-Sponsored Enterprises (GSEs) as before the crisis, they should still have a government guarantee, but the government guarantee will be explicit rather than implicit and will be limited. A utility model should also be explored for the successors to the GSEs but a utility model that ensures service and responsiveness to traditionally underserved communities. For purposes of responding to this request for comments, NCRC will call the successors to Fannie Mae and Freddie Mac, hybrid secondary market institutions (hybrid institutions).

The alternatives to hybrid institutions are a financial system with either no government involvement or an enlarged Federal Housing Administration (FHA) which will absorb the functions of Fannie Mae and Freddie Mac. A lack of government-involvement in the secondary market will create an unstable financial market that will threaten the broader economy with severe recessions. The current crisis was exacerbated, in part, by a lack of access to liquidity when the GSEs could not adequately perform their functions of providing a steady stream of investor capital to lending institutions. Without GSEs or any government involvement, the private sector by itself will be unable to consistently provide liquidity and the standardization necessary to produce reliable and affordable products.

Similar to no government involvement, an enlarged FHA will not work well either. The FHA performs a vital function in the marketplace, ensuring access to traditionally underserved populations that do not have pristine credit but nevertheless have good credit. Traditional FHA customers may not be able to save for a 10 or 20 percent downpayment, but they will pay on time if given the chance to buy a home.

As important as FHA is, it should not be massively expanded to replace Fannie Mae and Freddie Mac. A commitment to a competent FHA with adequate financial capacity has waxed and waned with different administrations. Therefore, if FHA becomes the primary vehicle for housing finance, particularly for blue collar Americans, the finance system will be too exposed to political whims. We should not diminish the role and responsibility of the private financial services sector to address the mortgage needs of all classes of creditworthy Americans.

The government should not become the lender of only resort for blue collar people, as a matter of equity and efficiency. Even with the most generous funding, government resources will not be sufficient to meet the capital and credit needs of underserved communities. In addition, large government agencies cannot innovate and adapt as quickly to market changes as private sector institutions. If FHA becomes a monopoly or an oligopoly sharing the marketplace with only a few other secondary market institutions, the entire market will become less innovative and effective.

In contrast, hybrid institutions can maintain their innovative edge. Hybrid institutions can also effectively utilize government guarantees. The government guarantee dramatically lowered the GSEs costs, and allowed the GSEs to promote the development of standard 30 year fixed affordable mortgages that fueled economic growth for decades. [1] The GSEs helped create a housing finance system that was the envy of the world and allowed a middle class to flourish in the United States. In addition, the GSEs have had an important role in financing affordable multifamily housing for families that are not yet financially ready for homeownership or do not want to be homeowners.

The Problem was Lack of Oversight, Not the GSEs

A lack of oversight, not the structure of the GSEs, bedeviled the GSEs. We should not lose sight of the proverbial forest through the trees. The GSEs performed extremely well for 95 percent of their history. It was the lack of regulation of both the private sector and GSEs that led Fannie Mae and Freddie Mac into the subprime abyss. If the federal agencies had been more vigilant in regulating the entire market, including the GSEs, the crisis would not have occurred and the GSEs would not be in conservatorship.

In the 1990s before the rapid increase in subprime lending, the major shortcoming of the GSEs is that they were not serving minorities and low- and moderate-income populations as well as the banks. In a report conducted for the Department of Housing and Urban Development (HUD), NCRC and the KRA Corporation found that the GSEs trailed the banks in the percentage of loans to low- and moderate-income borrowers and minority and low- and moderate-income neighborhoods in 1995 and 1996.[2] Part of the reason for this is that the affordable housing goals had higher income limits than the Community Reinvestment Act (CRA) income limits. In effect, the banks' regulators were asking the banks to focus on lower income populations than the GSEs' regulators.

In the first decade of the 21st century, the federal regulators of primary and secondary market institutions either relaxed their standards or did not implement new standards to keep pace with market developments. The Federal Reserve Board, for example, did not update its primary anti-predatory regulation, Regulation Z, until July 2008. The GSEs' regulatory agency likewise was slow to adopt anti-predatory standards. Each time the Department of Housing and Urban Development (HUD) revised the affordable housing goals, NCRC was one of the advocacy organizations asking HUD to adopt stronger anti-predatory safeguards and disallow no-income verification loans and other risky loans from counting for goals credit. HUD declined to adopt these stronger safeguards.[3] The safety and soundness regulatory agency (Office of Federal Housing Enterprise Oversight (OFHEO)) meanwhile, was not adequately overseeing the GSEs capital reserves or leverage ratios.

The results of regulatory neglect are clear. Unconstrained, the primary market rushed into making and financing risky and abusive loans. The GSEs eventually could not resist the competitive pressures and entered the subprime market. Major primary market institutions, investment firms, and the GSEs failed or became wards of the state.

