

Center for American Progress



**Statement of Julia Gordon
Center for American Progress**

**Before the Senate Committee on Banking, Housing and Urban Affairs
“Essential Elements of Housing Finance Reform”**

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Good morning Chairman Johnson, Ranking Member Crapo, and members of the committee. I am Julia Gordon, the director of housing finance and policy at the Center for American Progress. As part of my work, I convene the Mortgage Finance Working Group, a group of housing experts that have been meeting for more than four years to discuss the future of housing finance. The working group originally released its comprehensive “Plan for a Responsible Market for Housing Finance” back in January of 2011.¹ Since then, we have continued to offer comment on a variety of related developments. I greatly appreciate the opportunity to testify today about the essential elements of housing finance reform.

Housing finance mechanisms have evolved over time and in response to crises, from the creation of the Federal Home Loan Bank System and federal deposit guarantees to the more recent bailouts of private institutions and the conservatorship of the Government Sponsored Enterprises. Now, we have the opportunity to put in place a system that will serve the next generations even better than the systems that have preceded it.

In seeking reform of the housing finance system, Congress has important decisions to make. A new system could provide credit to a broad and diverse population, offer safe investment opportunities to a wide range of investors, and result in a larger, more stable housing market. Alternatively, it could create an environment in which credit and housing choices are more costly, more limited, and less sustainable, especially for minority and low- and moderate-income households, and where there are fewer opportunities for investors who do not seek credit risk.

These choices will determine not only the sustainability of a robust housing market, but also future economic opportunities for millions of families. Homeownership and the housing finance system play a unique role in ensuring strong families, strengthening neighborhoods, and boosting the overall economy. For this reason, it is critical to redesign the system to account for shifting demographics and changing consumer profiles, including the rapid growth of communities of color, ever-increasing student debt burdens, rising demand among rural Americans, and increased economic insecurity among all but the wealthiest families.

Why Congress Should Act Now

America's housing finance system needs reform now.

While housing prices have begun to recover in many (although not all) parts of the country, our national mortgage market today is significantly smaller than it was in the early 2000s.² The homeownership rate has dropped from close to 70 percent to 65 percent,³ and while the housing market has improved from the crisis, the fundamentals are not yet there for a robust, accessible and sustainable market to develop.

To start, approximately two-thirds of mortgage originations in the second quarter of 2013 were for refinancing, not home purchases.⁴ Many purchasers are now investors rather than owner occupants, and a large percentage of these investors purchase with cash rather than a mortgage (estimates suggest that nearly 40 percent of homes purchased in May 2013 were purchased with cash, meaning they were likely purchased by investors⁵). This investor presence may support housing prices and perhaps even inflate them,⁶ but will not necessarily stabilize neighborhoods or pave the way for homeownership in the future.

In the meantime, first-time homebuyers, young homebuyers and homebuyers of color – the future of homeownership in the United States⁷ – have largely been shut out of the conventional mortgage market. The Federal Housing Administration backed financing for 46 percent of first-time buyers in 2012 and about half of home purchases obtained by homebuyers of color in 2011.⁸ Homeownership rates for young people (ages 25-34) are among the lowest in decades.⁹ This decline in homeownership has led to an increase in renters.

Meanwhile, production of multifamily apartment buildings is falling behind demand.¹⁰ As supply and demand shift, rents have risen significantly – five percent in 2012 alone.¹¹ This is only putting more pressure on the nation's renters, more than half of whom are “rent impoverished,” or spending more than thirty percent of their income on housing.¹² These figures do not suggest well-functioning single and multi-family housing finance markets.

So where do we go from here?

We cannot go back to the status quo ante. It's true that for many decades, the government-sponsored enterprises, or GSEs (Fannie Mae and Freddie Mac), offered our nation's financial institutions a robust and reliable secondary market for mortgages, providing liquidity and stability for the housing market. Yet due to the so-called implicit guarantee -- which the GSEs routinely insisted did not exist -- these companies enjoyed all the benefits of a federal guarantee without any of the costs. Their funding costs were cheaper, giving their portfolio an advantage, their equity costs were lower because the guarantee substituted for a risk premium, and their regulator – already weaker due to structural differences from other financial regulators -- permitted gross undercapitalization.

Nor can we continue with the system we have right now. Last week marked five years since Fannie Mae and Freddie Mac went into conservatorship, an astonishing length of time that was never contemplated by the architects of the conservatorship. In the absence of direction from Congress, the Federal Housing Finance Agency is winding down the GSE presence in the market and limiting or eliminating the ways in which the GSEs serve a public purpose. While we agree with some of their actions, such as the initiative to establish a common securitization platform, and disagree with others, this single agency, whose deliberations largely take place behind closed doors, and whose officials are not elected, appointed, or confirmed, has vast control over decisions at the GSEs—decisions that impact American families broadly, whether they currently own their home, hope to become homeowners someday, or are seeking affordable rental options.

It is hard to see how the current system satisfies anyone, either those seeking smaller government (since

the system is now effectively nationalized) or those who believe the GSEs should fulfill their public missions by enabling broad based and affordable access to credit, adopting best practices in loss mitigation, and capitalizing the Housing Trust Fund and Capital Magnet Fund.

