CONSUMER MORTGAGE COALITION

June 1, 2009

Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
1700 G Street, N.W.
Washington, D.C. 20552
RegComments@fhfa.gov

Re: Portfolio Holdings IFR/RFC
RIN 2590-AA22

Dear Mr. Pollard:

The Consumer Mortgage Coalition (CMC), a trade association of national mortgage lenders, servicers, and service providers, appreciates the opportunity to submit its comments in response to the Federal Housing Finance Agency's (FHFA) proposed rulemaking regarding the portfolio holdings of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.

I. Background

Congress enacted major reform of the regulation of the GSEs with the Housing and Economic Recovery Act of 2008 (HERA).[1] Among many other significant reforms, the law requires the Director of FHFA to regulate the GSEs' investment portfolios.

> The Director shall, by regulation, establish criteria governing the portfolio holdings of the enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises. In establishing such criteria, the Director shall consider the ability of the enterprises to provide a liquid secondary market through securitization activities, the portfolio holdings in relation to the overall mortgage market, and adherence to the standards specified in section 1313B.[2]

HERA also provides the Director more flexible authority to temporarily adjust the GSEs' portfolios without the need for a rulemaking process.

[1] Pub. L. No. 110-289, 122 Stat. 2654.
[2] HERA § 1109(a), 122 Stat 2654, 2675 (to be codified at 12 U.S.C. § 4624(a)).

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> The Director may, by order, make temporary adjustments to the established standards for an enterprise or both enterprises, such as during times of economic distress or market disruption. . . . The Director shall monitor the portfolio of each enterprise. Pursuant to subsection (a) and notwithstanding the capital classifications of the enterprises, the Director may, by order, require an enterprise, under such terms and conditions as the Director determines to be appropriate, to dispose of or acquire any asset, if the Director determines that such action is consistent with the purposes of this Act or any of the authorizing statutes [charter acts].[3]

Congress has directed that the portfolio holdings meet three requirements: they must be –

- backed by sufficient capital;
- consistent with the mission of the GSEs; and
- consistent with safe and sound operations of the enterprises.

In establishing these requirements, the FHFA Director must consider a number of factors, including the ability of the GSEs to provide a liquid secondary market through securitization activities; the portfolio holdings in relation to the overall mortgage market; and the adherence to the prudential management and operation standards of § 1313B.[4]

II. Government Operation of the GSEs Changes The Portfolio Question

Congress enacted HERA before the GSEs were placed into conservatorship. Today, the GSEs effectively are federal government entities with FHFA directing the enterprises' operations as conservator. The United States holds warrants to purchase 79.9% of the common stock of each GSE. The GSEs are both wholly dependent on federal funding to keep the enterprises solvent. The federal government is using the GSEs as its fiscal agent and its compliance agents to implement the Homeowner Affordability and Stability Plan.

The relevant question is no longer whether there is sufficient capital to support the portfolios, or whether the GSEs are safe and sound, questions that, pre-conservatorship, Congress directed FHFA to address. Today, the relevant question is what the government should do with the two GSEs that it now is responsible for operating and whose capital it now fully supplies.

At the risk of stating the obvious, the GSEs' portfolios and their low capital requirements—combined with the fact that the GSEs funded 36% of the subprime market—put the GSEs into their current distressed condition. As FHFA noted:

> Recent events that eventually caused FHFA to place the Enterprises in conservatorship highlight the risks posed by their large mortgage portfolio

[3] HERA § 1109(a), 122 Stat 2654, 2675 (to be codified at 12 U.S.C. § 4624(b) and (c)).
[4] Section 1313B is HERA § 1108, 122 Stat. 2654, 2673 (to be codified at 12 U.S.C. § 4513b).

