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before

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hearing on

"The Private Mortgage Market Investment Act"

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Good morning Chairman Garrett, Ranking Member Waters, and members of the subcommittee. I am Janneke Ratcliffe, a Senior Research Fellow at the Center for American Progress Action Fund and the executive director for the Center for Community Capital at the University of North Carolina at Chapel Hill.

Thank you for the opportunity to testify today about the draft Private Mortgage Market Investment Act, which addresses a number of the important challenges that must be overcome to restore a well-functioning system of housing finance in America. I am honored to speak as a member of the Mortgage Finance Working Group, a group of mortgage finance experts convened by CAP who have authored a plan for responsible mortgage finance reform. Though I will summarize many aspects of that proposal in this testimony, I speak only for myself in any views expressed here today. I also offer my thanks to CAP's John Griffith for his assistance in preparing this testimony.

I will speak today about the discussion draft and how the regulatory framework it offers might fit in the broader mortgage finance system. The Mortgage Finance Working Group proposal, like most others, aims to have private capital at-risk play a much greater role in the market than it is playing today. In order for that to happen, investor confidence in non-guaranteed securities must be restored, and the bill lays out several steps that will be helpful to that objective.

Most importantly, this bill recognizes that the federal government is critical to a well-functioning mortgage market—even a purely private one—for both writing the rulebook and refereeing when the game begins. If implemented a decade ago, many of these thoughtful oversight measures likely would have staved off the bubble and bust of the mid 2000s and resulting financial crisis. I'm pleased to see the regulation of private mortgage-backed securities finally garnering the congressional attention it deserves.

While I applaud many of the solutions identified in this bill, other provisions raise questions that merit further analysis and modification. I'll also identify some significant concerns and limitations of the draft bill.

Specifically, I will discuss the following:

- Congress should focus on incremental steps for bringing back private investor confidence so the government sponsored enterprises, or GSEs, can stop serving borrowers and market segments that don't need them. But some government role in ensuring liquidity and access remains critical for the majority of the $11 trillion mortgage market. It would be unwise to pull the rug out from under the market by scaling back this support too quickly.

- Standardization of products, terms, and conditions is absolutely critical, but there are serious dangers to relying too heavily on borrower-based risk assessments and ignoring other loan features and delivery channels that are proven risk indicators. Borrower-related risk criteria are not always reliable determinants of default, and the last thing we want is to repeat the mistake of consigning borrowers with fewer resources to higher-risk, higher-cost products.

- Consumer protections, transparency requirements, and loan-level disclosures are welcomed changes to the private-label securities, or PLS, market. But they could potentially have a negative impact on the "to be announced," or TBA market, making this regime a useful complement but not a viable substitute for the conforming loan market.

- Certain provisions of the draft bill are problematic and ought to be reconsidered, including the proposals to strike the risk retention requirements, ban principal reduction initiatives across the government, and change qualifying mortgage rules.

- Some fundamental questions need to be addressed, including issues surrounding choosing the best regulator to fulfill the mandate and how this bill fits in with other GSE reform proposals currently before this subcommittee.

- Other critical next steps toward a more responsible system of U.S. housing finance.

The Private Mortgage Market Investment Act outlines many aspects of a robust regulatory framework. But in my view, these rules simply cannot be the government's only role in the mortgage market. In addition to a capable and empowered regulator, the market depends on a limited, explicit government guarantee to ensure liquidity, affordability, and equitable access for borrowers. I will discuss how we can achieve this later in this testimony.

Even if my colleagues on this panel and I disagree about the end goals of GSE reform, or what future role the federal government should have in the housing market, most of us can agree that government's role in the market needs to be reduced and private at-risk capital needs to play a far greater role. And many preliminary steps toward just about any new housing finance system are the same, as recently pointed out by former Treasury Assistant Secretary for Economic Policy Phillip Swagel.[1] These steps include setting new rules for the PLS market, setting an explicit price for any government guarantee, and narrowing the scope of mortgages eligible for government insurance.

Standardization is key, but must be done carefully

My colleagues and I seem to agree that standardization and transparency are necessary to give investors the confidence to begin investing in private mortgage-backed securities again. Establishing clear and reasonable regulations for the PLS market is a vital step forward.

Four years after the housing crisis began, investors are still slow to re-enter the PLS market. And for good reason: Years of excessive risk-taking and under-regulated lending as the housing bubble grew have shattered investor confidence in the private securities market.

