

Testimony of Shaun Donovan
Secretary of U.S. Department of Housing and Urban Development
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“Housing Finance- What Should the New System Be Able to Do? Part II-
Government and Stakeholder Perspectives”
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Mr. Chairman, Ranking Member Bachus, thank you for inviting me to talk about Fannie Mae and Freddie Mac, together often referred to as the GSEs, and the Administration’s efforts to reform our housing finance system.

I would like to begin my testimony by briefly reviewing how we arrived at a point of crisis in our housing markets, and the role that the GSEs played in that history. I will then talk about the federal response to the crisis, with emphasis on the comprehensive approach the Administration has taken and the role that the GSEs have played in conservatorship. And finally, I will discuss the principles and process that will guide us as we work to reform the housing finance system so that it can contribute to a more stable housing market.

Background: How We Got Here

As Secretary Geithner reviewed during his testimony before this Committee last month, there were many contributing factors that led to the housing crisis of the past few years. I will not revisit those factors in detail, but suffice it to say that I concur that there is plenty of blame to go around.

Low interest rates, global savings rates, greater investor appetite for housing and a mix of other factors combined to drive home prices to historic highs. But there were issues throughout the housing financing structure that made these increases in home prices unsustainable. Lightly regulated lenders and brokers with no “skin in the game” delivered increasingly risky loan products to the market. In the securitization market, instruments became increasingly complex, leading to widespread misunderstanding and mispricing of risk. And the regulatory environment was not sufficiently strong or broad to curb excesses in the market or clarify risk exposures for borrowers, investors, and the taxpayer.

Poor risk assessment and management existed in institutions at all points along the housing finance chain. Companies and managers assumed that risk could be virtually eliminated – relying on tools that were ill-equipped to assess the risk exposure embodied by Alt-A and non-prime loan products. And consumers drove demand for these products,

seeking quick returns, bigger homes or cash for other uses by entering into loans they could only afford if house prices kept rising indefinitely so that the loans could be paid off through sale proceeds or refinancing.

Seeing their market share decline as a result of this change of demand, the GSEs made the decision to widen their focus from safer prime loans and begin chasing the non-prime market, loosening long-standing underwriting and risk management standards along the way. This would be a fateful decision that not only proved disastrous for the companies themselves – but ultimately also for the American taxpayer.

With this broad shift towards riskier products and looser lending standards, we all know what happened next: an unsustainable market began to unravel. Foreclosures swept across the country, and housing prices went into a sharp decline, with prices falling nationally for the first time since the Great Depression. Homeowner equity declined by nearly 50 percent from its 2006 peak to \$6.6 trillion. This translated into an average loss of over \$80,000 for the American homeowner, with much of those losses concentrated in particularly hard hit areas of the country.

Faced with the collapse of the GSEs, the FHFA, with the support of the previous Administration, made the decision to place Fannie Mae and Freddie Mac into conservatorship in September of 2008.

A Comprehensive Response

Upon taking office last year, the current Administration took swift and comprehensive action to stabilize housing nationwide. Key elements of the response include:

- \$220 billion in purchases of Fannie Mae ,Freddie Mac and Ginnie Mae mortgage-backed securities by Treasury;
- \$1 trillion in purchases of Fannie and Freddie mortgage-backed securities and debt securities by the Federal Reserve through a program that has recently ended;
- The Treasury's changes to the senior preferred stock purchase agreements with Fannie Mae and Freddie Mac, which has allowed the GSEs to continue to support the availability of mortgage credit;
- The emergence of the FHA and Ginnie Mae as a major vehicle for continuing the extension of mortgage credit, with FHA insuring approximately 30 percent of all home purchase loans today, and Ginnie Mae guaranteeing more than \$620 billion since the beginning of fiscal year 2009 to fund FHA and other government-insured loans;