> holdings and the failure of the Enterprises to hold capital commensurate with the risks posed by those holdings.[5]

The GSEs' portfolios were not designed to resolve some preexisting problem in the mortgage industry. In fact, the GSEs successfully fulfilled their mission of ensuring a liquid and stable secondary mortgage market prior to their decision to grow their portfolios. Even the GSEs recognized that they did not need large portfolios to fulfill their Congressionally-mandated mission. In testimony before Congress in 1989, then Freddie Mac Chairman Leland Brendsel explained that his company refused to increase its portfolio to avoid interest rate risk and to maintain Freddie's safety and soundness, saying:

> "Since inception since 1970 Freddie Mac has had the same strategy, business strategy of avoiding interest rate risk. ...This strategy was started by its founders in 1970, continued on by my predecessors, and I carry on that tradition today."
>
> "We avoid interest rate risks by financing about 95 percent of all the mortgages we purchase with mortgage backed securities. ...As a result we are insulated largely from the squeeze on earnings experiences by most depository institutions when interest rates rise . . . [6]
>
> *   *   *   *
>
> Chairman Pickle [Rep. J.J. Pickle, D-TX]: "[H]ow much extra interest risk would it pose if you began a large portfolio in your lending program? ...What would prevent Freddie Mac, then, from becoming a large portfolio lender, anything? Yes, what?"
>
> Mr. Brendsel: "Me, the board of directors. Let me mention again—"
>
> Chairman Pickle: "'Me' is not 'the law.'"
>
> Mr. Brendsel: "No, I understand Mr. Chairman. The mission of the corporation is to increase the availability and the affordability of mortgage money. ...In order to do that, we must operate in a safe and sound manner..." [7]

According to nearly every government study conducted, the only purpose of the GSEs' portfolios was to enhance returns for private shareholders. It is completely inappropriate for these portfolios to create systemic risk and to put taxpayers at risk of loss for the sole benefit of private shareholders.

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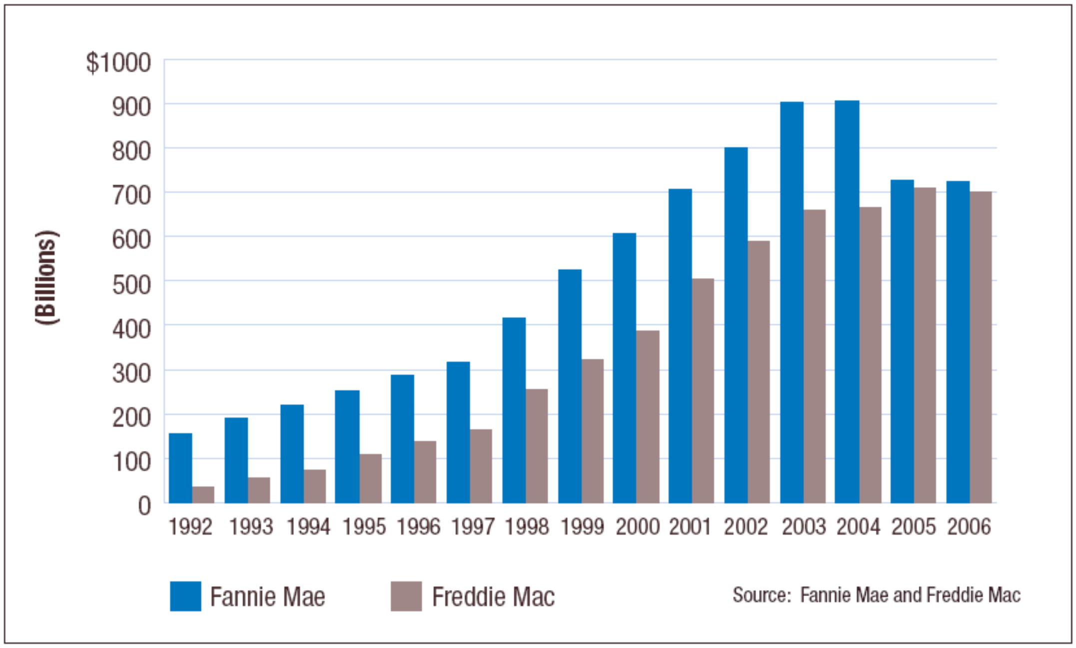
[5] 74 Fed. Reg. 5609, 5612 (January 30, 2009).