While the regulatory agencies and all parts of the financial industry bear responsibility for the subprime fiasco, the GSEs involvement in the subprime market was less than primary market institutions and Wall Street investment firms. The GSEs' subprime market activity was focused on their purchases of mortgage-backed securities. The mortgages that the GSEs purchased directly from lending institutions were primarily prime mortgages. Mortgages purchased directly from lenders by the GSEs continue to perform better than mortgages held in portfolio by lenders and mortgages purchased by private sector investors.[4] In addition, NCRC's recent study, *Foreclosure in the Nation's Capital*, documents that GSE-owned loans were considerably less likely to enter into foreclosure than loans in lender portfolios or privately securitized loans.[5]

Even though the GSEs eventually caught the subprime flu from primary market institutions, they were not the main perpetrators in the crisis and held the minority of subprime MBS.[6] The part of the GSE business (direct purchases of loans) which maintained due diligence controls remains more successful with fewer delinquencies than primary market institutions' business.

The bottom line is that it is not the structure of the GSEs, as hybrid institutions, that caused their downfall. The private sector collapsed as well. And the private sector goaded and enticed the GSEs into the subprime morass, not the other way around. The solution is uniform regulation applied to all actors in the marketplace, not just regulation applied to hybrid institutions and/or depository institutions with independent mortgage companies and Wall Street investment firms escaping rigorous regulation. It is our hope that the Dodd-Frank bill closes the regulatory loopholes and applies uniform regulation, though the Dodd-Frank bill did not address the GSEs. Extending the regulatory framework of the Dodd-Frank bill to the GSEs is the unfinished business of Congress.

Reform of Regulatory Oversight of Hybrid Institutions

We support bringing back the GSEs to their former public-private status, but with some key changes. First, they would be new hybrid institutions because government guarantees would be more limited. The government guarantee would be explicit and would be limited to direct purchases of mortgage loans instead of extended to corporate debt so that the hybrid institutions would not have an incentive to massively increase their portfolios and over-leverage themselves.[7] Explicit guarantees can also be structured to be clear to market participants about the extent to which the government will cover losses whereas implicit guarantees were vague, and encouraged highly risky behavior because they amounted to open-ended promises to finance enormous bailouts. Also, a utility model for the hybrid institutions should be explored that ensures the interests of financially vulnerable communities are served. In particular, community representatives must be on the hybrid institutions' boards, board meetings must be public with opportunity for the public to make comments to the board, and board meeting minutes must be public and released in a timely fashion.

Second, lawmakers must insure that a capable oversight body, perhaps the current Federal Housing Finance Agency (FHFA) with stronger enforcement authority, is in place to guard against future exorbitant risk taking and to require adequate capital reserves. The oversight body should place limits on the lobbying activities of the hybrid institutions so that their lobbying does not distort the decisions made by Congress.

Third, the FHFA must prohibit the hybrid institutions from purchasing high-risk loans directly from lending institutions or via securitizations. The FHFA must determine the types of loans that have too risky underwriting criteria and disallow the hybrid institutions from purchasing these loans. The FHFA must adopt the strongest standards from the Dodd-Frank bill and the Federal Reserve's Regulation Z.

Fourth, the FHFA must make sure that their affordable housing goals truly benefit those who underserved by the housing market. The affordable housing goals should match the income targets of the Community Reinvestment Act (CRA) instead of having higher income limits as was the case in the 1990s. Commendably, the FHFA has recently aligned the income limits in the housing goals with CRA. In addition, the FHFA can extend the same prohibitions against the hybrid institutions purchasing high-risk loans to the affordable housing goals or stipulate that loans counting for the affordable housing goals be the least risky of the loan purchases by the FHFA. In other words, loans that count for the affordable housing goals are truly plain vanilla, prime rate, fixed rate loans. In this manner, the affordable housing goals can be above reproach since they would require that the safest and soundest loans financed by the hybrid institutions are being extended to traditionally underserved populations.

The affordable housing goals should also be demanding in terms of the hybrid institutions financing multifamily rental housing, which is a pressing national need that was overlooked during the heyday of subprime lending. The hybrid institutions must return to their prominent role of financing affordable rental housing.

Congress and the Administration could also explore the possibilities of combining the affordable housing goals approach with a CRA-like exam. Currently, the FHFA is requesting comments on an evaluation process for assessing GSE performance in underserved markets. The FHFA proposes an evaluation system most similar to the strategic plan model of CRA exams. While the FHFA should strengthen aspects of its proposal, the overall concept is appealing and can allow for more refined measurements of financing housing for various subgroups in the population, particularly traditionally underserved or isolated communities.

The importance of affordable housing goals for the hybrid institutions and CRA for banks cannot be underestimated. It is unlikely that the private financial sector would serve as many low- and moderate-income and minority communities if the affordable housing goals and CRA were repealed. Without the affordable housing goals and CRA, it would seem that federal policy would then be suggesting that blue-collar borrowers should only get their loans from the government, which is not optimal from the perspectives of economic efficiency or equity.

Fifth, lawmakers should limit the total market share that each hybrid institution can capture. The market share limit can be specified in statute or regulation. Alternatively, the existing GSEs can be broken up into three or more hybrid institutions. A greater number of smaller hybrid institutions will limit systemic risk since no one hybrid institution can expose the financial system to as much danger as large institutions did during this current crisis.