- Support for temporarily expanding the limits for loans guaranteed by Fannie Mae, Freddie Mac, and the FHA from previous limits up to \$625,500 per loan to \$729,750 to provide needed support to keep markets functioning during this crisis;
- Maintaining the traditional and important role of FHA in helping homeowners refinance into more sustainable 30 year, fixed-rate FHA-insured loans, many of them at historically-low rates;
- The First Time Homebuyer Credit, which brought numerous new buyers into the market, and helped reverse the fall in housing markets, before it expired in November, 2009, and the subsequent Homebuyer Tax Credit, which applies to sales contracts signed by April 30, 2010.
- The Home Affordable Modification Program, or HAMP, which has resulted in nearly 1.3 million trial modifications being extended for mortgages at risk;
- Recent changes to FHA and HAMP that will motivate lenders to write down the principal of underwater borrowers, resulting in more sustainable mortgages and lower default rates;
- Aggressive loss mitigation efforts through several programs, including FHA's loss mitigation program and HAMP;
- Increased support for housing counseling services;
- Launched a \$23.5 billion Housing Finance Agencies Initiative which is helping more than 90 state and local housing finance agencies (HFAs) across 49 states provide sustainable homeownership and rental resources for American families;
- An additional \$2 billion in competitive funding through the Recovery Act for the Neighborhood Stabilization Program, to help communities mitigate the effects of concentrated foreclosures;
- \$2.25 billion for the Tax Credit Assistance Program and awards of \$5.4 billion in Housing Tax Credit Exchange Program funds through the Recovery to jumpstart housing construction and development stalled by the collapse of the Low-Income Housing Tax Credit; and
- The HFAs Hardest Hit Fund program, which will allocate over \$2 billion of funds from TARP to help ten state housing finance agencies develop innovative ways to address their communities' housing issues.

Since the GSEs have been in conservatorship, dozens of major lenders have either failed or greatly reduced their mortgage lending, and as a result we have witnessed a severe contraction of the private secondary market. The GSEs—along with FHA and Ginnie Mae—stepped in to fill the vacuum, playing an indispensable role at a time of inadequate private capital. Indeed, few would disagree that, had they not played this increased role, the secondary market may well have shut down completely, which would have sharply

constrained the availability of new mortgages and households' ability to take advantage of the opportunity to buy a home or refinance at historically low rates. Any such shut down of the secondary market and lack of financing, in turn, would have reduced demand sharply, leading to a deeper fall in housing prices than we experienced.

A Fragile Recovery

The Administration's comprehensive approach has helped to restore the stability of the housing market, easing the very painful fall in home prices and playing a critical role in our broader economic recovery.

According to the Federal Reserve Board, stabilizing home prices and lower financing costs nationwide have supported the recovery of homeowner wealth -- homeowner equity started to grow again in the second quarter of 2009 and, to date, has increased by over a \$1 trillion, or \$13,000 on average for the nation's nearly 78 million homeowners.

Over 4 million borrowers have refinanced their homes in the past 15 months, saving an average of \$1,800 per year on housing costs -- pumping an additional \$7 billion annually into local economies and businesses, generating additional revenues for our nation's cities, suburbs, and rural communities.

And just last month, our economy started creating jobs again -- 162,000. At the end of 2009, quarterly economic growth increased at the fastest pace in six years.

For all this progress, however, it is important to recognize that the housing recovery remains quite fragile. And while the current status of Fannie Mae and Freddie Mac in conservatorship is a temporary one, they are playing a critical role in these still-uncertain times. That is why, as we think through the next steps in reforming our housing finance system, we must proceed very carefully to avoid undermining the stability that has been achieved.

Principles of Housing Finance Reform

As we work to reform our housing finance system, it is essential to keep in mind our broader housing policy goals. While not all of these goals are addressed directly through housing finance, some certainly are, and we should not compromise any of our core policy goals in the decisions we make in structuring our housing finance system. These broader goals include promoting sustainable homeownership and sustainable communities; expanding affordable rental options and reducing rental housing discrimination; preventing avoidable foreclosures and mitigating the impact of foreclosures on communities; and decreasing homelessness and de-concentrating poverty.