Our vision of a well-functioning and responsible housing finance system that protects taxpayers is grounded in five core principles: liquidity, stability, transparency, access and affordability, and consumer protection.

- **Liquidity:** The system needs to provide 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, and for large and small lenders alike.
- **Stability:** Private mortgage lending is inherently procyclical. Stability for the market requires sources of countercyclical liquidity during economic downturns or in the wake of other exogenous shocks causing private capital withdrawal. Stability also requires sustainable products and capital requirements that are applied equally across all mortgage financing channels for the long cycle of mortgage risk.
- **Transparency:** 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. Secondary market transparency and standardization lower costs and increase availability of credit.
- **Access and Affordability:** It is critical for any housing finance system to ensure a level playing field for all creditworthy borrowers, rather than to allow lenders to “cream” the market, leaving perfectly creditworthy lower wealth, lower income or minority segments underserved. Additionally, the system should enhance access and affordability for underserved market segments. With appropriate incentives and tools, attaining these goals can benefit the market as a whole.
- **Consumer Protection:** As the current crisis has demonstrated, consumer protection is inextricably linked with financial institution safety and soundness. Along with regulators such as the Consumer Financial Protection Bureau, any structure supporting the nation's housing market must share a commitment to ensuring that the system supports rather than undermines the financial health of the consumer.

Today, we see a broad consensus emerging on the general outlines of housing finance reform in a way that has a potential to embody these principles. While the details differ, S. 1217, the work of the Bipartisan Policy Center, and numerous other proposals support our view that homeownership is a desirable option when viable, and that those who do not buy a home ought to have access to affordable, quality rental housing.¹³

Additionally, these proposals agree that a government role is critical to maintain access to long-term, sustainable mortgage products; that there is a critical need for a reformed multi-family finance system to meet the demand for affordable rental; and that the system must provide access to safe and affordable mortgages for all creditworthy borrowers, including those of low and moderate income.

Some policymakers still question the need for any government role in the housing market. This position

is embodied in the PATH Act legislation proposed by Chairman Hensarling of the House Financial Services Committee. It is becoming increasingly clear, however, that most stakeholders do not support such a radical restructuring of the market.

Thus, now is the ideal time to consider in some detail the essential elements of a reformed housing finance system in the context of broader, long-term considerations and priorities.

Ten Essential Elements of a Strong Housing Finance System

1. First and foremost, a new housing finance system must place the nation's housing needs at the center of the system.

The structures and processes of the secondary market are not ends in and of themselves. Rather, they are a means to provide housing to our nation's families. Placing the goal of access to affordable, sustainable credit at the center of the new system's mission will provide the greatest benefit in the long run not only to families but also to lenders and investors while protecting taxpayers from future bailouts.

While most people think of mortgage lenders as the point of intersection with the public, the less transparent but very large secondary mortgage plays a critical role in ensuring access and affordability within the housing finance system. Lenders prefer to make the types of mortgage loans that the secondary market will buy. For this reason, one of the most effective ways to ensure a broad, accessible and affordable primary mortgage market is by creating a secondary market that promotes those principles.

Using a range of possible tools, the secondary market can encourage lenders to provide all Americans access to safe, affordable mortgages, including traditionally underserved populations such as Hispanics, African-Americans, rural residents, low- and moderate-income families, Asians, and Echo Boomers; collectively, these are the future of the mortgage market. It can also help to increase access and affordability by supporting standardization and lowered costs and by adopting responsible, targeted product innovations that can be made widely available throughout the mortgage market.

Any legislation overhauling the nation's housing finance system should include a purpose statement that makes clear the goal of the system is to provide liquidity, stability, transparency, and access to affordable credit for qualified borrowers across all geographies, housing types, populations, and mortgage balances within specified limits, including providing credit to traditionally hard-to-serve or underserved markets and supporting mortgages that further the purposes of the Community Reinvestment Act and other regulatory or statutory requirements for which primary market originating lenders are responsible.

Moreover, the entity that administers the government guarantee -- in S.1217, this entity is called the Federal Mortgage Insurance Corporation, or FMIC, which I will use as a shorthand for this entity throughout my testimony -- should prominently include in its structure an office or offices dedicated to ensuring broad access to credit. Through such offices, the FMIC should annually examine the characteristics of all securities it insures to be sure that the market is effectively serving qualified borrowers and renters from all backgrounds, geographies, income levels and housing types. In short, a person should quickly be able to ascertain the centrality of these principles to the entity's mission simply by viewing the entity's organizational chart, and the FMIC should have the organizational capacity to implement these principles. To the extent that the FMIC is governed by a board of directors, the directors must reflect experience and expertise in housing policy and community investment as well as

securitization and capital markets.

In the remaining items in this list, we discuss additional ways to advance and support this core public purpose.

2. *The system should enable a deep, liquid market that will attract capital and keep credit affordable through providing a government guaranty and preserving the TBA market and the long-term, fixed rate mortgage.*

If we want to provide broad access to affordable, sustainable credit as well as provide attractive investment opportunities for a range of investors, any new housing finance system must incorporate three components of today's system: a guaranty for investors in mortgage-backed securities, a robust TBA market, and the widespread availability of long-term, fixed-rate mortgages. These three items are very interdependent, but we will look at each separately:

The government guaranty: The guaranty on government-backed securities provides a broad class of so-called "rate investors" the confidence to invest in the U.S. housing finance system at efficient, fixed rates.

