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Before

The U.S. Senate Committee on
Banking, Housing and Urban Affairs

"Housing Finance Reform: Protecting Small Lender Access to the Secondary Mortgage Market"

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Chairman Johnson, Ranking Member Crapo and members of the committee, my name is Bill Cosgrove and I am a Certified Mortgage Banker. I currently serve as Chief Executive Officer of Union Home Mortgage Corp., headquartered in Strongsville, Ohio, and I am the Chairman-Elect of the Mortgage Bankers Association[1]. I own and operate a family-owned business, and have been an independent mortgage banker for 28 years. My company employs 278 individuals, and I am very proud that since I purchased the company in 1999 we have helped more than 50,000 homebuyers finance and refinance their homes and achieve their dreams of homeownership.

Importance of small lenders to the housing finance system

Small lenders play a crucial role in the American housing finance system. More than 7,400 lenders originated mortgages in 2012 according to the Home Mortgage Disclosure Act (HMDA) data. The vast majority of these were small lenders with vital ties to their communities.

Fannie Mae and Freddie Mac report that roughly 1,000 lenders are direct sellers to the GSEs, and Ginnie Mae currently has more than 250 single-family issuers. The vast majority of these loan originators are smaller independent mortgage bankers and community banks. In fact, according to the most recent data, while independent mortgage banks represent only 11% of lenders who report under HMDA, this group originated 40% of all purchase money mortgages in 2012. Over the course of the next year, this group, and small lenders as a whole, will become increasingly important as we transition from a predominately refinance market to a primarily purchase market.

It is important to recognize that not all small lenders have the same needs when it comes to accessing the capital markets for mortgages. For example, not every smaller lender has the financial capacity or expertise to directly manage the risks and complexities of the secondary market. Rather than deal with the GSEs directly, these small lenders prefer instead to sell whole loans to aggregators. Many community banks are uncomfortable selling only to aggregators as they do not want to risk losing other key product relationships with their customers. And still others, like my company, desire to issue securities or sell whole loans based on the execution option that results in the best price for the customer. For most community lenders, it is critical to have direct access to the secondary market as an additional tool to ensure competition and an outlet for loans at times when the aggregators pull back.

Lenders with the skills and the capital should be in a position to make their own choices about how, when, where, and to whom to sell their production, based on their core competencies and other strategic objectives. Unfortunately, current GSE practices today sometimes limit the choices of otherwise qualified lenders.

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mba.org.

Options for the end state framework

Under the current GSE model, Fannie Mae and Freddie Mac are the issuers. They purchase loans from lenders and provide a guarantee (backed by an implicit government guarantee).

Under the Ginnie Mae model, lenders are the issuers. Lenders obtain loan-level insurance from a government program (FHA, VA, USDA) and then issue the securities, obtaining a security-level guarantee from Ginnie Mae.

The GSE model provides for many, typically smaller, lenders to sell whole loans to Fannie Mae and Freddie Mac for cash. This provides quick funding, which is a valuable benefit for many smaller lenders.

The Ginnie Mae approach puts greater responsibility and control with the lender. However, the operational complexities may prevent some smaller lenders from becoming issuers. As a reference, there are roughly 400 Ginnie Mae issuers, and over 1000 direct sellers to Fannie and Freddie.

It is important to note that both options can be made to work well for smaller, community-based lenders, provided policymakers address the issues outlined below.

Making the Secondary Market Work Better For Smaller Lenders

In the past few years, as the mortgage market has begun stabilize, more small lenders have chosen to diversify their secondary market options by selling directly to the GSEs, and retaining the servicing on the loans they originate. This has been a healthy trend, and an early sign that the market has begun to deconsolidate. The GSEs have already substantially increased their qualification standards in the post crisis period for lenders with respect to minimum net worth requirements. It is important to note that further increases in net worth standards for small lenders would block direct access to the secondary market for critically important community lenders.

As policymakers consider both transitional and end state reforms, the future secondary market needs to provide direct access, on competitive terms, for those lenders who can take on the requisite responsibilities. In particular, smaller lenders need a secondary market that delivers:

- Price certainty, including guarantee fees that reflect the risk of the underlying loan (and not the loan volume or the asset size of the lender);
- Execution for both servicing-retained and servicing-released loans;
- Single loan and/or small pool executions with a low minimum pool size;
- Ease of delivery;
- Quick funding.

Fannie Mae's and Freddie Mac's cash windows provide some, though not all, of these aspects today. While Ginnie Mae provides a means of securitizing single loans, the relative complexity of the process has kept many smaller originators from becoming direct issuers, thus the smaller number of Ginnie issuers relative to GSE direct sellers.

Price Certainty and Transparency

One major ongoing concern has been the pricing advantages (e.g., lower guarantee fees) and other preferences received by some lenders. These disparities contributed significantly to the consolidation of the lending market during the run-up to the financial crisis and in its aftermath. Although the FHFA has reported that these disparities have narrowed, there is little transparency on pricing and pricing concessions offered to certain lenders, despite the fact the enterprises are in their fifth year of conservatorship. Historically, certain lenders also received negotiated underwriting variances as well, which gave them additional competitive advantages.