The GSEs were a great example of the private sector and the government working together to insure a strong and vibrant system of housing finance. Reliance alone on a government funded affordable housing program will wax and wane with each election. A financially inclusive society and economy cannot prevail without the clear and meaningful participation of the private financial sector facilitated by hybrid secondary market institutions.

How Should the Housing Finance System Support Sound Practices and the Best Way for the Housing Finance System to Ensure Consumers are Protected Against Unfair Practices

In response to the Treasury Department ("Treasury") and HUD's questions about supporting sound practices and protecting consumers against unfair practices, NCRC believes that federal regulatory agencies must rigorously implement the comprehensive anti-predatory lending protections of the Dodd-Frank bill across the financial industry. The new Bureau of Consumer Financial Protection has a broad mandate to develop strong anti-predatory lending protections and apply the protections across a large swath of the lending industry. The Bureau will have to rely on vigorous enforcement of the current federal bank agencies in the case of banks with assets of under $10 billion. As stated above, the Administration and Congress must resume the unfinished business of addressing the future of the GSEs and ensuring that the same anti-predatory regulations apply to the GSEs as well as primary market institutions.

At the same time, the CRA must be broadly applied across the financial industry. CRA will ensure access to credit and banking services by requiring that institutions serve communities consistent with safety and soundness. Attached to this comment letter is NCRC's CRA testimony submitted for the federal agencies hearings this summer on CRA. The testimony describes in detail how to update CRA and expand CRA's reach in order to leverage hundreds of billions of loans and investments for traditionally underserved communities.

In Conclusion

NCRC appreciates the opportunity to comment on this important matter. Treasury and HUD should recommend reconstituting the GSEs as hybrid secondary market institutions, with stronger oversight and limited, defined backing, so that the objectives of liquidity, stability, and access can be attained. In addition, the uniform application of anti-predatory and CRA requirements across the financial industry will ensure access to safe and sound credit, capital, and banking services for traditionally underserved communities.

If you have any questions, please free to contact me or Josh Silver, Vice President of Research and Policy on 202-628-8866.

Sincerely,

John Taylor
President and CEO

Endnotes

[1] See Ingrid Gould Ellen, John Napier Tye, and Mark A. Willis, *Improving the U.S. Housing Finance through Reform of Fannie Mae and Freddie Mac: Assessing the Options*, May 2010, published by the Furman Center for Real Estate and Urban Policy, New York University.

[2] Patrick Boxall, KRA Corporation, and Joshua Silver, NCRC, "Performance of the GSEs at the Metropolitan Level," in Cityscape: A Journal of Policy Development and Reseaarch, Fannie Mae and Freddie Mac in the Housing Finance System, Volume 5, Number 3, 2001, published by the Department of Housing and Urban Development, Office of Policy Development and Research.

[3] These two paragraphs below are from NCRC's 2004 comment on HUD's proposed affordable housing goals. The new regulator still proposes standards that are too weak, disallowing goals credit for loans that violate the interagency guidance on subprime and non-traditional lending; we pointed out that the 2008 Federal Reserve Regulation Z and HOEPA update is stronger and should be the standard used by the FHFA.

NCRC is disappointed that HUD is not proposing additional protections against predatory lending. In the 2000 rulemaking, HUD established important safeguards against abusive lending. As a result of the 2000 rulemaking, the GSEs cannot count loans towards their affordable housing goals if the loans have points and fees of more than 5 percent of the loan amount, if the loans contain single premium credit insurance, or if the loans are subprime and are made to borrowers creditworthy for prime loans.[3] Since the 2000 rulemaking, the GSEs have voluntarily adopted additional protections including purchasing no subprime loans with mandatory arbitration or loans with prepayment penalties beyond three years. At the very least, HUD must codify these GSE promises in the affordable housing goals.

HUD asks the general public if the agency should establish a statistical procedure for estimating borrower income for loans without borrower income reported. HUD notes that the GSEs have been purchasing a larger share of "no income" documentation loans in recent years. Instead of establishing a new statistical procedure, HUD should prohibit the GSEs from purchasing "no income" documentation subprime loans as part of their affordable housing goals. In a recent rulemaking, the Federal Reserve Board effectively prohibited lenders from making "no income" documentation loans with high interest rates exceeding the triggers established by the Home Ownership and Equity Protection Act (HOEPA). The Federal Reserve was concerned that lenders making these high cost loans were not considering borrower ability to repay the loans. Similarly, HUD should disallow "no income" documentation subprime loans from counting towards the GSE affordable housing goals.

[4] OCC and OTS Mortgage Metrics Report, First Quarter, 2010, http://www.occ.gov/ftp/release/2010-69a.pdf

[5] See http://www.ncrc.org/images/stories/pdf/research/ncrc_foreclosure_paper_final.pdf for a copy of the NCRC study.

[6] See Ellen, Tye, and Willis, op. cit, page 10.

[7] See Ellen, Tye, and Willis, op. cit, page 13.