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HOUSING FINANCE REFORM: CONTINUATION OF THE 30-YEAR FIXED-RATE MORTGAGE

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE PROS AND CONS OF CONTINUING THE 30-YEAR FIXED-RATE MORTGAGE

THURSDAY, OCTOBER 20, 2011

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C O N T E N T S

THURSDAY, OCTOBER 20, 2011

HOUSING FINANCE REFORM: CONTINUATION OF THE 30-YEAR FIXED-RATE MORTGAGE

THURSDAY, OCTOBER 20, 2011

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

I would like to thank our witnesses for being with us today. This will be the 11th housing finance reform hearing held by the Committee. Before we began our series of hearings, I released my agenda for the Committee which included several priorities for housing finance reform. Maintaining the widely available 30-year, fixed-rate, prepayable mortgage was one of those priorities.

I firmly believe that we need to reform our housing finance system, but I am concerned about the unintended consequences for our housing market and economy that could result. A new system that eliminates the most popular and stable mortgage product in the country would be a step backwards rather than an improvement to our housing market.

Let me be clear. I am not advocating that the 30-year fixed-rate mortgage be the only product available. Shorter-term fixed-rate loans, like the 15-year or 20-year mortgage, can be appropriate for certain borrowers or families refinancing their mortgages. Well-underwritten, conventional, adjustable-rate mortgages can also be appropriate for borrowers who can afford them. However, any new housing finance system must ensure that the 30-year fixed-rate mortgage continue to be widely available to qualified borrowers across the country.

The prepayable, long-term fixed-rate mortgage allows households to budget their finances better and establishes a stable housing cost which is not always available by renting. Homeownership is not the right choice for everyone, but for those who choose to own a home, the 30-year fixed-rate mortgage is the most predictable option for financing a home.

Witness testimony during our last hearing stated that under some proposed systems, the 30-year fixed-rate mortgage would likely require substantial downpayments, higher incomes, and higher interest rates, restricting the number of borrowers to a substantially small number compared to today. This is the last thing our housing recovery needs.

Our witnesses have extensive experience and knowledge about the impact the 30-year fixed-rate mortgage has had on homeowners, the mortgage market, and the economy. I look forward to hearing their testimony regarding its merits and risks as well as the options for Congress if we are to continue what I believe is a necessary product.

With that, I will turn to Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

Today's hearing, as you said, will examine the pros and cons of the Federal Government continuing basically to subsidize the 30-year fixed-rate mortgage. During the Great Depression, the Federal Government established direct and indirect subsidies for 30-year fixed-rate mortgages. For many Americans, the 30-year fixed-rate mortgage has made homeownership possible, yet the failure of Fannie and Freddie and the $169 bailout of those institutions demonstrate that the Federal Government's support for the 30-year mortgage comes with a cost.

Accordingly, if this Committee ever decides to undertake housing finance reform, it will need to determine whether the benefits of the Government's support for the 30-year fixed-rate mortgage outweigh the costs. In addition, if it decides to continue to subsidize the 30-year fixed-rate mortgage, the Committee will need to find a way to protect taxpayers from having to pay for bailouts in the future.

Today's hearing should provide some insight into how the Federal Government's support for the 30-year fixed-rate mortgage impacts consumers and taxpayers. For example, is the 30-year fixed-rate mortgage always the best option for consumers? Is the prepayment option included in these 30-year fixed-rate mortgages truly free? And what has the subsidy of this product already cost the American taxpayer? And can this product be offered without that subsidy?

Consumer choice I think is very important. Consumers should be able to purchase a 30-year fixed-rate mortgage at the appropriate market rate if they determine that that product is best for them. I think we must not create incentives that should push people toward a 30-year fixed-rate mortgage even when it would be harmful to them.

I also hope to learn from today's hearing how subsidizing the 30-year fixed-rate mortgage impacts our financial system. For instance, is the claim that the financial crisis could have been averted if only more people possessed the 30-year fixed-rate mortgage a fact or fiction? What unintended consequences have been created by subsidizing the 30-year fixed-rate mortgage?

These are all important questions, and there are many more that I think need to be answered as we go along. For many people it is assumed that the narrative surrounding the 30-year fixed-rate mortgage has already been written and that there is no need to investigate the facts. As we proceed with housing finance reform, I think we must seek a full understanding of the facts. In other words, legislating by anecdote is not acceptable.

We need to take a hard look at this product and determine if the preferential pricing resulting from these subsidies truly creates a public good. Only by doing a thorough, fact-based analysis can we develop sensible, profound housing policy.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you all.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to welcome the witnesses for our panel today. Our first witness is Ms. Janis Bowdler. She is the Director of the Wealth-Building Policy Project with the National Council of La Raza.

Mr. John Fenton is President and CEO of Affinity Federal Credit Union and is appearing on behalf of the National Association of Federal Credit Unions.

Dr. Anthony Sanders is a Professor of Finance at George Mason University School of Management.

Dr. Paul Willen is Senior Economist and Policy Advisor with the Federal Reserve Bank of Boston.

And, finally, we have Dr. Susan Woodward, who is the President of Sand Hill Econometrics and the former Chief Economist at the SEC and prior to that HUD.

We welcome you all here today and thank you for your time. Ms. Bowdler, you may proceed with your testimony.

STATEMENT OF JANIS BOWDLER, DIRECTOR, WEALTH-BUILDING POLICY PROJECT, OFFICE OF RESEARCH, ADVOCACY, AND LEGISLATION, NATIONAL COUNCIL OF LA RAZA

Ms. BOWDLER. Thank you and good morning, and thank you for having me. My name is Janis Bowdler. I am the Director of the Wealth-Building Policy Project at the National Council of La Raza. My project promotes fair markets where Latino families can obtain assets and build wealth they can share with their children. I hope that today's hearing will shed light on a critical issue: the importance of the 30-year fixed-rate mortgage. Without this flexible financing tool, homeownership would become a luxury reserved for the affluent. We urge Congress not to abandon their commitment to providing a path to homeownership, which has long been the cornerstone of middle-class wealth.

This morning I will provide a brief overview of the importance of the 30-year fixed-rate mortgage. I will also share our ideas on how to maintain a responsible path to homeownership for future generations. Let me start with the benefits of the 30-year fixed.

The long term makes the asset more affordable. The fixed rate provides certainty. Modest downpayments open the door for those with sufficient incomes but who lack the family wealth. The amortization feature means the borrower can predict the final payment and build wealth as principal is repaid. Finally, most prime 30-year fixed-rate notes are prepayable, which means that the borrower can refinance or sell without penalty.

In sum, there are two key reasons why supporting the 30-year fixed-rate mortgage is good public policy. It makes homeownership affordable to working- and middle-class families who did not inherit wealth, and it provides stability to families who have to budget carefully to keep their biggest asset and investment—their home. Together, these features have helped create a stronger middle class. This is especially true for Hispanic and black homeowners for whom home equity makes up the majority of their wealth.

Unfortunately, the benefits of homeownership have not been equally available. An abundance of research has documented the unfair steering of borrowers of color to toxic mortgages, even when they qualified for prime loans. The subprime loans are not only expensive, they are also more likely to end up in default. So it is not surprising that Latinos have been hit hard by the foreclosure crisis. In fact, new data shows that wealth held in white households exceeds that of Latinos by a staggering 18:1, and 20:1 for African Americans. This gap is attributed to differences in home equity and the loss of homes through foreclosure.

Critics of the 30-year fixed note will argue that families would be better off in adjustable mortgages. However, most families do not view their home as a get-rich-quick scheme. They do not play the markets and they do not hedge interest rate risk. Rather, they are investing in a nest egg and a community with the anticipation of long-term returns. The predictability and security of a 30-year fixed-rate mortgage helps them meet those goals.