MBA believes that FHFA should expedite efforts to eliminate any remaining pricing and underwriting concessions. In addition, end state reforms should also ensure that the federally supported secondary market provides transparent pricing, programs and underwriting standards. Guarantee fees should reflect the risks of the underlying loans, and should not differ across qualified originators, except to reflect objective measures of counterparty risk. Access to programs and products should be made broadly available to all lenders that meet minimum standards, and any additional requirements needed to mitigate counterparty risk should be based on objective and transparent factors so that smaller lenders have a clear path to participate.

Pricing in the federally-supported secondary market should be more transparent and calibrated to objective measures of loan-level and counterparty risk.

Execution Options for Smaller Lenders

Because of the risks associated with the GSEs' large retained portfolios, most proposals regarding the future of the federally backed secondary mortgage market do not envision the successors to the GSEs having large investment portfolios of mortgages. Today, the GSE cash windows provide lenders of all sizes a bid for whole loans. While this bid may not always be the best execution available in the market, it is open every business day, provides quick funding for lenders, and is relatively simple in terms of operational process. MBA believes secondary market reform needs to ensure that any successors to the GSEs retain small portfolios necessary to operate a cash window and aggregate multi-lender securities.

Some lenders who have achieved additional scale and sophistication want to pool and securitize their loans themselves in order to get a better "all-in" price. Beyond selling to the cash window, there are existing means for lenders to deliver small lots into multi-lender pools. The *Ginnie II* and the *Fannie Majors* programs both allow single loan execution.

However, these programs are more complex than using the cash windows, and thus only a small number of lenders utilize the programs. There is a need for simplification of these processes to make them more user-friendly for smaller lenders. For example, although multi-

lender securities might not price as well in the capital markets as larger pools from a single lender, any discount could be reduced by pooling practices that increase the size of these multi-lender securities.

In addition, it is important for some smaller lenders that they have the option to securitize loans on either a servicing-released or retained basis. Currently, Fannie Mae and Freddie Mac have programs in place which facilitate bifurcation of originator and seller reps and warrants so that originators can deliver loans servicing-released. However, participation in these programs is tightly restricted. Such programs are necessary going forward, and should be made more broadly available to smaller lenders. MBA believes these programs do not need direct facilitation from any other player and that smaller sellers should be able to negotiate reps and warrants directly with any approved servicer.

Quick Funding

It is also important for smaller originators to have an option for receiving quicker funding. In the new system, there should be some consideration to moving to more frequent settlement dates to permit quicker funding. Broker dealers already provide a bid for off-settlement-date trades using interpolated pricing. The expectation is that this market could grow if more sellers utilize it. Direct sellers to the GSEs or issuers in the Ginnie Mae program must meet financial and managerial standards to be approved today. Smaller lenders who wish to be direct issuers will need to meet the issuer standards (net worth and other standards) set by the public guarantor in a future model. These standards need to be set at a level that allows for meaningful access by smaller lenders.

Key GSE assets should be preserved to assist small lenders in a new system

As Congress considers broader reforms to the secondary market, care must be taken to ensure a smooth transition, and that “switching costs” to a new system do not create a major barrier to participation by smaller lenders. Key GSE assets, including technology, systems, data, and people, should be preserved and redeployed as part of any transition associated with GSE reform. For example, certain assets could be moved into the Common Securitization Platform. Other assets could be made broadly available through a public leasing program, or sold/auctioned with conditions that ensure access to all market participants.

In addition to the infrastructure assets, the following functions and support services should be retained in any new system:

a. Cash Window/Whole loan execution;
b. Multi-lender security execution;
c. Single-loan securitization;
d. Servicing retained sales; and,
e. Servicing released sales.

In addition, single-family lenders should be able to utilize familiar credit enhancement options, such as mortgage insurance, to facilitate secondary market transactions in a timely and orderly way. Key credit enhancement functions present in today’s secondary market system should be

preserved and improved, while allowing new forms of private credit enhancement to develop over time.

It may well take a combination of approaches to ensure that the system works for both smaller and larger lenders. It is imperative that the new system provide access on a competitive basis to qualified institutions, as this vibrant competition will ultimately benefit borrowers.

Role of FHLBs in a new system

Congress should give serious consideration to expanding Federal Home Loan Bank membership eligibility to include access for non-depository mortgage lenders. In fact, historical evidence shows that such a move is consistent with the original intent of the system.[2] These lenders are often smaller, community-based mortgage bankers or servicers focused on providing mainstream mortgage products and services to consumers. They are a critically important source of mortgage credit, especially for purchase market – the Fed's recent HMDA report shows that independent mortgage bankers accounted for 40% of home purchase lending in 2012.

The Federal Home Loan Banks have had an important role in providing long-term funding for institutions that hold mortgage loans on their balance sheets. In the future system, this role could be expanded to include shorter-term financing for the aggregation of pools of mortgage prior to securitization. This financing would become even more critically important if the end state reform does not preserve a cash window option, but only if membership criteria for the FHLBs were expanded to include community lenders of a variety of business models, including independent mortgage bankers.