[6] "Government-Sponsored Enterprises," Hearing before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, Serial 101-65, September 28, 1989 (Testimony of Leland Brendsel), at p. 55.

[7] *Id*. at p. 99 – 100.

As FHFA notes, and the following chart illustrates, the GSEs' portfolios did not begin their substantial growth until the 1990s.[8]

Mortgage Markets and the GSEs Long Predate the Portfolios



In response to FHFA's second specific question posed in its proposed rulemaking, whether it is possible for the GSEs to fulfill their mission without portfolios of mortgage assets, certainly the answer is yes. Historically, the GSEs have fulfilled their mission from their inception until the 1990s without portfolios.

There is not and never has been any need from a market need for the GSEs to retain large mortgage portfolios. FHFA should, as it announced when the GSEs were placed into conservatorship, mandate the GSEs to direct the run-off of the portfolios over time so as not to disrupt markets, and thereafter only to allow the GSEs to maintain a small portfolio for cash flow purposes in the future. Furthermore, the holdings in that portfolio should be regulated so that the portfolio holdings are invested only in very safe and sound securities, similar to the investment restrictions imposed on the private financial guaranty insurance companies.

The portfolios are not, and never have been, a deliberate federal housing policy or strategy. Rather than design federal housing policy around the GSEs' portfolios, it makes sense to first identify the federal housing policy priorities and then develop an implementation strategy which implements those policies.

[8] 74 Fed. Reg. 5609, 5613 (January 30, 2009). The chart is from a 2007 Office of Federal Housing Enterprise Oversight Report To Congress.

In the third specific question posed in its rulemaking, FHFA asks: Could the federal government better ensure the liquidity and stability of the secondary market other than through GSE portfolios? Again, the answer is clearly yes, and that question is the primary focus of this letter. We begin our analysis by identifying what caused today's problems, then we propose a solution that would address these problems in Section V of this comment letter.

III. Conforming Loan Limit Should be Temporarily Suspended for Loans Below $1 Million Nationwide

While we do not believe that the allowing the GSEs to hold large portfolios would be of any benefit to the mortgage market, it would be most helpful if FHFA and the Administration were to immediately suspend the GSEs' conforming loan limit for loans below $1 million nationwide. This would allow the enterprises to ensure the liquidity and stability of the secondary mortgage market for the spectrum of mortgage loans across the country under $1 million.

Currently, the GSEs are not permitted to guarantee loans that exceed a stated dollar amount, called the conforming loan limit. This limit adjusts for inflation and home size, and is higher in certain geographic areas. Currently, it ranges from $417,000 to $729,750 for one-unit properties. In the past, Congress used the conforming loan limit to require the GSEs to focus their government backing on loans to lower- and middle-income families. In today's distressed mortgage markets, however, this policy is causing market disruptions. Loans above the limit are often quite difficult to finance, and are expensive. Without government support, the non-conforming segment of the mortgage market is dysfunctional.

We recommend that the conforming loan limit be suspended for loans below $1 million while FHFA serves as the GSE conservator so that the GSEs can add liquidity throughout the mortgage market and across the country. The suspension could be lifted to reinstate the conforming loan limit after the mortgage market has stabilized and the GSEs emerge from conservatorship.

If policymakers embrace our recommendations for reforming the structure of the GSEs over the longer term, the GSEs would have a more limited role in the mortgage market and the conforming loan limit would be permanently eliminated, as discussed in Section V of this comment letter.

IV. Problems That Caused the Present Mortgage Industry Crisis

The secondary mortgage market is one of the most significant developments in the history of modern finance. The flow of capital from the secondary market has been a key factor in the record rates of homeownership that our country has seen in recent years. However, the very characteristic of the secondary market that results in a flow of capital to lenders—the transfer of risk—enabled some marginally-capitalized entities to engage in mortgage lending (and related transactions) with an insufficient level of due diligence and very little, if any, capital at risk. In Wall Street parlance, these entities "had no skin in the game." The ultimate investors, to a large extent, relied on the rating agencies—that also had no skin in the game.