Of course, no one is suggesting that a family enter homeownership unprepared, and we definitely need a robust rental market for families for whom homeownership is not available or desirable. That said, now is not the time to abandon our commitment to putting ownership in reach of qualified families when it is their time. Several decades of innovative, affordable lending has taught us how to reduce the risk of lending to new buyers and low-wealth households.

For example, in a recent comparison of like borrowers where the only difference was the kind of loan they received, an affordable 30-year versus a subprime loan, the 30-year fixed dramatically outperformed the subprime loan. This reflects our own experience with first-time homebuyers. Over the last 13 years, NCLR Homeownership Network counselors have helped more than 25,000 moderate-income families purchase a home with a prime mortgage. This evidence shows that when families receive the right loan with the right support, they can be successful homeowners and build wealth, even with modest incomes and low downpayments.

Unfortunately, tight credit standards, pricing adjustments by the GSEs, and overlays on FHA are limiting prime loans in the market today and preventing qualified families from taking advantage of low rates and home prices. However, it is the threat to the future of affordable lending that has us most concerned. Earlier this year, Federal bank regulators promoted the idea of a wealth standard that would cement high downpayment requirements and regulations, and critics of Fannie and Freddie are going further by pushing for a complete dismantling of our current secondary market system, even though lenders, especially small community lenders, say they would not be able to offer a fully amortizing 30-year loan in a completely private system.

Rather than dismiss a proven finance tool and affordability features, we should work together to preserve those aspects of our housing finance system that work well. I have attached to my written statement a set of principles to guide our thinking on GSE reform. It is signed by NCLR and 16 other civil rights organizations. In addition to the principles laid out in that letter, I offer three specific recommendations today:

Maintain secondary market liquidity for affordable 30-year fixed-rate loans that are made equally available to all qualified families;

Support pre-purchase housing counseling and other credit enhancements that we know work for working families;

And reduce barriers to purchasing a home by eliminating loan level pricing adjustments and expanding the use of proven affordable lending models.

Thank you, and I would be happy to answer any questions.

Chairman JOHNSON. Thank you.

Mr. Fenton, you may proceed.

STATEMENT OF JOHN FENTON, PRESIDENT AND CEO, AFFINITY FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. FENTON. Good morning, Chairman Johnson, Ranking Member Shelby, and Members of the Committee. My name is John Fenton, and I am testifying today on behalf of NAFCU. We appreciate the opportunity to share our views on housing finance reform and the value of the 30-year fixed-rate mortgage to credit unions and our members.

Credit unions were not the cause of the recent economic crisis, and an examination of their lending data indicates that credit union mortgage lending has outperformed bank mortgage lending during the downturn. Credit unions focused on placing their members in solid products that they could afford.

Furthermore, there is no evidence that the recession and collapse of the housing market was due to the presence of 30-year fixed-rate mortgages. Congress gave credit unions the authority to offer 30-year mortgages back in 1977, and it has since been our dominant instrument in mortgage originations.

The fixed-rate mortgage is regarded as a consumer-friendly instrument because it is straightforward, easy to understand, and provides a predictable monthly payment schedule. With a fixed-rate mortgage, the lending institution assumes the risk associated with interest rate risk increases. Having too many long-term fixed-rate mortgages in the portfolio subjects the financial institution to greater interest rate risk and can be cause for examiner concern. At Affinity we mitigate risk in our long-term fixed-rate mortgage portfolio by hedging with interest rate swaps, caps, and matched borrowings. Selling on the secondary market to Fannie and Freddie is also an important risk mitigation tool. The securitization activities of Fannie and Freddie help lower the relative cost of 30-year fixed-rate mortgages and are an important factor in its viability.

Without a Government role in the secondary market, the 30-year fixed-rate mortgage may still exist, but likely with higher cost to the consumer and scarce availability. Long-term fixed-rate mortgages will become riskier propositions for credit unions. For safety and soundness reasons, consumers may face additional costs to mitigate risk. The lack of a Government role as a stabilizing force in the secondary market would have a significant impact on the ability of credit unions to offer affordable, consumer-friendly mortgages such as the 30-year fixed-rate mortgage. We believe that it would further limit the availability of long-term fixed-rate mortgage products and substantially increase the costs of mortgages to consumers.

Fannie and Freddie, as well as the Federal home loan banks, are valuable partners for credit unions who seek to hedge against the interest rate risks by selling their fixed-rate mortgages to them on the secondary market. Because Fannie and Freddie will buy loans on the secondary market, the credit union is not only able to mitigate the risks associated with these interest rates, but the liquidity created allows them to reinvest those funds into their membership or institution by making new loans. Without these relationships, credit unions would be unable to provide the services and financial products that their memberships demand and expect.

NAFCU would like to stress the importance of retaining a system that provides credit unions with access to the secondary market necessary to serve the mortgage needs of our 93 million members. As you consider legislative proposals for housing finance reform, we believe there is a core set of principles that must be considered to ensure that credit unions are treated fairly.

One, a healthy and viable secondary market must be maintained.

Two, there should be at least two GSE-type entities to ensure competition and to perform the essential functions currently performed by Fannie and Freddie.

The U.S. Government should issue explicit guarantees on the payment of principal and interest on mortgage-backed securities.

Four, during any transition to a new system, credit unions must have uninterrupted access to the GSEs and, in turn, to the secondary market.

Five, credit unions could support a model for the GSEs that is consistent with a cooperative or a mutual entities model.

Six, a board of advisors should be formed to advise the FHFA regarding GSEs.

Seven, while a central role for the U.S. Government in the secondary market is vital, the GSEs should be self-funded. GSE fee structures should place increased emphasis on quality of loans. Risk-based pricing for loan purchases should reflect that quality difference.

Eight, Fannie and Freddie should continue to function, until such time as necessary to repay the Government debts.

And, ten, reform of the Nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the Federal home loan banks.

In conclusion, the 30-year fixed-rate mortgage remains the most popular mortgage product to credit union members today. As such, it is necessary for the health of the housing market and the continued recovery of our economy that it remains a readily available product. The ability of credit unions to make these loans and to mitigate the interest rate risk by selling them to GSEs on the secondary market is important. With efforts to reform the Nation's housing finance system, it is important to consider the impact reforms may have on credit unions and make sure that they maintain access to a viable secondary market.

We thank you for your time and the opportunity to testify before you here today, and I would welcome any questions you have.

Chairman JOHNSON. Thank you.

Dr. Sanders, you may proceed.

STATEMENT OF ANTHONY B. SANDERS, PH.D., DISTINGUISHED PROFESSOR OF FINANCE, GEORGE MASON UNIVERSITY SCHOOL OF MANAGEMENT

Mr. SANDERS. Mr. Chairman and distinguished Members of the Committee, my name is Dr. Anthony B. Sanders, and I am the Distinguished Professor of Finance at George Mason University and a senior scholar at the Mercatus Center. It is an honor to testify before this Committee today.

The fixed-rate mortgage occupies a central role in the U.S. housing finance system. The dominant instrument since the Great Depression, the FRM currently accounts for more than 90 percent of mortgage originations. One reason why it enjoys enduring popularity is that the FRM is a consumer-friendly instrument. Not only does the FRM offer payment stability, the instrument provides a one-sided bet in the borrower's favor. If rates rise, the borrower benefits from a below-market interest rate. If rates fall, the borrower can benefit from exercising the prepayment option in the FRM to lower their mortgage interest rate.