In exchange for membership in the FHLB system, these institutions could be required to hold a limited class of stock with appropriate restrictions. Expanding FHLB access to these institutions would enhance market liquidity and ensure a broader range of mortgage options for consumers, and improve the execution options for FHLB members as a whole.

Creation of a Mutual Organization

S. 1217 proposes a system that is closer in many respects to the Ginnie Mae model. Lenders are issuers, and are responsible for obtaining private credit enhancement before delivering pools of loans to the central securitization platform for the government guaranty. This approach may work for some lenders, but may be too operationally difficult for many smaller lenders. S. 1217 provides an alternative for smaller lenders in the form of a mutual securitization company, a cooperative that takes the role of aggregator and issuer. S. 1217 also provides for the FHLB system to be aggregators for smaller lenders.

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[2] Professor Snowden notes that "Hoover had envisioned a federal home loan bank that would serve all institutional residential mortgage lenders, including commercial and savings banks, insurance companies and mortgage companies. The USBLL did not however, and, in the end, Hoover's reliance on that organization limited the breadth and effectiveness of the FHLB system during the 1930s."

The mutual could potentially fill the aggregation role for those lenders who do not have the operational capacity or desire to be an issuer. However, if Congress establishes appropriate parameters around capital requirements and credit standards and takes the proper steps to ensure small lender access throughout the core reforms, such as the execution options noted above, transparent pricing, and product access, a mutual structure may not be necessary. Regardless, broad standards for a mutual should ensure a fair governance process that does not advantage one class of mutual shareholders over another based on size or loan volume.

Questions arise regarding the economic model for the mutual. First, it appears that the mutual is likely a private, not a government organization. As such, its cost of financing may be high. Without a favorable cost of funds, it is not clear whether the aggregation business could be run profitably and safely. Second, lenders working with the mutual would likely be required to maintain an equity stake in the cooperative. This represents an ongoing liability that would likely be difficult to liquidate if the lender needed funds. Certain mutuals provide for capital stock to be sold back at a par value, but this then increases risk for the mutual. In structuring any mutual entity intended for smaller lenders, it is important to ensure that it is not an inferior execution option that limits small lender competitiveness.

Finally, there are questions regarding membership criteria for the mutual. If this channel of execution is optimal, it should be open to all lenders in order to maintain a level playing field. In fact, there should be provision for the creation of additional issuer entities that could compete along various dimensions.

Transition to a new system

Transition to a new housing finance system should occur in a manner that avoids disrupting the market. Preserving the execution options for small lenders will be critical to a smooth transition. Extended phase-in periods will be necessary, and the new regulator should have some discretion and flexibility to extend those phase-ins if necessary to ensure a smooth transition. Standardized securities and transparent underwriting and guarantee fee pricing based on the risk of the mortgages, and not the volume or asset size of the selling institution, will ensure that smaller lenders have access to the federally supported segment of the secondary market.

As policymakers begin moving the market toward the desired end state for Fannie Mae and Freddie Mac — either through regulatory, administrative, or legislative actions — two items need particular attention.

First, the GSEs' current cash window needs to remain in place until the new secondary market delivery systems are fully operational. As the GSE portfolios wind down, sufficient balance sheet space needs to be maintained to aggregate loans from smaller lenders who are not yet ready to securitize. As noted, the new system must also have fully viable small lender execution options before winding down the existing cash window.

Second, the FHFA platform initiative needs to include plans for the acceptance of small lot deliveries into multi-lender pools, perhaps initially designed as an expansion of the *Fannie Majors* program. Every effort should be made to further simplify this program so that it can be a viable, competitive option for lenders of every size.

Rural Concerns

Small lenders – community banks, credit unions and independent mortgage bankers – provide a critical link to rural communities. Maintaining access to the system in rural markets can be accomplished through the broader efforts to ensure small, community lender access to the new system. The use of percentage of business goals is too rigid, could lead to inappropriate risk assessment and would besubject to "counting" games that undermine their objectives and should not be used in the new system.

S. 1217 clearly addresses many of the concerns of smaller lenders with respect to maintaining direct access to the secondary market on a competitive basis. S. 1217 could be enhanced by requiring the new private credit enhancers to ensure small lender access through:

- a cash window for aggregation (not investment)
- additional small lender execution options like single loan and multi lender pooling options, and
- requiring fair, transparent pricing and access for all lenders.

Care must also be taken with respect to certain issues, particularly around transition, to ensure that key assets of the GSE model are redeployed to the new system, ensuring liquidity, access, and a level playing field for lenders of all sizes.

Conclusion

Making the secondary market work for smaller lenders is critical for providing a competitive market, which ultimately benefits homebuyers. We are encouraged by the recent work undertaken by this committee to tackle the complexities of housing finance reform, and urge you to ensure that secondary market reform provides smaller lenders with opportunities for direct access.

Thank you again for the opportunity to testify today, and for the chance to continue this critical dialogue with the members of this committee. I look forward to any questions you may have.