In recent testimony before this subcommittee, the Association of Mortgage Investors identified several problems hindering private mortgage securitization today. These included a lack of standardization and uniformity, a "thorough lack of transparency," conflicts of interest, and "antiquated, defective, and improper" mortgage servicing. [2] These are rare instances in which both investors and homeowners agree that market reform is necessary.

As the GSEs take tentative steps toward pulling back their role, Congress must take meaningful strides toward restoring confidence on the private side by laying out clear rules for the game, which seems to be the primary focus of the Private Mortgage Market Investment Act.

I applaud the authors for making standardization and transparency a cornerstone of this bill. It tasks the Federal Housing Finance Agency, or FHFA, with developing a standard model for securitization agreements, including explicit standards for pooling and servicing, purchase and sale, representations and warrantees, and indemnifications and remedies, based largely on models established by Fannie Mae and Freddie Mac. If done well, this will provide the clarity and protections necessary for investors to re-enter the market, one of the government's most important roles in the secondary mortgage market.

The bill tasks FHFA with prescribing broad risk classifications for mortgages, with the laudable goal of enabling a TBA market in which most agency mortgage-backed securities, or MBS, are sold today. Through this market, sellers agree to a future sale price but do not specify exactly which loans will be delivered to the buyer until a few days before the settlement date. Many market-reform proposals, including our own, recognize the importance of maintaining this efficient forward market, which reduces costs and enables borrowers to know what rate they will be paying well before they get to the closing table.

The agency TBA market works because of homogeneity and scale. That homogeneity stems from several factors, including guaranteed cash flows of principal and interest, standardized underwriting and securitization practices, the fact that there are only two issuers, and the simplicity of the securities.[3] Many—but not all—of these factors can be replicated in the private market through the measures outlined in the bill.

One outstanding question is whether the classifications of loans proposed in the bill—as well as the inclusion of multiple private issuers into the market—will work against the liquidity and efficiency of the TBA market. Further, while investor transparency is critical, we must recognize that there is a trade-off between granularity of information and TBA market efficiency. These concerns would be exacerbated in a purely private market segment where MBS carry no federal guarantee. This example underscores a critical point—that we must move incrementally and that this bill does not offer a viable replacement for the GSEs.

Nonetheless, I agree it is time to get moving, test an approach such as this, and start building a new private mortgage market that is efficient and sustainable.

Classifying loans by product characteristics—also known a loan payment terms—is essential for evaluating both cash flows and credit risk, and should be moved front and center in the process of establishing risk classifications. Moreover, delivery channel is not mentioned but should be included in the top factors considered.

Research has confirmed that product and channel characteristics in and of themselves contribute to risk. Our research at UNC finds that prepayment penalties, adjustable interest rates, balloon payments, and broker origination substantially increase the likelihood of default even when controlling for borrower characteristics like credit score and loan-to-value ratio.[4] In fact, subprime loans were three to five times more likely to default than loans to comparable borrowers originated under a community reinvestment program.[5]

Research from the Federal Reserve Bank of San Francisco further supports the importance of loan characteristics, which found that higher-priced loans tripled the likelihood of foreclosure after controlling for borrower characteristics.[6] I particularly commend the proposal for demarking the 30-year fixed-rate mortgage category, which has been demonstrated to be a more sustainable mortgage and has been the building block for middle-class economic security in this country since its introduction in the 1930s.

However, the consideration of borrower-based criteria—debt-to-income ratio, loan-to-value ratio, and credit history—is problematic. The provisions in the bill on borrower-based risk criteria potentially raise many of the same problems as the regulators' proposed definition of so-called quality residential mortgages, or QRM, under the Dodd-Frank Act, which exempt certain loans from risk retention requirements. Namely, borrower-based underwriting rules risk excluding many creditworthy borrowers, or at least consigning them to high-cost loans.