But these consumer benefits have costs. It is costly to provide a fixed nominal interest rate for as long as 30 years. And the prepayment option creates significant costs. If rates rise, the lender has a below-market rate asset on its books. If rates fall, the lender again loses as the mortgage is replaced by another one at a lower interest rate. To compensate for this risk, lenders incorporate a premium in mortgage rates that all borrowers pay regardless of whether they benefit from a refinance or not. Exercise of the prepayment option in the contract also has significant transactions costs for the borrower and imposes additional operating costs for the mortgage industry.

The adjustable-rate mortgage, or ARM, and shorter-maturity mortgages also have consumer-friendly benefits that are often overlooked. Banks, S&Ls, and other lenders will originate and hold 30-year fixed-rate mortgages even without the Government guarantee, just like they have done in previous years. This may be a short-term effect if some claim they cannot do this simply because Freddie Mac, Fannie Mae, and the FHA have cornered the mortgage market.

Second, we are the only country in the world with such a high 30-year fixed-rate concentration and Government housing mortgage subsidies. Most countries have higher percentages of shorter-maturity mortgages and ARMs than the United States and did not suffer the magnitude of the housing bubble burst that the United States experienced.

Third, the U.S. homeownership rate is comparable to that of other countries that have higher ARM and short-maturity mortgages, so there is nothing magical about the 30-year fixed-rate mortgage and homeownership.

Fourth, ARM rates such as 5/1 ARMs are typically less expensive to consumers than fixed-rate mortgages, generally from 100 to 150 basis points.

Fifth, all 30-year fixed-rate mortgage borrowers pay for the prepayment option even if they do not use it. Why not give consumers a choice of a less expensive non-prepayable mortgage that carries a lower rate of interest or a mortgage with refinancing penalties, again, resulting in a lower mortgage interest rate for consumers?

Sixth, the 30-year fixed-rate mortgage, which has a 95-percent market share, is risky for consumers since the principal pays down so slowly, small house price declines coupled with low downpayments put the borrowers into a stressful negative equity position, often very quickly. Should we be promoting 10- and 15-year mortgages instead, or 7? The 30-year fixed-rate mortgage leads to consumption of larger housing compared with 15-year mortgages since the payments are reduced via slower principal amortization. Is that our public policy objective, to put households in the biggest houses they can afford?

Eight, ARMs actually are consumer friendly in that by sharing the interest rate risk with lenders and investors, borrowers will be more careful about taking on more debt; that is, buying too much house even if the underwriting allows them to.

Ninth, if we examine FHFA's 2001–02 enterprise loan acquisitions, we find that ARMs actually had lower default rates than fixed-rate mortgages.

And, tenth, please bear this in mind. Homeowners, according to the Federal Reserve, lost $7.25 trillion from the peak of the housing bubble. Can we afford to do this again? Should we be putting everybody into low downpayment, 30-year, slow amortization mortgages which are catastrophic to those households if the market tanks again?

I understand why some consumers like the comfort of the fixed mortgage payments where they can prepay and lower their mortgage payment at will, but comfort comes at a cost in terms of higher mortgage rates and costs to taxpayers.

On the other hand, I do not equate Government policy encouraging households to buy larger houses and take on greater risk that they can afford as consumer friendly.

Thank you for the opportunity to testify.

Chairman JOHNSON. Thank you.

Dr. Willen, you may proceed.

STATEMENT OF PAUL S. WILLEN, PH.D., SENIOR ECONOMIST AND POLICY ADVISOR, FEDERAL RESERVE BANK OF BOSTON

Mr. WILLEN. Thank you. Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, I thank you for your invitation to testify today. My name is Paul Willen, and I am a senior economist and policy advisor at the Federal Reserve Bank of Boston. I come to you today, however, as a researcher and not as a representative of either the Boston Fed or the Board of Governors.

What I am going to take on today in my spoken remarks is a kind of conventional wisdom about the fixed-rate mortgage, and it starts with the invention of the fixed-rate mortgage, which is widely attributed to the FHA. The conventional wisdom is that in the 1930s most—prior to the 1930s, prior to the Depression, most American families or almost all of them had short-term variable-rate mortgages. These mortgages exposed them to volatile payments and caused massive disruptions during the Depression. And so the FHA, the conventional wisdom says, in order to solve this problem invented a new type of mortgage, which was the long-term fixed-rate mortgage. And the point of it was that the payment the borrower made never changed until the loan was paid off. Month in, month out, the borrower was never vulnerable to payment shock. And I think the conventional wisdom sort of views the fixed-rate mortgage as a sort of safety mortgage, sort of like the safety elevator came along. Before the safety elevator, if the cable in an elevator snapped, the passengers plunged hundreds of feet to certain death, and the safety mortgage took something that was very risky, like the previous elevators, and replaced it with something that was sort of inherently safe.

The conventional wisdom goes on to say that in the 2000s lenders forgot the lessons of the 1930s and started issuing complex, exotic, adjustable-rate mortgages. Borrowers were hit with these payment shocks, and the critical number of these payment shocks is what caused the crisis. So I am going to take on this conventional wisdom and argue that these basic premises do not fit the facts.

The first thing is the long-term fixed-rate mortgage was not invented in the 1930s by FHA. It was invented 100 years earlier by building and loan societies, and building and loan societies were not some niche player in the housing market. They were the single largest source of funding for the typical American family when they got a mortgage. They were widely used, and in 1929, the year immediately preceding the Depression, when they were supposedly invented, 40 percent by dollar value and a much higher number in number of the mortgages originated were originated by building and loan societies, and 95 percent of those originations were long-term, fixed-rate, fully amortizing mortgages. You can see it is in Table 2 in my prepared testimony. Despite offering only long-term fixed-rate mortgages, building and loan societies were devastated by foreclosures during the Depression.

In the recent crisis, you say, well, maybe it was not an issue in the Depression, what about the most recent crisis, wasn't that cause by payment shocks and adjustable rate mortgages? So in Table 1 of my prepared testimony, I show some data that we put together, but everyone who has looked at the individual level data, who has looked at it, the mortgage level data or property level data, has come to the same conclusion. Our sample is a sample of 2.6 million foreclosures, so these are all borrowers who lost their home, and what we show is that 88 percent of them suffered no payment shock prior to defaulting on their mortgage. The mortgage payment they made when they defaulted on the loan was exactly the same as the payment they made when they got the loan, the initial payment on their mortgage. In fact, of that sample, 59 percent of them actually had fixed-rate mortgages. That is something like 1.6 million mortgages. That alone should disabuse us of any notion that a fixed-rate mortgage is an inherently safe product.

OK. So let me just conclude by saying that when owning a home financed by a mortgage, a family faces many risks. There is job loss. There is illness. There is business failure. There is divorce. And what we have learned recently, the most important one of all, there is falling house prices. What our research has shown over and over again is that, compared to those risks, fluctuating mortgage payments present a small problem. So let me just say that the benefits in terms of foreclosure prevention of ensuring availability of a mortgage with a payment that can never go up in my opinion is very small.

Let me say I hope you find that these findings add insight to your work as policymakers, and thank you again for the opportunity to appear today. I would be happy to address any questions.

Chairman JOHNSON. Thank you.

Dr. Woodward, you may proceed.

STATEMENT OF SUSAN E. WOODWARD, PH.D., PRESIDENT, SAND HILL ECONOMETRICS

Ms. WOODWARD. Senators and Committee staff, I am honored to be invited to share my views with you. Thank you so much for inviting me.

I am Susan Woodward. I am here representing myself. I am an independent economist now, but I lived for 10 years in Washington and served 4 years as Chief Economist at HUD and another 4 years as Chief Economist at the Securities and Exchange Commission.

The critics of the 30-year fixed-rate loan claim that it is unfair for homeowners to benefit from the risk avoided by fixed-rate loans while taxpayers bear the risk from it. I think what this claim forgets is that taxpayers are homeowners, too. If we consider the lifetime exposure of homeowner/taxpayers, there is nothing unfair about this tradeoff. In fact, I think it is a really important piece of social policy. But let me offer first a few facts.