In the simplest terms, much of the problem in the mortgage market was that many of those responsible for making loans had too little financial interest in the performance of those loans and many of those with financial interest in the loans had too little involvement in the how the loans were made.

Over much of the last century, savings and loan associations, or "thrifts," originated the bulk of the mortgage loans in the U.S. In the traditional lending model, the thrift solicited deposits from its customers and then loaned that money to other customers to finance home purchases. If the borrower was unable to make his mortgage payment, the thrift would suffer the consequences directly. With the advent of deposit insurance, the depositors were protected and the only risk was to the institution's capital. With limited risk management capability and limited ability to raise deposits outside of their branch network, thrifts were subject to boom and bust cycles, creating erratic and uneven capital flows for mortgage lending.

The secondary market for mortgages was created to separate the process of originating mortgages from the capital required to fund the loans. In the secondary market, the risk of borrower default was transferred to an investor. Investors for the most part, however, were unwilling to take on the risk of borrowers whose credit characteristics were unknown to them. To facilitate the availability of capital, Ginnie Mae, Fannie Mae and Freddie Mac were established. Without getting into the full history or details, the main impact of these agencies was to assume the credit risk of borrowers and enable financial market participants to provide the funding for mortgages.

These agencies, along with private mortgage insurance companies, bore the primary risk of default. To protect themselves, they established underwriting criteria for the types of loans they would own or guarantee. While they did not originate loans (and are prohibited from doing so), these agencies have actively monitored the process of loan origination.

To further insure the performance of purchased loans, the mortgage market developed the practice of requiring representations ("reps") and warranties on purchased loans. These reps and warranties are designed to insure that the loans sold meet the purchaser's underwriting guidelines. This is necessary because mortgage market participants have long recognized that there is substantial risk in acquiring loans originated by someone else. Reps and warranties are only valuable, however, when the providers of those promises have sufficient capital to back up their obligations to repurchase any loans subsequently determined to be inconsistent with the reps and warranties.

Credit rating agencies played a central role by setting criteria to establish credit enhancement levels, which ultimately lead to ratings on bonds. In essence, <u>the rating agencies acted as a gateway to the secondary market</u>.

Rating agencies generally rely upon historical statistical analysis to set ratings. In rating mortgage-backed securities, the agencies typically used measures such as loan-to-value and debt-to-income ratios to make their determinations. While the agencies review the origination practices of the major mortgage banks, they generally do not review loans files or "re-underwrite" the mortgages.

Rating agencies also do not share in the economic cost of loan defaults. The agencies' methodology allowed for the inclusion of loans of dubious quality into subprime mortgage pools, including no- or low-documentation loans that allowed for an enormous amount of fraud to occur. With regard to ratings given to GSE credit-enhanced securities, the rating agencies based their ratings on the fact that the securities were enhanced by a government-sponsored entity, which enjoys an implicit guarantee by the federal government.

Despite warning signs regarding the problems and inherent danger of investing in riskier mortgages, investors continued to invest in this sector as the risks grew and reward decreased because they relied upon the ratings given by the ratings agencies on the securities. If the investment risk were presented in a transparent manner, in almost all cases, the investor could have attained the same level of income at a lower risk level. Once investors are blind to the level of risk inherent in an investment that obfuscates risk, market forces will work to increase the risk of those investments beyond the investors' expectations.

Thus, the primary problem facing the subprime market is a failure of industrial organization. The key risk takers in the market were too far from the origination process. At the origination end, without the discipline of a skeptical buyer, abuses grew. The buyer was not sufficiently concerned with the process of loan origination and the broker was not subject to sufficient constraints or supervision. Stories abound on the amount of fraud that has occurred. The mortgage investor was like an absentee landlord. Without supervision and oversight, there is no constraint on a volume-driven originator, whose compensation is based upon production. These fundamental structural problems of the secondary market have resulted in a dysfunctional mortgage market and staggering losses to end investors and the U.S. taxpayers.