Along those lines, I have specific concerns about each of the proposed cutoffs for borrower-based risk:

- *Debt-to-income ratio*. Intuitively, the ratio of debt payments-to-income, or DTI, would seem a good predictor of default risk; in practice, the ratio has been unreliable. The poor predictive power of DTI is because of several factors, including the fact that it is hard to arrive at a standard calculation, and it is highly variable over time even though cutoffs fall within a narrow range. DTI is neither precise, accurate, nor constant. Yet, in the risk retention NPR, FHFA notes that DTI ratios are the most restrictive factor within the proposed QRM definition.[7]

- *Credit history.* Following the example of the risk retention NPR, credit history thresholds should not be based on proprietary black-box scoring models, and should encourage lenders to review the actual credit history of borrowers. However, I am not aware of any evidence to support the proposed rigid single 60-day late exclusion. FICO finds that certain borrowers with credit scores in the 500 range would satisfy the standard, while others with scores over 800 would not. In fact, FICO estimates that 7.65 million consumers with FICO scores above 690 who got loans between 2005 and 2008 would have failed to meet the QRM credit history criteria.[8] Further, setting such a bar imposes disparate disadvantages on demographic groups, such as African Americans and Latinos, individuals younger than age 30, and recent immigrants.

- *Loan-to-value ratio*. The correlation between loan-to-value ratio and default is clearer than for debt-to-income. At the very least, higher equity provides a cushion so that when a borrower encounters an adverse event like income loss, the borrower can sell the home for at least enough to pay the mortgage and selling expenses, rather than default. However, there is ample evidence that high LTV lending can be done safely. And that's good news, because requiring borrowers to make 20 percent down payments would effectively shut down the housing market, at a time when 65 percent of borrowers put down less than 20 percent.[9] One such example is in the mortgage insurance sector, mentioned in bill as a factor the regulator should consider in creating loan classifications. There is evidence that loans with mortgage insurance had lower default rates and higher cure rates than low down-payment loans with purchase money seconds, even after controlling for a long list of risk factors.[10] [11] Moreover, mortgage insurers' countercyclical capital requirements encourage stockpiling of reserves in stronger markets to pay claims under weaker economic conditions.[12]

Despite the rhetoric of some, there are several examples of sustainable high LTV lending models. Here are a few:

- *Self-Help's Community Advantage Program:* Since launching in 1998 by Self-Help in partnership with Fannie Mae and the Ford Foundation, this program has funded nearly 50,000 mortgages nationwide. The UNC Center for Community Capital has been studying this portfolio for nearly a decade.[13] The risk profile of these mortgages looks daunting, especially by today's standards: 39 percent had a credit score at origination of 660 or less and 80 percent of the borrowers put down less than 10 percent, including 69 percent who put down less than 5 percent. Yet to date, just 5.5 percent of the loans have ended in foreclosure for Self-Help, who retained recourse on the mortgages. Meanwhile, the median CAP owner has accumulated more than $16,800 in equity from origination through the first quarter of 2011.

- *Massachusetts Housing Partnership's SoftSecond Program:* Massachusetts Housing Partnership has operated the SoftSecond Loan Program since 1990, financing over 15,000 home purchases, typically at 97 percent LTV. The program targets households earning less than 60 percent of area median income. Yet, as delinquencies peaked in the summer of 2010, the SoftSecond program had a foreclosure rate of just 1 percent. For comparison, the foreclosure rate for prime loans in Massachusetts was 2.1 percent, and for subprime loans it was 13.6 percent.

Furthermore, soft-second liens and other forms of bona fide down payment assistance should be favored—and certainly not penalized—by the proposed restrictions on second liens. These flexible loans can ensure successful homeownership experiences by preserving the liquidity of household financial assets, which is especially important for lower-income households in covering unexpected expenses that sometimes arise. A recent survey by the Center for Community Capital of 117 housing counselors nationwide found that 54 percent were seeing frequent use of soft second mortgages or down payment assistance programs.[14] These programs are important in today's fragile market

Borrower-related criteria for determining risk classifications are not always reliable determinants of defaults. But driving certain borrowers to costlier channels can increase the risk of default of those borrowers, simply by virtue of the loan terms and conditions. The last thing we want to do is repeat the mistake of consigning borrowers with fewer resources to higher risk, higher-cost products—or as former Federal Reserve Board Governor Ned Gramlich once put it, continuing a trend where "the most risky loan products [are] sold to the least sophisticated borrowers."[15]

Though it is unclear at this early stage how the categories will be set, it is clear that it will be a challenge to get right. There is real risk that the outcome duplicates or even worsens the problems raised by the QRM proposal, which have driven so much of the critique of the regulators' proposed risk-retention rule.

The goal of mortgage market reform should not be to partition the market and make some segments more expensive—and thus riskier—than others, but to ensure its sustainability in its entirety. That requires ensuring that sustainable loan products are the preferred option for creditworthy but less well-resourced borrowers, and proceeding with caution in creating multitrack markets. It also underscores why it is essential to approach reform incrementally and maintain the government support that's necessary to make the market work.