While the homeownership rate now stands between 65 and 70 percent, the fraction of households that eventually become homeowners at some point in their lives is more like 85 percent.

Second, household incomes rise over time and peak at about age 55.

Third, homeowning households on average have higher incomes and pay more taxes than others. Thus, the people who benefit from the availability of a 30-year fixed-rate loan are also the same people who pay taxes if and when problems arise. The benefits come when families are young and have more need for security, and the same people potentially bear a cost when they are older and have more income. This is a fair tradeoff. Ask the taxpayer/home-owners. Tell them what the deal is. My guess is all of them will say, yes, we want the 30-year fixed to be available.

And we should not forget the risk of adjustable-rate loans. This has been downplayed so far, but in the current environment, I think there is some considerable risk. The ARM design is basically flawed because it does not link payment changes to household income changes. To take an example based on numbers that are relevant to today, suppose the rate of inflation picked up from, say, 2 percent to 4 percent, moving the homeowners rate from 4 percent to 6 percent, the likely change in the homeowner's income is the current inflation rate of about 4 percent. But the borrower's payment on a young-ish mortgage will rise about 25 percent. Only affluent households with a lot of room to maneuver can tolerate this level of cash-flow uncertainty. And it was mostly affluent households that prior to this financial crisis had the adjustable-rate loans.

ARMs threaten the economy, too. The recession of 1980–82 would have been far worse with far higher levels of mortgage defaults and an even bigger collapse in economic activity if all borrowers had had ARM loans then. That is my first point. Yes, the 30-year fixed-rate loan has some risk of potential cost to taxpayers, but since taxpayers are virtually all homeowners also, there is nothing unfair about this tradeoff.

OK. The second issue, do we need Government support for the 30-year fixed? I believe that the answer is yes, that it helps. The two most important innovations in financial markets in the 20th century were undertaken by the Federal Government. The first was FHA's support for long-term, amortizing, fixed-rate, and prepayable loans. Now, Paul and I have discussed this before the hearing, exactly what FHA's role was. It made the amortization baked in and more precisely scheduled, not tied to ownership of shares in building and loan societies. And it also pooled the default risk nationwide through the FHA insurance fund. And so borrowers really were better off, and banks were better off, too, because they were much more comfortable making these loans than with the situation that we had before. So it was a huge innovation, and it improved the stability of housing finance and the quality of life for households, too.

The second big innovation was Ginnie Mae. Ginnie was and is an astounding success. Ginnie Mae's role is to package already insured FHA loans into traded securities. When Ginnie was introduced, FHA borrowing rates fell 70 basis points. With a long-term real mortgage rate of about 4 percent, that is a big number.

What is more, I believe that there is no cost to taxpayers from Ginnie Mae. This was all entirely already insured FHA Loans, and what this was was an improved packaging of them.

And so at the end of the day, we are not going to have institutions like Ginnie or Fannie and Freddie without some Government push, especially now when the large banks have such better access to the capital markets than the smaller lenders do. If we are going to give the smaller lenders that access also, and I believe there are many reasons that we should, then we should have a continued role of the Federal Government in the market.

Thank you.

Chairman JOHNSON. Thank you.

Dr. Woodward, what elements of today's housing finance market must be preserved to ensure the availability of the 30-year fixed-rate mortgage for borrowers in rural areas like those in my State of South Dakota?

Ms. WOODWARD. I think that the really essential function if Ginnie Mae, Fannie, and Freddie is to be able to turn illiquid whole loans into liquid securities through an entity like them.

Chairman JOHNSON. Dr. Willen, in the past 4 years, we have seen a major dip in the origination of adjustable-rate mortgages as the credit markets dried up and an increase in percentage of 30-year fixed-rate products. If the 30-year fixed-rate mortgage were eliminated, how would the availability of credit to average Americans change in times of economic turmoil?

Mr. WILLEN. Well, I think there are two separate questions here. Again, I think we need to make sure, I think in all these conversations, that we separate out what it is—the 30-year fixed-rate mortgage, really what we are here discussing I think is the fixed-rate part of it. I think there is an issue. What happened in the last 4 years, when the mortgage market collapsed in 2008, is that every part of the mortgage market collapsed, including the Government-insured part of it, including Fannie and Freddie. And so if Fannie and Freddie had been doing—or if the mortgage market—if the Government was going to intervene to back up the market, they could have just as well intervened to back up the adjustable-rate market. The point was that the portion of the market that we intervened to help was the fixed-rate part of the market, and that is why the fixed-rate part of the market was the part that survived. So, for example, when the Federal Reserve engaged in large-scale asset purchases, we almost exclusively bought mortgage-backed securities backed by fixed-rate products.

Chairman JOHNSON. Ms. Bowdler, I have a question for you about eliminating the Government guarantee. How would the absence of a Government guarantee affect the availability of the 30-year fixed-rate, prepayable mortgage? How would this ultimately affect the average American borrower?

Ms. BOWDLER. Our understanding, from having talked to a lot of lenders, is that without that guarantee they would not only offer—they would not offer 30-year fixed-rate mortgages, and they would not be able to offer long-term financing at rates that the average person can afford. And so, yes, some sort of financing may continue to exist without the next generation of Fannie and Freddie, but it would not be for the average middle-class family. It would only be for families that have large amounts of inherited wealth that they can put toward downpayment or that they can use to ride out interest rate shock.

Chairman JOHNSON. Dr. Woodward, in your research what skills do borrowers need to have to evaluate the risks of adjustable-rate mortgages or understand how their interest rates would adjust?

Ms. WOODWARD. They need at least an MBA. I think it cannot be even 1 percent of households that really understand the interest rates that are behind ARMs, the London Interbank Borrowing Rate, even the 1-year Treasury rate, I had a friend's panicked daughter come to me in 2007 because she could not refinance her ARM. And so I looked at her loan documents, and her ARM was tied to the 12-month moving average of 1-year Treasurys. I know exactly where to look up this number. It is a fairly benign ARM index. But she was completely panicked. She had no idea to what rate her loan might reset. Once I told her what it was going to look like, then she calmed down, and she just let the ARM reset. It was fine. But I think that almost no households really understand the interest rates to which their ARMs are linked.

Finance is hard. People have to stay in school a long time to learn finance

Chairman JOHNSON. Mr. Fenton, what are the characteristics of the borrowers that come to your institution and request 30-year fixed-rate mortgages? Why is that product so popular?

Mr. FENTON. The characteristics are very diverse. We have all different segments of the community come in to borrow, and the product itself is important at different times. You have to offer members choice. They have all different levels of credit backgrounds and understanding of the products that are out there. But the key to it is to understand that in a time of low interest rates you need to be able to support a product like a 30-year fixed-rate mortgage, and in times of rising interest rates you might look at a different type of product. And in our case, we evaluate each member as they come in based on their needs and what is the best product for them.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Dr. Sanders, a central argument made by some advocates for the continuation of the Federal guarantee of mortgages is that without the guarantee the 30-year fixed-rate mortgage would not be available to consumers. For the moment, if we could just set aside the question of whether the 30-year mortgage is always the best product for consumers and go to this: Based on your research, if a consumer desires this product, would it be available even if there is not a Federal guarantee? Just anecdotally, I can go back to myself many years back, and I bought a house. It was a conventional 30-year mortgage from an insurance company. There was no Federal guarantee involved. The Federal Government was not involved. We had to come up with a pretty healthy downpayment, but that is what we wanted to do. Elaborate.