Some have asserted that the significant development of the financial sector since the 1930s means that a purely private mortgage system could effectively serve the mortgage needs of Americans today. They point to the nascent recovery in the so-called jumbo mortgage markets, an area that lacks any government support because these mortgages are for the high end of the housing market, as evidence supporting the idea that the purely private markets can capably serve the mortgage markets.¹⁴

However, the fact that the purely private markets may be able to meet the mortgage needs of a small, wealthy slice of homebuyers does not mean that they will be able to meet the mortgage needs of all Americans. This argument ignores the limited investor appetite for long-term debt investments—the type of investments that fund home mortgages—in the absence of a government backstop. While investor demand for long-term sovereign debt is enormous, totaling many trillions of dollars for U.S. Treasuries alone, the demand for privately issued long-term mortgage obligations that don't carry a government backstop is small in comparison.¹⁵ What's more, the jumbo market is enabled by the existence of the conventional market, as lenders need to compete with a product that wealthier borrowers could access with a larger down payment or if they bought a less expensive house. The conventional market also provides transparent pricing information and benchmark prices and rates upon which the jumbo market relies for its own pricing and rate-setting.

We agree with the drafters of S. 1217 and the Bipartisan Policy Commission that a 100 percent government guaranty is not necessary to achieve the benefits of a government-backed system. Our plan also recommends that private capital take a first-loss position on the guaranteed securities. However, as we discuss later in this testimony, we think that how that first-loss position is structured has very significant implications for the workability of the new system.

The TBA Market: The TBA ("to-be-announced") market -- which really can be used to describe an overall market or a type of trade or delivery -- today provides for the forward sale of mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae before the securities have actually been manufactured (i.e., before the mortgages that will back those securities have been identified). The TBA market is an important part of today's mortgage finance system, and proposals to reform the system must take into account how they would affect the TBA market's operation.

The TBA market is important to consumers for several reasons. First and foremost, in combination with the government guarantee, the existence of a deep and liquid market where MBS are easily traded is another essential precondition of the long-term, fixed-rate mortgage. Second, forward commitments facilitate rate locks, thereby providing consumers with certainty going into their home purchase, protecting them from a possible increase in rates during the time required to finalize the purchase of the house and to close on the loan. Third, because the TBA market is so liquid, it attracts a great deal of both domestic and foreign investment, which results in mortgages that are more affordable to everyone.

The TBA market is also critically important to investors. It provides a safe investment for rate investors, who can enter and exit the market at will, and it provides a high degree of price transparency. These characteristics are critical for a variety of different types of investors, including foreign central banks, fixed-income investors, and regulated financial institutions who are subject to restrictions based in charter, statute or regulation. In addition, the TBA market enables the pricing and hedging of many non-TBA eligible mortgage products, including jumbo mortgages.¹⁶

Unfortunately, the structured transaction solutions envisioned by S. 1217 and some other proposals would not be compatible with a deep and liquid TBA market. In a senior/subordinate deal, the subordinate piece would certainly not be eligible, and it is not clear that investors would consider senior tranches to be sufficiently homogeneous. What's more, even for a credit-linked-note transaction or other structured deal without a separate subordinate piece, any variations in the underlying documents from one deal to the next would lessen the level of homogeneity that's required for a market where new MBS are traded alongside more seasoned securities.

It is also worth noting that significant cutbacks in loan limits will result in a smaller overall market, which will reduce liquidity and raise prices. However, generally speaking, we believe that reducing loan limits is a better way to bring in private capital than over-charging for the guaranty fee.

The long-term, fixed rate mortgage: The explicit government guaranty together with the TBA market enable the widespread availability of the long-term, self-amortizing, fixed-rate mortgage, which maximizes affordability and economic security for the majority of American homeowners. While adjustable rate mortgages may be right for some borrowers under specific circumstances, they expose borrowers to interest rate risk, and shorter-duration products with balloon payments that are designed to be refinanced every two to seven years expose borrowers not only to ordinary interest-rate risk, but also to the risks that they may not be able to refinance when they need to due to other adverse changes in market conditions. While mortgage rates have been low for a long time, they are turning upward, and that can do a lot of damage quickly to borrowers who are not prepared.

Research conducted at the UNC Center for Community Capital confirms the important role that safe and sustainable products play in making homeownership work better for more households. A longitudinal study of nearly 50,000 families, with a median income of around \$35,000 who purchased homes in the decade leading up the bubble and bust, has found relatively low default rates, despite the fact that most of these borrowers put down less than 5% on their home purchase and about half had credit scores below 680. Although these borrowers would be very unlikely to get approved for a mortgage in today's tight market, they turned out to be good credit risks even through a major recession, and they even managed to build some equity at the median. These loans were prime-priced, fully underwritten loans, extended by banks around the country and sold to Fannie Mae.¹⁷ A comparison with similar borrowers receiving adjustable-rate and other non-traditional loan features

via the purely private market, who defaulted at rates three to five times as high, highlights the important role that good products play in reducing credit risk.¹⁸

Providing borrowers with that kind of stability also has benefits for the economy as a whole. Prior to the introduction of the major housing and finance reforms of the 1930s, the United States had a mortgage system that closely resembled the purely private system conservatives are arguing for today. Mortgages were typically for a term of 5 years and depended on regular refinancing.¹⁹ That system failed spectacularly when the Great Depression hit and half of all homeowners defaulted on their mortgage (although foreclosure rates remained lower than today due to the government's creation of the Home Owners' Loan Corporation).²⁰ In the 2008 crisis, the mortgages that brought down the system were not long-term fixed rate products, but were hybrid adjustable rate mortgages, interest-only, or option ARMs with negative amortization.