There are of course many others, but together our housing policy goals form the broader framework within which any comprehensive reform of our housing finance system must be carried out.

With that in mind, the Administration believes that a stable and well-functioning housing finance market should achieve the following objectives:

- *Widely available mortgage credit.* Mortgage credit should be available and distributed on an efficient basis to a wide range of borrowers, including those with low and moderate incomes, to support the purchase of homes they can afford. This credit should be available even when markets may be under stress, at rates that are not excessively volatile.
- *Housing affordability.* A well-functioning housing market should provide affordable housing options, both ownership and rental, for low- and moderate-income households. The government has a role in promoting the development and occupancy of affordable single- and multi-family residences for these families.
- *Consumer protection.* Consumers should have access to mortgage products that are easily understood, such as the 30-year fixed rate mortgage and conventional variable rate mortgages with straightforward terms and pricing. Effective consumer financial protection should keep unfair, abusive or deceptive practices out of the marketplace and help to ensure that consumers have the information they need about the costs, terms, and conditions of their mortgages.
- *Financial stability.* The housing finance system should distribute the credit and interest rate risk that results from mortgage lending in an efficient and transparent manner that minimizes risk to the broader financial and economic system and does not generate excess volatility. The mortgage finance system should not contribute to systemic risk or overly increase interconnectedness from the failure of any one institution.

Our nation's housing finance system could be redesigned in a variety of ways to meet these objectives. However, the Administration believes that any system that achieves these goals should be characterized by:

- *Alignment of incentives.* A well functioning mortgage finance system should align incentives for all actors – issuers, originators, brokers, ratings agencies and insurers – so that mortgages are originated and securitized with the goal of long-term viability rather than short term gains.

- *Avoidance of privatized gains funded by public losses.* If there is government support provided, such as a guarantee, it should earn an appropriate return for taxpayers and ensure that private sector gains and profits do not come at the expense of public losses. Moreover, if government support is provided, the role and risks assumed must be clear and transparent to all market participants and the American people.
- *Strong regulation.* A strong regulatory regime should (i) ensure capital adequacy throughout the mortgage finance chain, (ii) enforce strict underwriting standards and (iii) protect borrowers from unfair, abusive or deceptive practices. Regulators should have the ability and incentive to identify and proactively respond to problems that may develop in the mortgage finance system.
- *Standardization.* Standardization of mortgage products improves transparency and efficiency and should provide a sound basis in a reformed system for securitization that increases liquidity, helps to reduce rates for borrowers and promotes financial stability. The market should also have room for innovations to develop new products which can bring benefits for both lenders and borrowers.
- *Support for affordable single- and multifamily-housing.* Government support for multifamily housing is important and should continue in a future housing finance system to ensure that consumers have access to affordable rental options. The housing finance system must also support affordable and sustainable ownership options.
- *Diversified investor base and sources of funding.* Through securitization and other forms of intermediation, a well functioning mortgage finance system should be able to draw efficiently upon a wide variety of sources of capital and investment both to lower costs and to diversify risk.
- *Accurate and transparent pricing.* If government guarantees are provided, they should be priced appropriately to reflect risks across the instruments guaranteed. If there is cross-subsidization in the housing finance system, care must be exercised to insure that it is transparent and fully consistent with the appropriate pricing of the guarantee and at a minimal cost to the American taxpayer.
- *Secondary market liquidity.* Today, the US housing finance market is one of the most liquid markets in the world, and benefits from certain innovations like the “to be announced” (or TBA) market. This liquidity has provided a variety of benefits to both borrowers and lenders, including lower borrowing costs, the ability to “lock in” a mortgage rate prior to completing the purchase of a home, flexibility in refinancing, the ability to pre-pay a mortgage at the borrowers’

- *Clear mandates.* Institutions that have government support, charters or mandates should have clear goals and objectives. Affordable housing mandates and specific policy directives should be pursued directly and avoid commingling in general mandates, which are susceptible to distortion.