Mr. SANDERS. Well, again, like yourself, my experience has been I have had home loans, both ARMs and fixed-rate mortgages from S&Ls and banks, and they were never touched by Fannie and Freddie. So the answer is that once we get out of this rut we are in, they will start making loans again. The problem we have now is since Fannie, Freddie, and FHA have such a dominant presence in the securitization market, and as Mr. Willen has pointed out, one of the key things of our various bailouts is that we bailed out the 30-year fixed and not the ARM, so we *de facto* have made it the contract of choice in the United States. So we kind of undercut the private sector so that they do not want to hold the interest rate risk.

And, by the way, just to follow up on something, everyone here is mentioning the fact that there is interest rate risk associated with a 30-year fixed, but they are more than willing to dump them on the taxpayers and Fannie and Freddie because they do not want to be touched by the—and I understand it, but we should be forcing consumers to bear a part of that risk as opposed to having somebody in Keokuk, Iowa, suddenly get hit with a higher tax bill because somebody had a fixed-rate mortgage that went underwater again. But it will come back.

Senator SHELBY. The prepayment option, in your testimony you discuss how borrowers who have a 30-year fixed-rate mortgage with a so-called free prepayment option are, in fact, paying for that option whether or not they realize it or not. Explain what you mean.

Mr. SANDERS. Well, in other countries they actually have non-prepayable mortgages. You sign up, and unless you move or sell the house or some other form of termination, you are stuck with the interest rate you get. And if we compare in other countries the non-prepayable mortgages with a prepayable one, there is a substantial difference in interest rates. It can be anywhere from 30 to 70 basis points. So, in other words, we could help consumers out by actually offering them a non-prepayable mortgage, and it would actually cut their expenses. ARMs are cheaper, 15-fixed are cheaper. I do not know why we are bent on the most expensive of the contracts to give consumers. To help them?

Senator SHELBY. I do agree with the economist here that a lot of consumers do not understand the adjustable-rate mortgage. What can we do to make them understand? Can we be more explicit in their terms when they are buying a house or making a loan and say, "look, you are paying X today, but this could go up, it might go down," you know, rather than just "sign here, sign here"? A lot of them do not understand, and they are not that sophisticated. A lot of them are very sophisticated.

Mr. SANDERS. Two issues. We discussed this at one of the Wharton mortgage conferences where we said it was very simple to have a simple cover sheet, like we do in securities, where we have a risk page, saying that—in fact, we sort of do have this, but saying here is your current rate, and it will be fixed for this amount of time, and at the end of that time it goes up to whatever LIBOR plus some spread, have that laid out explicitly, and I know Susan is going to kick me after this thing is over, but I just want to point out one thing. If a consumer sees something and it has terminology like LIBOR in the contract and they have no idea what it is, why did you sign it? I would suggest a little research by consumers to help themselves to look into these things.

And, again, I think—and Susan actually clarified this quite nicely. It is much more benign than we are making it sound. LIBOR-indexed ARMs are not a problem. But, again, we could make it more clear perhaps. But that is not because of the problem in the country.

Senator SHELBY. Dr. Willen, I want to direct this to you, if I could. I want to say this. Dr. Woodward states, quoting her, "The 30-year fixed-rate loan is unquestionably easier for households to understand than any adjustable-rate mortgage." She further states that the average household will not understand what risk it is undertaking with an ARM, adjustable-rate mortgage.

Dr. Woodward's behavior on economics approach, as I understand it, to this issue suggests that consumers are not capable of making educated choices. I think they could make those choices.

Based on your research, Dr. Willen, have you seen any evidence that suggests that consumers are not sophisticated enough to handle an adjustable-rate mortgage and this has led to an increase in foreclosures? And let me ask a follow-up to this. Are there in stances in your research in which the 30-year fixed-rate mortgage could actually be more harmful to a borrower than an adjustable-rate mortgage?

Mr. WILLEN. All right. So let me answer.

Senator SHELBY. First, first.

Mr. WILLEN. First, first. There are many things we deal with in life that we do not—where we have as much understanding as we need. So most people do not understand what a transmission is or how it works, but that does not stop them from driving cars.

The risk embedded in an adjustable-rate mortgage—this is what I keep coming back to—compared to employment risk, compared to the risk they face in their jobs, the income risk that they face in their jobs, is tiny and no one understands employment risk. You know, to understand the distribution of your labor income next year, no one understands that, and yet everybody lives with—you know, those people who do not work for the Government live with income risk all the time, and they——

Senator SHELBY. And that is most people, isn't it?

Mr. WILLEN. And that is most people, and they deal with it. And it is much bigger. So, you know, if the mortgage payment is a third of your income and it goes up by 10 percent, that is 3 percent of your income. People deal with 25-percent income loss in a year, and they do not end up in foreclosure, and they do not end up bankrupt. So I think people can handle risk, so that is the answer to your first question. Remind me of the second? Oh, the benefits.

Senator SHELBY. That is right.

Mr. WILLEN. So, actually, I think in this crisis we have seen exactly how much damage the fixed-rate mortgage can do. So everybody focuses on the fact that rates on adjustable-rate mortgages can go up, and we completely dismiss the fact that they can go down. And they do not go down randomly. They go down when interest rates go down. And when do interest rates go down? Usually they go down in recessions, and they have gone down by 500—LIBOR has gone down by 500 basis points. We looked in the data. So people who had fixed-rate mortgages from 2005 and 2006 and 2007, most of them are paying 5.5 percent or more on those mortgages. These are the people with negative equity. The people who had adjustable-rate mortgages, their rates are under 4.5 and a third of them are paying less than 3.5 percent on their mortgages. They do that without any assistance whatsoever from anyone. They do not have to beg their lender. They do not have to get a modification. The only people with fixed-rate mortgages and negative equity who are paying low interest rates are people who have fought bitterly with their servicer to get a modification.

So the adjustable-rate mortgage has this automatic built-in stabilizer property which the fixed-rate mortgage does not.

Just one more thing. Prepayment is not free. You have to get an entirely new mortgage, and that costs——

Senator SHELBY. It is built in to the price, isn't it?

Mr. WILLEN. No, no. When you get the—in other words, the option is not free, that is right. But even when you get the—right now why are we having this problem? Why are we having hearings about the fact that people cannot refinance their mortgages? It is because between the closing costs, getting new title insurance, you know, covering the transaction costs to the lender and all of that, it costs 2 points. So there is no free prepayment, forgetting the option price. That is why so few people are refinancing right now.

Senator SHELBY. But in all fairness, adjustable-rate mortgages, you have got to tell the consumer it can go down, which it has been doing because of the price of money.

Mr. WILLEN. Absolutely.

Senator SHELBY. But it could go up, too.

Mr. WILLEN. Absolutely.

Senator SHELBY. And oftentimes I think a lot of people have not realized that. But they should.

Mr. WILLEN. They should. Let me say, just going back to this, at least in Massachusetts, there is a rider on an adjustable-rate mortgage which every borrower signs, which goes through—it does exactly what you describe. It says this is your rate, this is what it is tied to, this is where you can find it out, and this is what will happen if the rate goes up and this is what will happen if the rate goes down.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Dr. Willen, in your testimony you point out, I believe, that adjustable-rate mortgages are defaulting more than fixed-rate mortgages—or, in your words, fixed-rate mortgages default less often than adjustable-rate mortgages. I will put it precisely. So if there is this automatic correction benefiting from falling rates, why are people with adjustable mortgage rates defaulting more?