New consumer protections and transparency requirements are welcomed changes

While the bill does not directly address consumer protections, it does take steps to better serve investors, especially regarding servicer issues. Most servicing today is done within large financial holding companies, many of which have affiliates who hold second liens in the form of home equity loans and other products. This often leads to a compelling conflict of interest in which servicers of a mortgage also own the second lien—an arrangement in which consumers historically come third behind investors and servicers.

The bill establishes important consumer protections by prohibiting servicers from owning a second lien when they are servicing the first lien of the same mortgage. This will help restore consumer confidence in the PLS market by ensuring that servicers' other interests are not put before their duty to minimize investor losses.[16]

One notable question, however, is how the provisions on ex-post second liens will be implemented. I urge this subcommittee not to constrain the legitimate use of accumulated housing wealth for such purposes as paying for college education, forming a small business, or meeting major unplanned needs.

Moreover, as I previously noted, such provisions should favor the use of legitimate down payment assistance and soft-second mechanisms.

Another boost to consumer confidence comes from the bill's enhanced transparency and loan-level disclosure requirements. For too long investors in the PLS market were kept in the dark about the risks they were taking. Reliable information on product pricing and loan-level risk will force all market participants to do their business in the light of day, and help FHFA and other regulators mitigate fraud and abuse.

More granular loan-level information and standardization is critical to the re-emergence of a competitive and efficient private mortgage-backed securities market. The American Securitization Forum recognizes this in its Project on Residential Securitization Transparency and Reporting Restart, launched in July 2008, calling for loan level reporting of some 160 data points on each loan as well as new standards for bond-level reporting.[17]

To be sure, even with loan level data, product standardization, and correcting servicer/second-lien-holder conflicts, investors will still be exposed to principal-agent problems and other conflicts of interest.[18] Originators and issuers will still have access to greater information than investors can observe. Among the problems that will not be solved by provision of data is adverse selection—where originators/issuers may choose a different execution for loans they know to be of different risks. Moreover, detailed information does not assure that the right conclusions will be reached and the right decisions made. Weaknesses in the ratings process of the credit rating agencies [19] and the fact that investors and insurers misapplied sophisticated financial models [20] are well documented.

Despite these imperfections and unintended consequences, greater transparency in the PLS market is still a noble goal for Congress to pursue. And I believe the bill's current language is a helpful starting point to discuss how to strike the necessary balance of market efficiency and consumer protection.

However, investor transparency is not a perfect substitute for risk retention, which brings me to a concern.

Instead of repealing risk retention requirements, adapt a broad QRM standard

The bill would effectively strike down Section 941 of the Dodd-Frank Act by prohibiting the Office of the Comptroller of the Currency, the Federal Reserve, Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, and the Security and Exchange Commission from issuing any rule or regulation to require risk retention. This provision ratchets back more than a year of progress in bringing greater accountability to the mortgage market.

As mentioned above, the bill gives the regulator authority to develop representation and warrantee standards and remedies; I urge that these be meaningful and actionable, so that they do result in real accountability. Yet there can be no greater accountability than for agents to have a financial stake in the success of the loan. Even small amounts of risk retention can align the economic interests of borrowers and investors with the agents in between them while building some flexibility into the system.

But risk retention is a complex tool with a high potential for unintended consequences, as demonstrated by recent challenges faced while implementing Dodd-Frank over the past year. In commenting on the notice of proposed rulemaking implementing Dodd-Frank's risk-retention requirements, I urge regulators to reconsider applying risk factors that would greatly and disparately limit market access. Regulators should enact a broad definition of QRM.

Given the fragility of the current market, a broad QRM has the potential to restore access to credit more equitably, support broader homeownership and help the private market recover, without compromising systemic safety and soundness.

A key rationale for a broad QRM definition is that the future landscape of the mortgage market will be much less risky than the practices that prevailed in the mid-2000s. Any policy based on recent historic defaults should take into account the complementary regulations that will constrain the abusive lending that capsized the market. To name a few, the Federal Reserve used its authority to ban yield spread premiums based on selling higher-rate loans, and other forms of "steering" consumers into loans not in their best interests. The SEC recently proposed new rules to increase transparency and standardize credit analysis at rating agencies.[21] Dodd-Frank will bring greater regulation, standardization, and transparency to derivatives.[22] The Consumer Financial Protection Bureau will provide ongoing oversight of consumer financial products. And Section 1411 of Dodd-Frank creates a new minimum ability to repay standard for all mortgages.