3. The system should protect taxpayers from having to bail out any part of the mortgage or financial system, which is best accomplished through a bond guarantor structure.

Our proposal, along with S. 1217 and the Bipartisan Policy Commission, all contemplate protecting taxpayers by making the government guaranty more remote behind private capital in first-loss position and by adequately pricing and reserving for the government guaranty. In all these scenarios, the first layers of risk would be absorbed by owners' equity and, on lower-down-payment loans, by traditional private mortgage insurance. Similarly, all the scenarios contemplate a government insurance entity such as the FMIC that will step in as a catastrophic reinsurer.

Where the plans differ is how to structure putting private capital in a credit-risk-taking, first-loss position. Some, like ours, call for specialized mono-line institutions or bond guarantors, as they are called in S. 1217. Other plans envision issuers that lay off the credit risk through structured transactions. S. 1217 offers a plan through which issuers could toggle between bond guarantors and a purely private capital markets transaction.

In our view, the institutional solution of well capitalized, bond guarantors chartered or licensed by the FMIC has significant advantages and ultimately, is the only structure that meets all the other requirements we believe are necessary. First, such a system is far more likely to be regulated and managed effectively for safety and soundness. There will be far fewer bond guarantors than issuers, and especially if these guarantors are chartered entities, the regulator will be able to closely monitor their operations and recognize risks early on. On the other hand, the FMIC would need extraordinary regulatory capacity or ironclad coordination with banking regulators to evaluate the safety and stability of the many institutions involved in the structured transactions.

Second, bond guarantors are much more efficient at pooling and spreading risks, which is the core function of insurance. Structured transactions, to the extent that they cover a single or limited number of pools, cannot allocate risks and reserves across years, regions, lenders, and so on.

Third, as we have seen in recent private label securitizations, investors in structured transactions have proven unwilling to assume risk on anything but the most pristine mortgages. If investors are assuming the first-loss risk, their high level of scrutiny will result in higher prices for non-traditional but still creditworthy borrowers, as the investors will demand a premium for taking risk that is not well-understood or serving borrowers who are perceived as more risky.

Fourth, as we noted earlier, individual deals are much less likely to be able to support a robust TBA

market.

Fifth, although the appeal of a structured transaction is that the money is already there to cover losses, it is much harder to ascertain how the investor institutions are accounting for these assets on their own books. As a result, these structures could export risk from within the four corners of the security out into the larger financial sector, which puts the taxpayer at risk once again.

Finally, bond guarantors can provide more protection to the taxpayer at less cost. For example, if losses occur in a senior/sub arrangement or in a credit-linked-note transaction, there is a stop-loss on that deal at the ten percent mark, at which point the government guaranty will attach. With bond guarantors, however, the guarantor can spread risk among pools, so if one pool loses 11 percent and another loses only 1 percent, there is no need to access the guaranty. Furthermore, the bond guarantor would have to exhaust not only its reserves but also its corporate resources before tapping the reinsurance fund. These institutions will have established business lines and a strong incentive to stay in business through the ups and downs of the business cycle. (To be clear, we do not intend to prohibit using structured transactions anywhere in the system. Bond guarantors can choose to lay off risk however they choose, including in capital markets.)

We do not believe the S. 1217 approach of offering both executions will work. First, as currently drafted, the bill tilts the playing field toward the pure capital markets approach, since that execution has little by way of regulatory requirements and can more easily meet the capital thresholds through leverage. Moreover, allowing investors to toggle back and forth between executions will likely fragment the market sufficiently to undermine TBA.

4. The system should operate effectively throughout all economic and business cycles.

The more central a role is played by private capital, the more instability is introduced. Private capital is inherently pro-cyclical, meaning that it tends to be plentiful and cheap during good times and scarce and expensive during downturns, thus inflating bubbles and deepening downturns, a lesson that we learned very painfully during the recent financial crisis. If Fannie, Freddie, and FHA had not been readily available to provide countercyclical capacity, the housing market decline would have been far more severe and the resulting economic damage would likely have been a full-blown depression rather than a recession.²¹

While this is a challenging problem, we suggest that there are two keys to solving it. The first is to build in countercyclical capability in an intentional and effective way. The mechanism envisioned in S. 1217 to change the attachment point of the government guaranty in an economic downturn requires the written agreement of two agencies together (FMIC plus HUD), would be limited to six months, and could not occur more than once in a three year period. Recent experience has shown that requiring multi-agency agreement can be very contentious and time consuming. But more concerning, recessions or downturns can last more than 6 months and happen more than once in a three year period. For this reason, rather than risking getting this critical function "wrong" in the statute, it might make more sense to permit the government entity to set the terms of the attachment point through regulation, considering how best to move quickly in times of economic stress when private capital flees. This flexibility will be easier using a system based on bond guarantors rather than structured transactions, because institutions may tighten, but Wall Street transactions may dry up entirely.