An unintended consequence of the readily available credit provided largely by the marginally-capitalized mortgage market participants was that many borrowers were able to buy homes that they otherwise could not afford. As demand for housing rose, the price of houses soared. When home prices stopped rising, the inadequacy of loan underwriting standards become clear to all market participants.

V. Recommendations for Mortgage Industry Improvements

While we continue to develop our recommendations for the future of the GSEs, the following are our suggestions for reengineering the mortgage finance system at this time.

Mortgage Clearinghouse – Public / Private Joint Venture

The Mortgage Clearinghouse, an at-cost cooperative entity, would be established to standardize, centralize, and enhance the residential mortgage securitization process. (This cooperative would be analogous to the Depository Trust & Clearing Corporation, which provides an efficient and safe way for buyers and sellers of securities to make their exchange, and thus "clear and settle" transactions.)

The purpose of the Mortgage Clearinghouse would be to act as a "gateway" for securitized mortgage loans which would restore liquidity to the securitization market now and maintain the integrity of the market in the future. To accomplish these purposes, the Mortgage Clearinghouse would establish sound and fair loan origination underwriting rules, require sensible data transparency for secondary market investors, and provide financial guaranty reinsurance coverage, backed by effective levels of capital, on the securitizations. The GSEs, in a reconstituted form, along with their private sector partner/investors, would participate by providing some government sponsorship of securitizations, sufficient to support the long-term (e.g., 30-yeear, fixed rate) prepayable consumer mortgage loan. Under this structure, the GSEs would not put taxpayers and financial markets at risk for the benefit of private shareholders.

Fair and Sound Origination Standards

Some of the problems we see today were caused by loan originators who had an incentive to make loans, even inappropriate loans. It is necessary to restrict the types of mortgage loans that can be made to consumers. The Mortgage Clearinghouse would ensure all loans placed in a securitization meet basic underwriting and eligibility standards, established by its board of directors (the Board). These conventions should include fair and sound standards, such as full documentation of income and financial resources, no negative amortization, acceptable loan-to-value ratios, and clear consumer disclosures. All investors would be assured that all loans in the secondary market meet these standards.

Transparent Loan Data for Investors

Secondary market investors need data on the particular characteristics of their investments so they will not need to rely on credit ratings. While rating agencies need enhanced regulation, investors and securitizers should themselves ensure the soundness of loans underlying a securitization. The Mortgage Clearinghouse would make available to all investors standardized data on each loan in a mortgage-backed security. The data must cover both the creditworthiness of the borrowers and the characteristics of the property. The Mortgage Clearinghouse can enhance transparency for investors and improve information efficiency by setting standardized disclosure requirements for loan originators.

Ownership Structure

We suggest that the Mortgage Clearinghouse would be half owned by well-capitalized private investors and half by a government entity, with Board members appointed by the respective parties. We recommend that the government entity be a single GSE resulting from the merger of Fannie Mae and Freddie Mac. We also recommend that the merged

GSE have this role and no other. Because the Mortgage Clearinghouse safeguards are important regardless of loan size, there would be no continuing need for the GSE conforming loan limit. The GSE's presence would facilitate continued federal support of homeownership and the mortgage industry. Investors would put their private capital at risk of loss to prevent today's problems from recurring.

Reinsurance Backed by Capital

The Mortgage Clearinghouse would process securitizations and provide a public/private financial guaranty reinsurance "wrap" on its securitizations, placing the private industry lender owners at risk of loss for the securitizations they sponsor. That responsibility could be shared mutually or could be born individually. Either way, this risk of loss would mean only loans that have a reasonable ability to perform would be able to enter the secondary market. This vehicle does not exist in the market place today.

The GSE participation would ensure that the securities would be liquid and marketable. Even in today's very distressed markets, agency securities remain liquid. Under the Mortgage Clearinghouse, the market would retain that aspect of government support, which would ensure the continued availability of a long-term, prepayable consumer mortgage.

Affordable Housing Support

Under this re-engineered structure, the current GSE affordable housing goals also would need to be redesigned. There are a large number of federal policies and programs that support affordable housing. These programs should be reviewed to ensure that they are both effective and safe and sound, and then integrated into a reengineered housing finance system.