Mr. WILLEN. OK, so let me be careful about that. There is a difference. It is a relatively small difference. It is not anywhere of the order of magnitude of the increase in foreclosures that we have seen. In other words, going from 1 or 2 percent of borrowers or 1 percent of borrowers to 5 percent of borrowers, that is not because of adjustable-rate mortgages. That is because of falling house prices. So they do default more. I think what I said in my written testimony is the people who take out adjustable-rate mortgages are different from the people who take out fixed-rate mortgages. The assumption here is that if they took out fixed-rate mortgages, they would also be more likely to default. So for people who intend to keep properties for a short period of time—there are a lot of unobserved factors in the data. The fact that the borrower did not intend to keep the property for a long time, that is why they went with an adjustable-rate mortgage, and people like that are more likely to be people who are speculating on property. That is what we think that difference is picking up, not anything about the product itself. There is no evidence that the product—and as I said—there are two things. In point of fact, adjustable-rate mortgage defaults have been much lower relatively than we expected, partly because of the falling interest rates. So the notorious option ARMs, which were the sort of poster child for the complicated mortgage product, because interest rates have fallen a lot, those loans have ended up performing much better than we expected back in 2007. So I think the—so let me just say the other thing, which is—I keep coming back to here that the reason people default on their mortgage is negative equity and something else—job loss, illness, some life event that hits them. That is why they default on the mortgage. That does not depend on a fixed or adjustable-rate mortgage. There is nothing you can do about that. But since we have spent a lot of time in the last 2 months talking about how we can stimulate consumption by getting people into lower interest rate products, the adjustable-rate mortgage product does that automatically.

You know, it is difficult to measure in the data, but presumably the people with adjustable-rate mortgages have more free cash-flow with which to consume. At least that is the goal that we have.

Senator REED. Dr. Woodward, what is your view of this differential between adjustable-rate defaults and——

Ms. WOODWARD. I think that Paul is right, that the households that sign up for ARMs are different from the households that sign up for fixeds.

Now, in terms of, you know, when interest rates change, how they change, how it affects households, remember that we had an episode of rising interest rates from 1970 to 1980, and there were ARM loans outstanding then, but they were all very affluent households that had those ARM loans. They were not ordinary households.

So then from 1980 until now interest rates have come down, down, mostly down, and so we have not really seen the full force of what happens when ARMs reset upwards.

Now, today we look at sort of the term structure of interest rates. It is pretty flat. It does not predict that interest rates are going up much, but could they? Yes, they could. It is certainly much more likely that they could go up a lot than that they could go down a lot, because we are so close to zero we cannot go down very much. And it is the case that if the ARMs reset up 2 points, the payment is going to rise 25 percent, and the household income increase is not going to be that big.

So you want households that are good at managing their finances, not bad at managing their finances, taking that risk. And what we can see in the ARM data is that the default rates are higher, and they are higher, other things equal. You know, the same credit score, same debt-to-income ratio, same loan-to-value ratio, the households that sign up for ARMs are taking some risk somewhere else, too, that we cannot observe.

Senator REED. We had an experience in the 1980s where we had a significant increase in the interest rates.

Ms. WOODWARD. We did. I am old enough to remember, too.

Senator REED. My father told me about it.

[Laughter.]

Senator REED. In Canada, they had, I think, much less of a commitment to 30-year fixed-rates, and they saw a lot of turbulence in their housing market.

Ms. WOODWARD. They did.

Senator REED. And that was an example where—in fact, that might be the example which has influenced a lot of people to get into 30-year fixeds, that if you were, like I was and like you were, I suspect, about 25 to 26 in the 1980s, having a fixed-rate looked really good then.

Ms. WOODWARD. It looked really good.

Senator REED. We might be sort of captives of our history.

Ms. WOODWARD. Two things about the Canadian market. Yes, they did have a lot of defaults in the early 1980s as ARMs reset, and that is even in a market where the rate to which they reset is kind of managed by the Government. You know, it is not a completely objective rate like LIBOR or 1-year Treasurys. There is some pushing against it at the Federal level. But they still had big defaults.

Senator REED. Thank you all.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman.

As we look at the GSEs and the low guarantee rate that has been charged and the fact that, you know, credit was available all the way through, it seems that it had two effects. Number one, when you have an artificially low interest rate, it actually drives up the prices of housing because people are looking at what their mortgage payments are. I go back to Dr. Woodward. I think that is, generally speaking, what people are looking at when they go buy a home, is what is their payment going to be, regardless of all those other issues.

And so what we have had is a situation where our Government guarantees, which artificially kept prices lower than they should have been, have actually done the opposite thing for consumers that we like to see happen, and that is, it has actually driven up home prices. It has. There is no question. And I am not asking a question. It is just a fact. It has.

And then you have a situation where you do not have any price signals; in other words, because we continue just to have these—as we had this bubble, you know, we had nothing in the market that was slowing that down, and without this Government guarantee, I think the private sector, which we do have a 30-year mortgage market in the private sector today without Government guarantees, and it is not as robust as it was because we had this housing crisis. But it seems to me that much of what has happened could have been avoided without the GSEs playing the major role they did. And I wonder if you might respond to that, Dr. Sanders or Dr. Willen.

Mr. SANDERS. I will take the first crack at it. I would say, yes, the GSEs, courtesy of the guarantee, whether it was implied or explicit later, did help—they underpriced their insurance; therefore, they could charge lower rates to consumers. It sounds good, but when you couple that with lower downpayment mortgages and sort of easing of credit standards over time, we got what Austrian economists would call a nice "credit bubble." We got housing prices climbing up, and once in the house I put that, and I said, "This is making housing affordable?" Which you will notice Fannie and

Freddie no longer have that as a slogan, which they did a couple decades ago.

We created a bubble, and it burst. And as I said, $7.25 trillion of home equity has been lost, which has been devastating, particularly for lower- and middle-income households. So I think those guarantees are dangerous instruments, and they have got to be pared back or taken away.

Senator CORKER. I know that there has been a whole industry sort of built around those, and it is sort of interesting to be here in Washington in various sectors, not just this one. There is a whole infrastructure that is built around making money off what sort of the Government has put in place. And I know that we all thoughtfully want to move away from that. I think everybody wants to see us move away regardless of where you sit today from where we are today. I think that is universal. We want to do it in an appropriate way.

But let us just move back to where the GSEs are at this moment. I never have understood why we do not have a built-in prepayment penalty. I mean, why has it been in sort of the psychology of what we have done here a one-way street? You know, I own commercial buildings, or have in the past. When you pay the loan off, you have got to pay a penalty. I am sorry. You know, if it is not—if rates are lower than when you have financed, you have got to pay a penalty. Why have we not had that? It seems like that would solve a big part of the problem we have today?

Mr. SANDERS. Yes, I was going to put that into my testimony, that on the commercial side we have ARMs galore, and they have either lockouts, prepayment penalties, yield maintenance, or something, saying that if you are going to refinance, you are going to pay a hefty price.

One of the reasons why we do not in the residential market is we have built kind of a huge empire of mortgage-backed securities that are agency—Fannie, Freddie, and Ginnie Mae. And to facilitate trading, you want to have liquid prepayments, meaning that the option to prepay is what everyone likes to speculate on, how it is going to do, and they really avoid having prepayment penalties or non-prepayable mortgages because there is not a lot of action in them, so to speak, on the market. But that should not be driving public policy, the fact that mortgage-backed security traders like the prepayment option.

Senator CORKER. Any other comments regarding the prepayment only?

Ms. WOODWARD. Yes.

Senator CORKER. Yes, go ahead, Dr. Woodward.

Ms. WOODWARD. You know, it is my understanding that the absence of prepayment penalties is mostly a matter of State law. Essentially all 50 States have limits on the prepayment penalties that can be created. And as far as the mortgage-backed securities market goes, what the mortgage-backed market wants is not necessarily the absence of prepayment penalties. What they want is securities where the prepayment penalties are all the same so that they can trade as liquid instruments.

Senator CORKER. So the penalty is zero.