Importantly, a broad QRM standard will go quite some ways toward addressing other concerns raised about the risk-retention proposed rule,[23] simply by greatly reducing the universe of non-QRM loans.

The Dodd-Frank Act is critical to moving toward a stable, fair, and responsible secondary mortgage market. The act identifies several key steps to safety and soundness and avoiding a similar debacle in the future. Those provisions should be preserved as is, and regulators should continue to translate the legislative text into reasonable and unambiguous rules.

Other provisions that should be reconsidered

The bill oversteps its intended goal of "ensuring the rule of law" by prohibiting any federal department or agency from requiring principal reduction for any securitized mortgage loan. With about 11 million properties currently underwater, roughly 22 percent of all U.S. homes, housing debt remains one of the biggest drags on demand for goods and services in our economy.[24] Families that are underwater on mortgages are digging their way out of debt, not spending in stores. And the more low- and moderate-income families spend on housing, the less they spend on clothes, food, and other consumer goods, making businesses leery of investment.

To date, the number of principal reduction modifications has been miniscule. Large-scale principal reduction may be politically controversial, but it has enormous potential for stabilizing the leaden housing market and spurring broader economic growth. It is also well within the current regulatory powers of FHFA as the conservator of Fannie Mae and Freddie Mac. That's why many industry experts and prominent academics have called for some sort of principal reduction strategy, including current Chairman of the Federal Reserve Ben Bernanke,[25] former Fed Vice Chairman Alan Blinder,[26] and former Chairman of President Reagan's Council of Economic Advisers Martin Feldstein.[27]

To be sure, there are legitimate concerns with any principal reduction initiative, and such a program would have to be carefully crafted to limit potential losses to investors and taxpayers and manage moral hazard. But it would be unwise for Congress to prohibit any such program from seeing the light of day.

There's also a critical question of whether this prohibition applies just to new mortgage loans or to all existing loans, and whether it includes judicial modifications, which are currently allowed. The latter is especially relevant today, as principal write-downs are likely to be a key component of upcoming settlements between state attorneys general and mortgage servicers accused of faulty foreclosure practices.[28]

Another concern is the proposed changes to the Qualified Mortgage, which strike the rebuttable presumption approach in favor of the safe harbor approach. Regrettably, the events leading to the mortgage crisis made it necessary for Congress to mandate that lenders verify ability to repay when extending mortgage credit.

To avoid a repeat, it is in the best interest of borrowers and investors alike that the markets have accountability, which is better achieved through a rebuttable presumption with reasonable remedies, rather than through the immunity provided by a safe harbor. This is particularly true because the proposed safe-harbor approach does not even require lenders to consider such tried and true factors as employment status, debt levels, debt to income, and credit history. Under the rebuttable presumption, however, the lender still has the responsibility checking what is readily knowable, and proving they did so. With appropriate regulatory guidance, it need not be unduly burdensome to require lenders to make certain checks and to be accountable to investors for doing so.

I have significant concerns over any provision that would give blanket immunity given the lessons learned and the need to restore market confidence. It also seems to remove the CFBP jurisdiction to adjust QM rules, which should be reconsidered. A rebuttable presumption would signal to investors and consumers alike that this mortgage has been properly designed and underwritten; a safe harbor would not, thus defeating the purpose of the QM.

Unanswered questions

There are some provisions in the bill that need to be fleshed out before we can assess the possible impact on investors, borrowers, or the broader mortgage market. The draft only just became available, so we have not had a chance to complete a full assessment, but I raise these issues requiring further inquiry and discussion.

First, is the Federal Housing Finance Agency the best institution to head such a robust regulatory agenda, and what are the implications of reducing the role of the SEC and other agencies? To be sure, FHFA has dutifully fulfilled its mandate as regulator and conservator of Fannie Mae and Freddie Mac since 2008. But I see little evidence that the agency has the expertise or resources necessary to assess risk and loan quality for the notoriously complicated PLS market, which is almost certain to grow in the coming years.

Since the passage of the Dodd-Frank Act, the Security and Exchange Commission has made substantial changes to its regulatory framework for residential asset-backed securities. For example, the agency has proposed rules to prohibit conflicts of interest between securitizers and investors, beefed up disclosure requirements for issuers, and adopted new rules around representations and warranties.[29] Admittedly, FHFA is likely better suited to sort out the technical issues in the mortgage-backed security market, and well positioned to prevent the private-label market from destabilizing the other sectors as it did in 2007. But it would be a shame to see all this progress unwound as a result of this legislation.