Special Focus: Equal Access, Responsible Ownership, and Sustainable Rental

Among the broad set of issues that housing finance reform touches, all of which are of vital importance, I would like to speak in a bit more depth on a few subjects. The first is the importance of maintaining equal access to housing credit. The second is facilitating a responsible, sustainable form of homeownership that involves safe, easily understood financing products that work for most Americans. And the third is ensuring that reform supports a sustainable and stable market for rental housing, which is directly related to and influenced by the single-family ownership market.

Maintaining Equal Access to Credit

In recent decades we have witnessed an important democratization of credit. This provided many of those families that had previously been shut out and unable to make investments in home ownership with an opportunity to access this option for the first time. And we subsequently witnessed a dramatic growth in ownership among underserved groups. Though the current crisis reminds us that great care is needed to promote homeownership that is sustainable over the long-term, ensuring that home ownership opportunities are available to members of these communities should remain a priority.

Responsible home ownership can be a critical foundation upon which American families build wealth and stability. In the early 1990s, housing represented the largest single asset for 53 percent of households, according to the Survey of Consumer Finances. And even after the boom in 401(k) retirement plans and broader engagement of families in the stock market, the fraction of households for which the home was the major asset remained basically unchanged. In the run-up to the recent crisis, many homeowners made decisions that contributed to the crisis, taking on more debt on their homes as a way to boost their spending power, and many others who had behaved responsibly saw their equity fall as the value of their homes dropped in the crisis. Yet, even after the recent declines in home prices, home equity continues to be a central asset for American families.

So a reformed housing finance system should ensure broad access to mortgage credit and capital markets. At HUD, the FHA has long played this role for minorities and others who have historically not been able to access mortgage capital through mainstream financial channels. For example, in 2008, 50% of all home loans made to African American families were FHA loans and 45% of all loans made to Hispanic families were FHA loans.

For Fannie Mae and Freddie Mac, the affordable housing goals expanded the reach of lower-priced mortgage credit to many families. Some have argued that these goals were a principal cause of Fannie and Freddie's collapse and subsequent losses. But this argument is simply not supported by the facts.

Early this year, we released a detailed report to Congress on the Root Causes of the housing crisis. As shown in the report, one of the primary factors driving GSE losses was the desire to recapture market share and increase profits. The housing boom saw a rapid rise in non-prime and alt-A originations and securitization outside of the GSEs. To regain market share, and increase revenue, Fannie and Freddie made poor strategic decisions to take on greatly increased risk, notably in alt-A mortgages. Management made clear that increasing revenue was the motivation for purchasing non-prime and other alternative mortgage products that subsequently produced significant losses (Root Causes, p. 42).

We should thus be careful not to learn the wrong lesson from this experience and sacrifice an important feature of the current system: wide access to mortgage credit for responsible borrowers. The affordable housing mandates under the current system spurred innovations that have promoted responsible homeownership among lower-income families. We must be careful to ensure that the incentive structures in a reformed housing finance system do not retard the development of such innovations.

Promoting Responsible Homeownership

At the same time, we also must make sure that our commitment to access does not drive some to take imprudent risks. As I noted, consumer behavior was a contributing factor to the housing crisis, and we have seen the devastation that such risk-taking has inflicted upon families and communities across the country. Many borrowers simply used their home like "ATM machines" – without sufficiently considering the risk involved.

We must ensure that our efforts to maintain access are coupled with incentives that minimize the likelihood that a family gets a mortgage that they cannot afford -- a system

in which families take out home mortgages that are affordable in the long-term. Promoting this kind of sustainable and responsible homeownership is an important goal for this Administration.

Of course, there are many components that will be required to accomplish this. First, we need market practices that support responsible homeownership. Second, a strong regulatory system that discourages excessive risk-taking, enhances market discipline, and eliminates predatory activities is critical. And third, improved and streamlined disclosures that make clear the commitments that homebuyers are making as well as the obligations of brokers, realtors and lenders, will increase transparency and reduce the possibility of abuse.