Ms. WOODWARD. Well, it does not matter whether it is zero or it is $100 or $1,000. What they want is for all mortgages to have the same prepayment penalties so that they can trade identically.

Senator CORKER. Well, my time is up. I would just—go ahead.

Mr. SANDERS. I agree with Susan on that statement, but I would say if you looked at the number of prepayable mortgages with huge prepayment penalties or yield maintenance or something, you are going to find the number close to zero at Fannie, Freddie, and the FHA. They are just non-existent.

Senator CORKER. May I ask another question?

Chairman JOHNSON. Yes.

Senator CORKER. What do you think would happen if Fannie and Freddie all of a sudden said, you know, we will continue doing what we are doing, and we all know they are jacking up their G-fees and all of that. But what if they also said, but we are going to have yield maintenance on these things, and, you know, candidly, if you want to refinance in 7 years, which is what most people—that is what the average is. If you want to refinance in 7 years but have the opportunity for a 30-year low fixed-rate mortgage, you are going to pay yield maintenance on that. What would happen in the marketplace.

Mr. SANDERS. Well, what would happen is that mortgage rates would actually decline because since you are sharing some of the risk with consumers—and, again, the risk, I guess with Paul, is relatively negligible. But since you are sharing some of that risk, that leads to the rate declining because, once again, the prepayment option raises mortgage rates, which is one of my arguments in HAMP. Why weren't we refinancing households into ARMs, 5/1 ARMs? Why did we pick 30-year fixed? That is a problem across the whole system. If we are interested in homeowners, we should have lowered the rates if we believed that theory. We should have done 5/1 ARMs or 3/1 ARMs for consumers that were getting loan mods, but we did not.

Senator CORKER. Thank you.

Mr. FENTON. Senator, if I may?

Senator CORKER. Yes, sir.

Mr. FENTON. I would like to disagree with that to some extent. I believe it is an affordability issue, and if you add on prepayment penalties to the consumer, you are shifting that cost out to the consumer and in the long-term effect, it is going to have a negative effect on the real estate markets as we go forward.

I think you have to have a choice. There are members in every life segment and every life style, and so depending on where you are in those, there are options for you. Prepayment may be one of those. Adjustable rates may be one of those. We cannot just have one product, but there are different timings of it all and you have got to have an effect. The consumer should not bear all of the cost on this, nor should any one segment. Risks should be spread balanced over all of the segments.

Senator CORKER. Well, it seems to me that the person who has taken a loan out should bear the cost of that loan. I mean, I do not understand what you are saying about consumers not—that is a really weird statement to me. I mean, if I am borrowing money and I decide that—and there is a cost to society of me taking certain actions, it seems that I should bear that cost. That is a strange statement, it seems, that you just made.

Mr. FENTON. Well, it is how you view cost. Cost is an investment sometimes, and it depends on which angle you are looking at it from. From a public policy perspective, I think the cost is an investment that returns in a more vibrant economy eventually. And so there is return for us making that investment. It should not be borne by the consumer because the consumer, A, does not understand it fully enough, and sometimes it is going to affect their ability to go into it, and so rather than go into it, they will rent a home as opposed to buying it. And again, I think that has a negative impact on the economy. So you need to look at it from all different angles, from the policy statements as well as what the effect is on the consumer.

Senator CORKER. Thank you.

Chairman JOHNSON. Dr. Sanders, the fixed-rate mortgage has been criticized as problematic for homeowners when interest rates and home values fall because homeowners cannot take advantage of lower interest rates without refinancing. Do all ARMs allow for a drop in interest rates?

Mr. SANDERS. Yes. Virtually all ARMs allow you to refinance, but you—yes, they do. But, again, most people refinance at the reset dates.

Senator Johnson, can I finish my answer?

Chairman JOHNSON. Yes.

Mr. SANDERS. One of Susan and my common friends, maybe Paul, too, is a famous person locally in the mortgage market and he only uses ARMs. Why? Because he did a study showing that ARM rates continually, with a couple of episodes, have always been lower than fixed rates, so he just says, I will either roll them over if the rates stay low. If they are not, I will just—and the reset has been always very trivial in comparison. So other than one shock, we have not seen a problem with them.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

I appreciate the witnesses being here. I certainly appreciate Mr. Fenton from New Jersey, who is well known as an expert in the financial industry and in our home State, as well as Ms. Bowdler, who has worked for La Raza and has been extraordinary.

I am concerned that there is a universe of borrowers who, in fact, can be responsible borrowers, but at the end of the day, without the guarantee of a 30-year fixed mortgage ends up eliminating the opportunity for them to be a responsible borrower and basically gets them out of the market.

I have noticed that even though there are those who argue that the private sector alone will do this, that we have not really seen much securitization at all of jumbo mortgages in this marketplace, so the private sector has not come in as of now to provide the opportunity to do that.

So if we do not have an evidentiary set of circumstances under the most probably propitious opportunity for the private sector to come in and they have failed to come in to accomplish them, then how is it that we expect individuals who can be responsible borrowers under a long-term fixed rate to be part of the marketplace? Do any of you have a comment on that?

Mr. FENTON. Senator, I do agree with you that the securitization and jumbos is a great example of where privatization has not entered the marketplace. You cannot rely solely on privatization to come in and bring capital in without some offset to the risks that they are going to take. Risk is offset by price, and in this case, I think the price would negatively affect a different segment, which is the consumer segment. And so we need to be able to balance that, and that is where the Government has a role to come in to try to encourage the private sector to bring their capital to the table.

Senator MENENDEZ. Yes, Ms. Bowdler.

Ms. BOWDLER. I would also point out that while we have this issue on the jumbo side, we have the same problem on the lower end of the market. I mean, right now, what Fannie and Freddie are financing is essentially middle market, affluent, sort of the best of the best. I mean, they are taking cream of the crop right now, and borrowers who are qualified but maybe live in a neighborhood that they have deemed not desirable or lack the family wealth to make sizable downpayments are getting left out of the market. And those are borrowers that we know, the research shows, right product with the right support, those can be qualified families who perform very well and we do not see the private market stepping in to help those families, either, and Fannie and Freddie is not serving them.

Senator MENENDEZ. Dr. Sanders, welcome back.

Mr. SANDERS. Thank you very much, Senator Menendez.

Senator MENENDEZ. You are a regular at our hearings, so——

Mr. SANDERS. That is right. I am a Jersey boy, so——

Senator MENENDEZ.——our Subcommittee hearings, so we appreciate it.

Mr. SANDERS. Let me just take a little bit different spin on it, although I do not disagree with what anyone is saying. What I am saying is that the guarantee in the 30-year fixed, the low downpayment mortgages, when you combine that all into a ball, what we have done is we have really encouraged households to take on more risk than they ordinarily would have. We give them the illusion that everything is going to be fine with a 30-year fixed, and then, lo and behold—I have said this about five times already today—from the peak of the housing bubble to now, $7.25 trillion—that is a mind-boggling number if you want to figure out one of the reasons why our economy is not jump starting very well—we lost that much wealth in the housing market, and that is terrible.

So again, I am saying, if we can figure out a way to pare back some of this, we are not encouraging people to take this risk that turned out to be a bad pony. Housing was great for a while during the run-up, but it had a catastrophic collapse and a lot of middle-income and lower-income households really got creamed in it. And so I am just saying——

Senator MENENDEZ. Dr. Sanders, let me interrupt you there for a moment. But the reality—a bubble, regardless of when that bubble is, is problematic whether you are in a fixed mortgage or whether you are in an adjustable rate mortgage. As a matter of fact, it seems to me that part of our challenge that created this bubble was that we had all of these instruments, including no doc loans and teaser rates and a whole host of other set of circumstances, that brought people into a market that probably should not have been, certainly not under those circumstances. And that is part of creating the bubble.