Regardless of which agency is deemed suitable to regulate the PLS market, I urge Congress to incorporate the advancements made since enactment of Dodd-Frank, and to equip the agency with the resources, personnel, and systems necessary to carry out such a daunting and critical mandate. Moreover, Congress should not overlook the question of how to adequately fund the regulator to carry out this work.

Second, the bill mentions nothing about the multifamily mortgage market. It is projected that the shortage in affordable rental housing is only going to be exacerbated in the wake of the foreclosure crisis. Over the next 30 years, we may need to add more than 40 million new housing units of all types to meet the demand. We cannot get on track without a strong rental housing finance system. If this bill were to be enacted, how would the multifamily market continue to operate, particularly if the GSEs are wound down?

Finally, it's unclear to me how the authors intend this bill to fit into other proposals for GSE reform currently under consideration in the subcommittee. The House majority has drafted 15 bills to wind down different aspects of Fannie Mae and Freddie Mac's current business, and industry experts and notable academics have proposed a bevy of other policy alternatives. Is this bill intended to work in tandem with these other bills? Or is it simply intended to replace the current GSE model, leaving the federal government with only a regulatory role in the mortgage market? The language in the bill does not explicitly say.

If this is indeed intended to replace the GSE model, there appear to be many gaps in the regulatory coverage, which I address in more detail below.

Next steps toward a more responsible market for housing finance

As mentioned above, with some substantial changes this bill marks an important first step toward broader GSE reform. But it cannot be the only step. While standardization and transparency are essential to a well-functioning U.S. mortgage market, they are not enough. Our Mortgage Finance Working Group proposal is built on five key principles: liquidity, stability, standards and transparency, affordability, and consumer protection.

Any new system of mortgage finance must be based on lessons learned in the past. History has shown us that a housing finance system left to private markets will be subject to a level of volatility that is not systemically tolerable, given the importance of housing to the economy and to the American family.

The past decade exposed serious flaws in our housing finance architecture.[30] The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost.

The housing bubble was driven by the development of a "shadow banking system" in which mortgage lending and securitization was largely unregulated and certainly undisciplined. In time, this system drew in the quasi-governmental entities Fannie Mae and Freddie Mac who increased their own overall risk during the "race to the bottom" that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses. The new system must be designed to avoid the same pitfalls in the future.

Five principles of a new system of U.S. housing finance

First, there must be broad and constant liquidity. The new system needs to provide investors the confidence to deliver a reliable supply of capital to ensure access to mortgage credit for both rental and homeownership options, every day and in every community, during all kinds of different economic conditions, through large and small lenders alike.

Broad and constant liquidity also requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. The capital markets have therefore come to play an essential role in mortgage finance. But as the past decade so stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at other times with devastating effects on the entire economy.

Second, any new system must foster financial stability. Stability is achieved by reining in excessive risk-taking and promoting reasonable products and sufficient capital to protect our macro economy and household economies from destructive boom-bust cycles. A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause significant wealth destruction that brings with it devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the broader economy.

Private mortgage lending is inherently procyclical. As we saw in the previous decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a "race to the bottom" that threatens the entire economy. Stability for the market requires sources of countercyclical liquidity even during economic downturns.

Third, transparency and standardization will support these other principles. Underwriting and documentation standards must be clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk and regulators can hold institutions accountable for maintaining an appropriate level of capital. During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products that could not be understood by consumers at one end of the chain to securities that could not be understood by investors at the other. The lack of transparency and standardization set the stage for adverse selection because the issuers knew more than the investors.

Because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all mortgage-backed securities in the marketplace. A private mortgage-backed securities market will not reemerge unless investors are convinced these issues have been resolved. Secondary market transparency and standardization lower costs and increase availability. And for borrowers, standardization and transparency mean that they can make good choices from among well-understood and standard mortgage products.