Fannie Mae and Freddie Mac provide an instructive lesson in how responsible homeownership can be impacted by our housing finance structures. For many years, they played a pivotal role in promoting responsible ownership through the standardization of underwriting requirements and mortgage products.

Looking forward, we will want to ensure that these kinds of standardized products are widely available, and that homebuyers are fully aware of the risks associated with products that fall outside of such standard product offerings. Ultimately, we need a housing finance system that will help us once again see housing not simply as a tool for investment, but as the platform for stability that it has been throughout our history.

This will mean that, for some, ownership will not be the right answer. As you have noted on numerous occasions yourself, Mr. Chairman, while we continue to promote affordable homeownership, for many Americans renting will continue to be the only or preferred option.

Creating a System that Promotes Stability and Real Choice for Renters

The next-generation housing finance system must also facilitate a healthy rental market as part of a comprehensive, balanced national housing policy that supports responsible homeownership and affordable rental housing alike. This means not only ensuring that those considering renting have a choice, but that they have a real choice, meaning affordable housing that is close to schools, work, and amenities. A well-functioning rental market will be particularly important in the immediate future, as rental markets will absorb a larger-than-usual number of families who owned homes during the bubble but will be renting in the near future.

Throughout the past decade, evidence suggests that rental markets have contributed to considerable stress for families. For example, Census data show that 8.7 million renter households paid more than half of their income on housing in 2008, an increase of 400,000 households in just one year.

Moreover, we have witnessed severe disruptions in the Low-Income Housing Tax Credit program, which in the past decade was responsible for about half of all new multifamily developments, and has been the federal government's principal program supporting construction or rehabilitation of affordable rental units. This is directly related to the problems facing the GSEs, which were a substantial purchaser of these tax credits.

Through the Recovery Act, the Tax Credit Assistance and Tax Credit Exchange programs have temporarily eased some stress in the tax credit markets and provided some additional support to affordable housing production. But while much attention has been placed on the distress in single-family ownership housing, and rightfully so, it is important to recognize the effect this crisis has had on renters, many of whom were already struggling.

We thus cannot consider reforms to the ownership market without also factoring in the effects on rental markets. Those families with the fewest assets and resources—namely, those that rely on the rental market or are tenuously attached to ownership—would potentially be exposed to greater volatility and turmoil absent a stable rental market infrastructure. We therefore must be careful to promote policies that provide countercyclical support for rental markets as we have for single-family ownership markets.

In recent years, Fannie Mae and Freddie Mac have emerged as major providers of financing for the ownership and production of multifamily housing. Moving forward, we must make sure that this role is not overlooked, and that the government continues to provide adequate support for the production and preservation of affordable rental housing. In short, government support for multifamily housing is important and should continue to ensure that consumers have access to affordable rental options.

Relationship to the FHA and Ginnie Mae

Any discussion of reforming our housing finance system must take account of the role of FHA and Ginnie Mae in relation to the GSEs. Each provides enhancements to basic loan products that are defined by strict and clear underwriting standards. Each serves the single-family ownership and multi-family rental markets. Each has mission elements that represent important components of their current activities. And there is clear evidence

that actions by the GSEs, FHA and Ginnie Mae influence the other in real ways. As such, housing finance reform must carefully consider both the roles of the FHA and Ginnie Mae and the impact of any changes on them.

This is of course true also for institutions beyond the FHA and Ginnie Mae. The Federal Home Loan Banks, community development financial institutions, community banks and other private institutions play important roles in housing finance. Any significant changes to our housing finance system must explicitly recognize the interconnections and overlaps in the current market structure as well as recognize the overall role that the government plays in supporting the housing market. And of course, if government support is associated with the activities of private entities in a reformed housing finance system, we believe that such support must be carefully designed and appropriately priced.