The second key to countercyclical capacity is to recognize that what is done in good times is just as important as what is done in times of stress. Adequate reserving and building up of capital is critical

and can best be achieved using institutional risk taking solutions (rather than structured transactions). Regulatory discipline around pricing and risk management also needs to be imposed on the private market, and should be the charge of a strong regulator.

5. *The system should ensure that all creditworthy borrowers have access to the mainstream housing finance system regardless of demographic characteristics, geographic location, or housing type.*

For a variety of reasons, the mortgage market often serves those borrowers perceived to be the “easiest,” most lucrative, or least risky borrowers at the expense of borrowers who are equally able to sustain homeownership but require more customization and consideration due to factors such as self-employment, nontraditional credit histories, the purchase of smaller homes, or living in certain rural or urban neighborhoods.

We see this phenomenon quite vividly today. Lenders are now requiring higher credit scores, larger down-payments, lower debt-to-income ratios, and essentially refusing to lend in certain geographies, regardless of a potential homeowner’s creditworthiness. Symptomatic of this trend, between 2007 and 2012 originations of prime home purchase mortgages fell 30 percent for borrowers with credit scores above 780 but fell 90 percent for borrowers with credit scores between 620 and 680.²² As a result, the market is largely serving the most pristine borrowers, those seeking higher balance loans, and those in well-served locations. In other words, they are “creaming” the market.

Because the secondary market can play a crucial role in determining the behavior of the primary lending market, we believe any new system should build in a requirement that lenders provide a level playing field for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher-income portions of that market.

This obligation would have four parts:

- Bond guarantors as a whole would be expected to mirror the primary market (roughly) in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct government insurance) that are securitized and are eligible for the guaranty.
- Bond guarantors (or issuers) for multifamily loans would be expected to demonstrate that at least 60 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.
- Bond guarantors (or issuers) would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that are more robust than those of the Public Use Database currently produced by the Federal Housing Finance Administration.
- All entities would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single-family and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters. Substantial underperformance could lead to fines and possible loss of the ability to access the guaranty.

This mechanism can proactively support the flow of fair and affordable credit by identifying market

gaps, elevating promising products, and halting predatory or discriminatory activity. As is the case in our current housing-finance structure, there must be a market regulator responsible for monitoring the use of the taxpayer guarantee, ensuring that the public benefit is not abused or unfairly rationed. Because it will have a comprehensive view of the national housing landscape, the secondary market regulator will be in the best position to ensure that the benefits of a taxpayer-funded guarantee are available to all qualified borrowers, regardless of the ultimate structure of the system.

6. *The system should include provisions to help enable more borrowers to access the mainstream housing finance system.*

For generations, affordable homeownership has provided a primary means for families to climb the economic ladder and achieve financial stability. Homeownership results in a host of positive externalities both for families and for their neighborhoods, ranging from better health and education outcomes to safer streets and more small-business development.²³

While mechanisms to level the playing field for creditworthy borrowers can help, they will not fill all the gaps left by a national history of discrimination and wealth disparities. These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending or were hit very heavily by the recession and unemployment. These neighborhoods, who are most in need of capital to rebuild, will likely be the last to get it from a private market left to its own devices. The Community Reinvestment Act is too limited in scope to be expected to generate the level of support required solely through banks' balance sheet lending.

However, many prospective homeowners and owners of rental homes who are not easily served by private markets demanding competitive rates of return can be well served with limited amounts of credit enhancement. These borrowers inhabit a "grey zone" between private credit and fully insured credit through agencies like the FHA, VA and USDA's Rural Housing Services (RHS). During their most effective years, the GSEs generated some of this innovation through their own risk capital by relying on standard, fully documented loans; their large market shares; and broadly priced credit products, using limited pilots or trusted partners. Banks subject to the Community Reinvestment Act also do some of this on a limited scale, both internally and through support of mission-oriented intermediaries such as Community Development Financial Institutions (CDFIs).

To ensure that the new system has the capacity to serve these categories of borrowers, we propose establishment of a Market Access Fund, which would have three broad functions:

- Provide support for research, development and pilot testing of innovations in products, underwriting and servicing geared to expanding the market for sustainable homeownership and for unsubsidized affordable rental.
- Provide limited credit support for products that expand sustainable homeownership and affordable rental but that cannot be piloted at sufficient scale to determine whether they can be sustained by the private market, or, alternatively, are best served by FHA, VA and/or USDA or by state housing finance agencies.
- Provide incentive grants to encourage development of self-sustaining support services, such as housing counseling, that have proven effective in expanding safe and affordable homeownership, but that so far have not developed a sustainable business model that combines lender support, client fees and limited government and philanthropic subsidy.