Fourth, the system must ensure access to reasonably priced financing for both homeownership and rental housing. Liquidity and stability are essential to affordability and, for most families, the lower housing costs produced by the modern mortgage finance system over the past half century (before the recent crises) facilitated wealth building, enabling them to build equity, save, and invest. This contributed to the building of a strong middle class and has been an important guiding concept in modern U.S. housing finance policy—and a key component of the American socioeconomic mobility of the 20th century.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, pre-payable mortgages, such as the 30-year mortgage. The long term of this loan provides borrowers with an affordable payment while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility. In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to the nation's middle class, which has been so effectively served by 30-year residential mortgages, and to the nation's many renters who rely on multifamily property owners' ability to finance and refinance their apartment buildings.

A responsible plan recognizes the interdependency of all segments of the mortgage market and calls for a coherent array of government supports—from regulations and standards to limited security guarantees to loan guarantees to subsidies to direct funding. We have learned the lesson of how failures in one sector—for example, the private-label market—spill over into the other sectors. Likewise, we know that when one particular segment functions well, it can have positive spillover for the rest of the market. For example, sustainable affordable lending creates a strong and accessible housing ladder today that means a strong move-up market tomorrow. Therefore, it is in the interest of all segments to support activities that create sustainable rungs on that ladder. Moreover, government oversight will facilitate efficiency and liquidity in the "pure-private" market, resulting in economic benefits to investors, lenders, and consumers in this market, and these benefits should be taken into account.

Finally, the system must support the long-term best interest of all borrowers and consumers and protect against predatory practices. The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also deliver devastating consequences to communities, the financial markets, and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans instead of the safer, lower-cost products.

The Mortgage Finance Working Group's plan

The Private Mortgage Market Investment Act takes noteworthy strides toward the third principle: transparency and standardization. After improving and passing this bill, it'll be time to move on to the other four.

The Mortgage Finance Working Group's "Plan for a Responsible Market" strikes the necessary balance between private investment and government support in the secondary mortgage market.

First, we call for a larger role for a pure private market, one that will serve those borrowers who have the resources to access mortgage capital under reasonable terms and conditions without any support—other than regulatory protections—from the government.

For the middle market, our proposal creates a system that preserves the traditional roles of originators and private mortgage insurers but assigns functions previously provided by Fannie Mae and Freddie Mac to three different actors—issuers; chartered mortgage institutions, or CMIs; and a catastrophic risk insurance fund, or CRIF.

Issuers will originate or purchase and pool loans, issue MBS, and may purchase credit insurance on MBSs that meets certain standards from CMIs. CMIs also will be fully private institutions not owned or controlled by originators. They will be chartered and regulated by a federal agency and their function would be to assure investors of timely payment of principal and interest only on MBSs that are eligible for the government guarantee.

The CRIF would be an on-budget fund (similar to the FDIC's Deposit Insurance Fund) that is run by the government, and funded by premiums on CMI-guaranteed MBSs. In the event of the CMI's financial failure, the explicit guarantee provided by the CRIF would protect only the interests of holders of only qualified CMI securities.

The government would price and issue the catastrophic guarantee, collect the premium, and administer the fund. The fund would establish the product structure and underwriting standards for mortgages that can be put into guaranteed securities and the securitization standards for MBSs guaranteed by the CMIs. The government would also establish reserving and capital requirements for CMIs, and these would be at higher levels than those held by Fannie and Freddie.

It is important to note that under our plan, private capital would play a far greater role, with the government role restricted to filling in gaps where needed to ensure each market section can function efficiently. For the traditional conforming conventional market, there would be several layers of protection standing ahead of any taxpayer exposure. Borrower equity, the CMI's capital, and in some cases private mortgage insurance all would stand ahead of the CRIF. All of these private sources of funds would need to be exhausted before the CRIF would have any exposure to loss. We believe this system will serve the needs of the vast majority of households that are looking for the consistent availability of affordable credit and predictable housing costs that can be achieved through a limited government market backstop.

I believe that many aspects of the regulation of private-label securities under the Private Mortgage Market Investment Act align with the Mortgage Finance Working Group's model for the future. At the very least, the bill lays out the rules for the private-label security market, in which issuers would package and sell MBSs without a government guarantee. With some minor modifications, these rules can also govern the activities of the newly chartered CMIs.

In closing, I would like to commend the chairman and the other members of this subcommittee for holding this hearing. As Congress and the administration work to design a better system of housing finance for the future, it's critical to make sure the rules of the game are laid out clearly and fairly before anyone can be expected to start playing again. I believe the Private Mortgage Market Investment Act as drafted is a helpful starting point for negotiating those rules, but it must be seen as only a first step toward broader GSE reform. I would be happy to take any questions.

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