Transition to New System

All of these issues point to the need for fundamental but careful reform. But transition from where we are today to where we need to be itself presents several important challenges. There is a large stock of investments on the balance sheets of the GSEs, and financial markets are depending on the ability of the GSEs, in their current form, to make good on their obligations. The GSEs and the federal government, through the FHA and Ginnie Mae, are playing a larger role in the housing finance market today than they have since the Great Depression. Conditions must be created so that private capital will return in a substantial manner to the housing market.

In conjunction with the Treasury's commitment to supporting the GSEs while in conservatorship, it should be clear that the government is committed to ensuring that the GSEs have sufficient capital to perform under any guarantees issued now or in the future and the ability to meet any of their debt obligations. Given the nascent state of our recovery, the Administration will take care not to pursue policies or reforms in a way that would threaten to disrupt the function or liquidity of these securities or the ability of the GSEs to honor their obligations. We recognize the central importance the mortgage finance market plays in the broader capital markets and we will ensure that this market is not allowed to be disrupted. Maintaining the current securitization operational flow, TBA liquidity, secondary MBS market liquidity, and the ability of the GSEs to issue corporate debt securities during the transition will remain key priorities for the Administration.

All of that said, government's role in the housing finance system and level of direct involvement must change, and the Administration is committed to encouraging private capital to return to the housing finance market. The substantial direct support for the housing markets that has been put in place will be allowed to fade as the market recovers and fully stabilizes – and we have taken initial steps to prepare for this.

A good example of these steps is the recent action taken by the FHA, where we are requiring a higher FICO score for those borrowers putting down less than 10%, stepping up enforcement on bad actors in the market, and increasing premiums to improve the financial health of the MMI fund. Together these steps will put the FHA on more sound footing heading into the future.

In addition, through regulatory reform and other supervisory actions, the Administration is committed to clarifying the framework for new securitizations to restart these important markets. These steps should create the room necessary for private markets to re-emerge.

Finally, during this period of transition the GSEs must be able to effectively continue to support a stable housing market. There are important human resources, infrastructure and capabilities at the GSEs that have great value. Through the transition we will seek to maintain this extensive infrastructure, knowledge, personnel, and systems. Designing an effective transition plan that leverages these resources and minimizes market disruption will be a critical component of reform.

We have confidence that this approach will result in a next-generation housing finance system that achieves our broad principles, strengthens our country and endures for decades to come.

Questions for Public Comment

In his testimony before this committee last month, Secretary Geithner announced that we would be releasing a series of questions to solicit the public's thoughts on these subjects by April 15th. In keeping with that commitment, HUD and the Treasury have today released a copy of these questions, and they will be submitted tomorrow to the Federal Register to be published for formal public comment.

These questions will help us consider what functions we want our housing finance system should serve, the structure or structures that they should take, how housing finance fits within our broader housing policy goals, and the best steps to get from where we are today to a stronger housing finance system.

The public's input will be invaluable as we think through these difficult and complex issues. So we will take that input in two forms. First, we will ask the public to submit written responses to the questions. The Federal Register notice will contain guidance on where the public should submit their responses and the form that the responses should take. Second, the Administration intends to hold a series of public forums across the country over the summer and fall of this year.

Together these opportunities for input will give a broad range of constituents the opportunity to deepen our understanding of the issues and help inform our response as we move forward over the coming year.

This is both in keeping with this Administration's commitment to openness and transparency, and the careful, deliberative way that we have approached our housing recovery to date.

And so, Mr. Chairman and Ranking Member Bachus, I hope you can see that the Administration is committed to building a next-generation system of housing finance that meets the diverse housing needs our country requires, while building on the nascent housing recovery we have established to date, protecting the taxpayer and, above all, ensuring we prevent a crisis of this magnitude from ever happening again.

Given the challenges we still face, we must take a responsible approach to housing finance reform in which transition is not marked by hasty changes that could threaten another breakdown in the market, but by care and deliberation as we work with Congress to develop proposals to support the institutional structure for the next-generation of housing finance.

In the months to come, I look forward to working with you, Mr. Chairman, Ranking Member Bachus, and the members of this committee to make this charge a reality. Thank you.