We propose that the Market Access Fund be funded through a 10 basis point assessment on all securitized mortgages, whether or not an issue receives a federal catastrophic guarantee.²⁴ The fee would be structured as a “strip” from the mortgage coupon, in the same way that servicing fees are charged, and would continue for the life of the mortgage. It could be easily collected by the SEC on behalf of the Fund, or, if proposals for a single mortgage backed securities platform are implemented, by the platform. Estimates suggest this fee would result in approximately \$5 billion in revenues by the fifth year of generation.

This fee would be split among the Market Access Fund, the National Housing Trust Fund, and the Capital Magnet Fund (the latter two funds were established by HERA but the FHFA has declined to fund them citing conservatorship as a reason, an action now being challenged in court²⁵). The National Housing Trust Fund allows the states to expand the supply of rental housing for those with the greatest housing needs, and the Capital Magnet Fund enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact.

By creating and using the Market Access Fund in this manner, all participants in the mortgage market will be contributing to the stability of that market and of the economy. That will be a marked contrast to the pre-crash system in which the so-called private market was able to use the credibility and stability of the US capital markets to simultaneously abuse lower wealth borrowers and communities and make huge profits.

Other proposals call for all low- and moderate-income lending to be served through the FHA. This approach ignores the fact that much of this segment can be well and safely served by the core conforming conventional market, and that the primary market’s conventional lending to such segments, through CRA and otherwise, depends on a reliable secondary market outlet. Instead, it would institutionalize a dual mortgage market, with less choice and higher costs for borrowers who would most benefit from access to the prime conventional market, and it would unnecessarily and inefficiently drive credit risk onto the government’s balance sheet.

We argue that access and affordability objectives can be achieved whether the GSEs are replaced by numerous private credit-risk takers, a public utility, or a nationalized secondary market. That said, the more centralized the credit-risk-taking entity (s), and the more authority it has, the easier it is to align the delivery of the guaranty with broader housing policy objectives.

7. The system should provide financing to preserve the existing privately-owned affordable housing stock and support the construction of new affordable units.²⁶

Approximately one-third of Americans live in rental housing.²⁷ Rental homes provide a starting place for new households, mobility for people who move with their work, convenience to transit, a transition for older adults who no longer need a large home, and affordable shelter for many Americans of low and moderate income. Rental housing is in urban, suburban, and rural communities. As we restructure the mortgage finance system, we must ensure that it directs capital to rental housing, particularly housing that is affordable to low- and moderate-income households.

The cost of rental housing is an increasing burden, particularly for people with the least income. HUD recently reported that the number of low-income renter households with worst case needs increased to 8.48 million in 2011, up from a previous high of 7.10 million in 2009.²⁸ Looking specifically at working households, the Center for Housing Policy found that more than one in four renter households spent

more than half of their income on housing.²⁹ In most places, rents are rising faster than income.³⁰

Rental housing needs access to capital to serve the many people who rely on it. Construction of new rental properties only occurs if there is permanent mortgage capital available to finance it once construction is complete. In addition, properties large and small need periodic renovations, typically every five to seven years. To preserve older affordable rental housing, developers often need financing to acquire as well as renovate the properties. The secondary mortgage market provides a critical source of capital to finance all of this construction, acquisition, renovation, and refinancing.

The primary means that the federal government uses to ensure that capital flows to rental housing are FHA and the GSEs, each of which has a division devoted to multifamily housing.³¹ During the 2008 financial crisis, when private capital retreated nationwide, FHA and the GSEs were virtually the only sources of capital for financing rental housing.³² Even as private capital has gradually returned to multifamily, it has mostly focused on A-class properties in the strongest urban and suburban markets, leaving government channels to finance older, less-expensive properties and those in secondary and tertiary markets. As private capital gradually broadens its risk exposure, the recent crisis is a reminder that only a government-supported channel provides the countercyclical capacity to ensure steady access to capital for rental housing.

But even under normal conditions, private sources of multifamily rental financing often cannot provide enough credit in rural areas and smaller cities or produce the long-term, fixed-rate mortgages that attract diverse investors and to produce affordable properties.³³ The GSEs have long played a role in making sure these gaps in the multifamily market are filled.

Performance of the GSE multifamily divisions, in particular, has been strong throughout the financial crisis. Default rates for Fannie Mae and Freddie Mac multifamily loans have remained well below 1% throughout and since the financial crisis—a fraction of the multifamily default rate seen by commercial banks and private-label MBS.³⁴ Disciplined underwriting, a strong network of originators, and active asset management kept both GSE's multifamily divisions profitable—far different from single-family.³⁵ That provides a strong track record on which to build as we consider options for housing finance reform for multifamily.

Ensuring adequate financing for affordable housing preservation and construction requires a carefully deployed and targeted government guarantee to encourage private capital to bear risk ahead of the government for affordable multifamily finance. It is essential that multifamily rental finance needs get explicit attention in housing finance reform so that the eventual new system preserves the strengths that have lasted through the financial crisis to finance affordable rental housing.

As we recommend in the single-family area, we believe the way forward should be for bond guarantors (most likely specializing in multi-family) to take predominant risk ahead of the government guaranty for permanent financing. These entities would be required, on an annual basis, to demonstrate that 60 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of median income. Moreover, as in single family, the entities would pay the fee that will help support the National Housing Trust Fund and the Capital Magnet Fund – existing funds that, if properly capitalized, would help bridge the housing affordability gap.