Portfolios

The Mortgage Clearinghouse would not be allowed to hold a large portfolio. Again, a small portfolio might be held for cash flow purposes only, and the holdings in that portfolio would need to subject to regulation to ensure that the investments were limited to very secure, safe and sound, low-yielding investments.

VI. Portfolio Restrictions Should Be In Regulation As Well As In Senior Preferred Stock Purchase Agreements

The GSEs' portfolios today are limited by Senior Preferred Stock Purchase Agreements (Agreements) that each GSE has entered into with the Department of Treasury. Those Agreements were originally executed in September 2008, and were amended in May 2009.[9] One of the May amendments increased from $850 billion to $900 billion the amount that each GSE may hold in its portfolio during 2009.

[9] The amendments are in GSE securities filings. *See* Fannie Mae's March 31 Form 10-Q, Exh 4.21; Freddie Mac's March 31 Form 10-Q, Exh 10.6.

The proposed regulation would not itself set criteria governing the GSEs' portfolios. It would merely incorporate the Agreements by reference:

> The Enterprises are required to comply with the portfolio holdings criteria set forth in their respective Senior Preferred Stock Purchase Agreements with the Department of the Treasury, as they may be amended from time to time.[10]

The proposed regulation would remain in effect as long as –

> This part has not been superseded through amendment, and [the GSEs] remain[ ] subject to the terms and obligations of the respective Senior Preferred Stock Purchase Agreement.[11]

It is unclear whether or how the Agreements will be amended in the future. The May amendments to the Agreements were not preceded by public notice and opportunity to comment. It also is unclear how long the Agreements will remain in effect and what, if any, portfolio regulations would be in place when the Agreements terminate. We believe it would be advisable to have a regulation in place for that event. Congress requires FHFA to establish portfolio criteria by regulation, not by GSE agreements.

> The Director shall, by regulation, establish criteria governing the portfolio holdings of the enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises.[12]

We therefore recommend that the portfolio limitations that are in the Agreements be restated in FHFA's final regulation directly rather than by reference to GSE Agreements. Doing so would in no way constrain FHFA's ability to take emergency action if needed, as Congress gave FHFA express authority to do so:

> The Director may, by order, make temporary adjustments to the established standards for an enterprise or both enterprises, such as during times of economic distress or market disruption.[13]

By putting the specific limitations in regulation, regardless of when the Agreements are terminated, there would be a regulation in place that would prohibit unregulated portfolio growth. Also, by putting the limitations in a regulation, FHFA would continue to provide notice to the public and opportunity to comment on portfolio regulations, as Congress requires.

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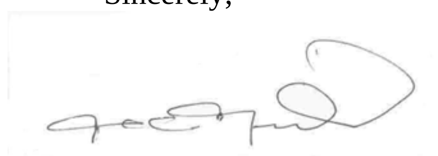
[10] Proposed 12 C.F.R. § 1252.1.
[11] Proposed 12 C.F.R. § 1252.2
[12] HERA § 1109(a)(2) (to be codified at 12 U.S.C. § 4624(a).)
[13] HERA § 1109(a)(2) (to be codified at 12 U.S.C. § 4624(b).)

VII. Conclusion

The GSEs' mortgage portfolios are not—and never have been—necessary. The risks the GSEs bore and the enormous losses they have placed on American taxpayers and on the financial markets were an unfortunate and avoidable outcome. The portfolios were not designed to implement or support any housing policy; they were designed to increase the GSEs' earnings per share for their private stockholders. The portfolios remain an inappropriate and counterproductive way for the GSEs to participate in housing markets.

The GSEs' losses are so enormous that a serious redesign of the GSEs' business model is imperative. We suggest a redesign that could provide federal support for the long-term, prepayable consumer mortgage loan, a basic ingredient of American housing policy. Importantly, this proposal would provide that support without the risks of the portfolios, risks that inevitably have been realized to the country's detriment.

Sincerely,



Anne C. Canfield
Executive Director