8. *The system should support effective and fair mortgage servicing practices as well as appropriate systems to support clarity of property title.*

One of the most "broken" parts of the housing finance system is mortgage servicing. In the aftermath of the housing and financial crisis, the perverse financial incentives embedded in the current system of servicer compensation as well as confusing pooling and servicing agreements resulted in servicers severely compounding the damage rather than ameliorating it.

The single largest driver of the foreclosure crisis was servicers that routinely foreclosed on homes when foreclosure was not only unnecessary, but neither in the best interest of the investor or the homeowner. This occurred in large part because the way servicers are compensated gives them an incentive to pursue foreclosures over modifications. Once a loan is in default, servicers must choose to foreclose or modify. A foreclosure guarantees the loss of future income, but a modification will also likely reduce future income, cost more in the present in staffing, and delay recovery of expenses. Moreover, the foreclosure process itself generates significant income for servicers.³⁶

Yet, for servicers, the true sweet spot lies in stretching out a delinquency without either a modification or a foreclosure. Income from increased default fees and payments to affiliated entities can outweigh the expense of financing advances for a long time. This nether-world status also boosts the monthly servicing fee and slows down servicers' largest non-cash expense, the amortization of mortgage servicing rights, since homeowners who are in default are unlikely to prepay via refinancing.³⁷ Finally, foreclosure or modification, not delinquency by itself, usually triggers loss recognition in the pool. Waiting to foreclose or modify postpones the day of reckoning for a servicer. But delay can cost a homeowner the opportunity to obtain a modification.

Servicers also have routinely overcharged homeowners and investors for routine activities such as insurance and default servicing fees. For example, overcharging for lender-placed insurance (also called force-placed insurance), as well as placing that insurance when not necessary, often pushed borrowers who were otherwise making their monthly payments into default and foreclosure. There is ample evidence that servicers have received kickbacks from insurers, made force-placed insurance a profit center through "commissions" to servicer affiliates, and entered into captive reinsurance schemes with servicer affiliates.³⁸

Going forward, congressional legislation concerning the securitization system should build in standardization, accountability, and transparency concerning servicer compensation and contractual obligations. For example, servicers should be prohibited from having any financial interest in force-placing insurance other than the coverage provided by the insurance, and Congress can address the non-competitive market structure for third-party products generally – including title insurance, private mortgage insurance and force-placed insurance – by requiring mortgage securitization platforms to enable investors to directly purchase these products instead of reimbursing inflated charges made by servicers and loan originators. Contracts must spell out the core principle that servicers should act in the best financial interest of both investors and borrowers, keeping homeowners in their homes rather than foreclosing when doing so would return the greatest value to investors. Failure to fulfill this obligation should result in financial consequences that incentivize compliance. (While the Consumer Financial Protection Bureau has established loss mitigation standards for servicers that offer loss mitigation, it did not mandate offering loss mitigation, leaving this issue up to Congress.)

Additionally, once an initial request for loss mitigation has been made by the homeowner, the servicing agreements should require servicers to refrain from initiating a foreclosure or, where a foreclosure has been initiated, from taking any additional steps to pursue that foreclosure, until completion of the review

of any loss mitigation application, including written notice to the homeowner documenting any denial and the completion of any appeal process. The practice of pursuing loss mitigation and foreclosure simultaneously (also known as "dual tracking") has been one of biggest drivers of unnecessary foreclosures.

One structural suggestion for improving servicing practices is to provide bond guarantors with the ability to buy defaulted loans out of pools and hold them in portfolio to have more flexibility in modifying those loans. Ginnie Mae does not have a portfolio now, which requires servicers themselves to purchase loans having payment difficulties out of the pass-through securities and then attempt to re-securitize them. As a result, servicers can only modify the loans to current interest rates and 30-year terms (in other words, very shallow modifications) to fit into new Ginnie Mae pools. Fannie and Freddie, on the other hand, have been able to offer modifications that are both more affordable and sustainable because they can buy loans out of pools and hold them in portfolio, where it is easier to reduce interest rates and/or extend loan terms.

Another set of abusive servicer practices related to their failure to use the traditional systems of tracking property title, resulting in massive confusion and lack of ability to prove ownership or the right to foreclose. Various legislative proposals suggest creating one privately operated national system rather than multiple, publicly operated state systems. There are several problems, however, with such proposals.

First, clarity of real property title is a public good and should be provided by the government, rather than by private parties, as is already done by the federal government for patents, trademarks, copyrights, broadcast spectrum, airplanes, and nautical vessels, among other types of property.

Second, the existing proposals would separate land and mortgage records, which are currently maintained in unified local databases. While the aim in doing so is to improve on MERS, a troubled privately-operated mortgage registry, MERS operates as a superstructure addition to local land records, rather than as a completely separate database. When a lien is registered with MERS, MERS is listed as the lienholder in the local land records, with the actual mortgage rights tracked in MERS' electronic database, so someone investigating property title will see in the local land records that there is a lien. With a separate national system, local land records would cease to provide definitive sources of clear title, but would also continue to exist and be relevant for determining title. The result would undermine the very goal of a national system, as it would only add a title system, rather than consolidate existing ones.

Third, none of the proposals has considered the interaction between voluntary mortgage liens recorded in a national database and various types of involuntary liens (such as tax liens, construction liens, and judgment liens) recorded in local land records. Similarly, the national system would not be mandatory for all consensual mortgage liens, but only for those using a new federal securitization platform or insured by a new government-sponsored entity. This means that the national database would be incomplete even as to voluntary mortgages.

A fourth problem is that in about half of all states, a mortgage is considered actual ownership of the land with the borrower having a repurchase option, rather than as a lien, so mortgage recordation and transfer law in these states is subject to various legal requirements relating to the transfer of real property. The interaction of a national system with these local real property laws has not been considered and could potentially create more confusion than a national database resolves.

Finally, it is not clear whether there is constitutional authority for the federal government to interfere with real estate recordation, which is traditionally a local right.

A simpler solution to lack of consistency of mortgage title procedures among the states would be to recreate a federally-owned and operated MERS-type system that would sit as a superstructure on local land records. Such a system could easily interface with existing land records, local real property law, and lien priority rules. Further, with any federal-MERS system, it would be simple to correct the major failings of the MERS system: failure to properly and timely register transfers could have definite legal effects, thereby ensuring the accuracy of the database; foreclosures could be required to be undertaken in the name of the real party in interest; and transfers within the database could only be made by properly registered and vetted agents of lenders, rather than by MERS' poorly-supervised and much-criticized system of 20,000 "signing agents," none of whom actually work for MERS.

9. *The system should provide access and a level playing field for both large and small lenders.*

A diverse lending market is crucial for ensuring broad access to credit for all borrowers and communities, including rural communities, communities of color, and communities that have been hard-hit by the recession. A secondary market that enables lenders of all sizes in all communities to offer mortgages on equal and well understood terms is one of the major beneficial functions of Fannie Mae and Freddie Mac that, going forward, the reformed system must retain and even improve on.

In revamping the current housing finance system, we risk building a system that favors large, well-capitalized banks (and their affiliates) and leaves small originators at the mercy of their larger competitors as to whether and under what terms they can access the government-guaranteed market. Some proposals, including S. 1217 and the Bipartisan Policy Commission proposal, would explicitly allow banks and originators to perform the predominant credit risk-taking function. In a marketplace already characterized by extreme concentration of origination and servicing in entities that have both explicit government guarantees (on deposits) and implicit guarantee ("too big to fail"), this structure would only extend the large banks' market power and encourage the accumulation of risk with an implicit government guaranty. In effect it would be recreating Fannie and Freddie, except under the control of the largest originators. While proponents point to the Ginnie Mae model where originators are also issuers, they ignore the fact that the credit risk-taking function is not provided through Ginnie Mae or the issuers, but through FHA on a per-loan basis, universally available on equal terms. In the case where issuers themselves are determining the risk parameters and pricing for the predominant credit risk, such a transparent and level playing field will be hard to achieve.

In our view, originating lenders should not also be able to own the bond guarantors or other entities that perform the predominant credit risk-taking function, except as part of a broad-based mutually owned entity designed to ensure access at equitable prices to smaller lenders such as community banks, credit unions and community development finance institutions. It might also be appropriate for a government entity, such as a housing finance agency or agencies, to become a guarantor. While S. 1217's proposal of a cooperatively-owned entity is a useful idea, in the context of the rest of the bill, it is not clear that it would provide comparable access on equal terms.

10. *The system should include strong regulatory tools to supervise, monitor and ensure the appropriate operation of entities that provide access to the government guarantee.*

Regulatory supervision for system safety and soundness will be a crucial part of a well-functioning housing finance system. Lax regulation and captured regulators in many ways led to the crisis we

recently experienced, both in the housing finance system and the financial system as a whole. As former FHFA director James Lockhart recently noted, "An ounce of prevention is worth a pound of cure."³⁹

For any new system, it is critical that the government have access to the full range of regulatory tools to supervise bond guarantors, issuers, and other counterparties. There needs to be a regulator with authority to examine and even take injunctive type action, similar to the FDIC's Prompt Corrective Action, or PCA, which can and should be done in coordination with the FMIC if the FMIC is not the primary regulator. Furthermore, any entity providing insurance of any type, whether it's loan or pool level, must be licensed as an insurer either by a state (potentially subject to standards set at the federal level) or by the federal government.

We believe that effective oversight may be difficult to achieve in a system where issuers engage in diverse structured transactions. Initial "approval" of an issuer does not equal oversight, and in fact, may be counterproductive in that it may give a green light to subsequent actions that are unmonitored by the regulator. It will be much more effective to provide the FMIC with adequate tools, including the power to charter or license bond guarantors, and other counterparties have their own regulators with whom the FMIC can coordinate.

Conclusion

From the 1930s through the end of the last century, the United States enjoyed a vibrant, stable, housing market that evolved to provide liquidity for mortgages in all parts of the country through every business cycle. The system was not perfect, but it taught us valuable lessons as we look to rebuild. By applying those lessons, we have the opportunity to build a mortgage market that is fair, accessible, affordable, and fiscally sound -- in short, one that works better for more households and communities than ever before.

Thank you again for inviting me to testify today. I look forward to continuing discussion on these important matters as the Senate moves forward on housing finance reform legislation.

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