So I do not know that a bubble itself is the reason not to look at a 30-year fixed-rate mortgage. On the contrary, it seems to me that there is long-term stability there for the individual to know what their responsibility is and not necessarily with engaging in the fluctuations of the marketplace, including on the mortgage side, which some of the adjustables and no downpayment and interest rates ended up being. So I appreciate your comment about the bubble, and I understand that. I just do not necessarily subscribe it to a 30-year mortgage.

And the final point I would like to make is I am increasingly concerned, because my dear friend and colleague, Senator Isakson, who has a long-term experience—he is actually someone who has been a Realtor for, I think, 30-some-odd years and knows this pretty well—he made a comment on the floor yesterday on an amendment we have which is it is not just the size of the loan, but it is the lending criteria. And he commented that the lending criteria has been almost so pristine now and so difficult that the risk is dramatically downsized, and I get concerned, in addition to the 30-year issue and having some Government role, that I think the least we can do in a very difficult, to say the least, housing market is to do no further harm, at least in the short term.

It is this whole issue of what is the down, because, you know, saying that a qualified residential mortgage is now 20 percent, well, that is going to eliminate a whole universe of people who can, again, be responsible borrowers. I mean, I look at it, a middle—a median single-family home cost approximately $170,000 in 2009. Median household income is approximately $50,000. Just think about how long it will take for a family earning twice the median to save $17,000, much less—that is about 10 percent—much less 20 percent as a mandatory.

So it seems to me lending criteria is important to determine who will be a responsible borrower and not permit the bubble to take place, but that lending criteria is not in and of itself that you have got to have 20 percent down. In other words, you could have 20 percent down and still not have the other criteria to be a responsible borrower. Is that a fair statement?

Mr. FENTON. Senator, if I can, I would go further with that. Lending criteria is one of the keys that actually was a major influence in the crisis that we are just coming out of. There were a lot of lax credit standards, so we ignored some of the rules that we had actually established for ourselves, and that is what had more of an effect than interest rates, whether it is adjustable rates or 30-year fixed-rates, on this whole situation.

So what stops us from lax credit standards? The GSEs had set those—established those standards and allowed them to become more lax. There were certainly different components in the unregulated market. They were selling products that were not good for the consumers. Credit unions have always stood by and looked at the consumer and said, let us figure out what is best for you. If it is a 30-year or a 40-year fixed, it may not be the best thing for them. So we try to look beyond that. I am suggesting that that was not done in all parts of the economy.

Senator MENENDEZ. All right. My time is over, but maybe, Ms. Bowdler, you can make a final comment if the Chair permits it.

Ms. BOWDLER. Sure. So in my written statement, I went through some things that we know that can make borrowers very successful and I think that is the better place to focus this conversation, not about taking options away, but what makes borrowers at any income range really succeed in their mortgages. What makes them responsible. Certainly, that is underwriting criteria, but there are other things we can do, as well, like housing counseling, which we are a big proponent of. We have invested a lot of money in helping families figure out how to eat their veggies. Let us get your budget right. Let us get your credit right and step into this when it is your right time.

I am concerned that there has been a dichotomy here that somehow everybody who got ARMs were really savvy consumers and people who are getting 30-year fixed are somehow the chumps that do not really understand interest rate markets. In fact, I think people are making these choices because, at least in part, it works for them.

Now, I completely agree that there should be choices and there is certainly not a single product for everybody, but a good housing counselor or other advisor like a credit union can help families evaluate those options and make the choices that really fit for their family and their long-term financial plans.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to thank all of our witnesses for being here with us today. This hearing has been very useful to the Committee as we continue to explore the future of the housing finance system and the financial products for that system.

This hearing is adjourned.

[Whereupon, at 11:16 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions follow:]

PREPARED STATEMENT OF JANIS BOWDLER

DIRECTOR, WEALTH-BUILDING POLICY PROJECT
OFFICE OF RESEARCH, ADVOCACY, AND LEGISLATION
NATIONAL COUNCIL OF LA RAZA

OCTOBER 20, 2011

Good morning. My name is Janis Bowdler. I am the Director of the Wealth-Building Policy Project at the National Council of La Raza (NCLR). NCLR is the largest national Hispanic civil rights and advocacy organization in the United States, dedicated to improving opportunities for Hispanic Americans. I oversee our research, policy analysis, and advocacy on issues that are critical to building financial security in Latino communities, such as homeownership, consumer credit, auto lending, and financial planning. In this capacity I have produced a number of publications on related issues, including *The Foreclosure Generation: Long-Term Impact of the Housing Crisis on Latino Families and Children; American Dream to American Reality: Creating a Fair Housing System that Works for Latinos; and Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market.*

The NCLR Wealth-Building Policy Project promotes fair and accessible financial markets where Latino families have the opportunity to obtain assets and build wealth in a manner that will last a lifetime and can be shared with the next generation. NCLR conducts research and analysis on public policy affecting the financial security of Latino families, such as threats to sustainable Hispanic homeownership, access to affordable financial services, and access to affordable credit. The NCLR Homeownership Network (NHN) provides financial, homebuyer and foreclosure prevention counseling to more than 65,000 families annually. Our subsidiary, the Raza Development Fund (RDF), is the Nation's largest Hispanic community development financial institution (CDFI). Since 1999, RDF has leveraged more than $680 million in financing for local development projects throughout the country. This work has increased NCLR's institutional knowledge of how Latinos interact with the mortgage market, their credit and capital needs, and the impact of Government regulation on financial services markets.

I hope that today's hearing will shed light on a critical issue—the viability and advantages of the 30-year fixed-rate mortgage. For nearly eight decades, 30-year fixed-rate mortgages have put homeownership within reach of America's middle class and first-time homebuyers. Long-term financing allows credit to be extended at a price that is affordable to middle-income families, and the fixed rate provides certainty around housing costs. Without this flexible financing tool, homeownership will become a luxury reserved for the affluent, and the majority of families will be left without the appreciable asset that has long been the cornerstone of middle class wealth.

In my testimony today I will discuss the role of the 30-year fixed-rate mortgage and explain its advantages for homeowners. I will also share our perspective on how to maintain a viable path to homeownership for future generations of homebuyers.

Advantages of a 30–Year Fixed-Rate Mortgage

The 30-year fixed-rate mortgage has become so ubiquitous that some have taken its benefits for granted. However, such financing has not always been available. Prior to the creation of the Federal Housing Administration (FHA) in 1934, most loans were limited to 50 percent of the home value, which means that a family would have to pay the other 50 percent in cash to purchase a new home. Such loans were often short-term notes where a family would have to refinance every few years to cover the final balloon payment. Even this payment schedule could not be counted on. In the lead-up to the Great Depression, cash-strapped banks could call the note for immediate repayment, forcing many into foreclosure.[1] President Franklin D. Roosevelt and Congress responded by creating FHA mortgage insurance to reduce barriers to purchasing a home and provide banks and consumers with certainty and predictability in the transaction. This, along with the introduction in 1938 of the Federal National Mortgage Association, popularly known as Fannie Mae, standardized the 30-year fixed loan and made it available nationwide.

The 30-year fixed-rate mortgage remains an essential financing tool for homebuyers in the modern mortgage market. By spreading the cost of the home purchase over a 30-year term, the asset becomes more affordable. The fixed interest rate provides certainty, allowing a family to budget their housing costs and make long-term

[1] Jacob Gaffney, This housing crisis is the not the Great Depression, *HousingWire,* June 16, 2011, *http://www.housingwire.com/2011/06/16/this-housing-crisis-is-not-the-great-depression* (accessed October 16, 2011).

financial plans. Modest downpayment requirements have opened the doors of homeownership to families with incomes sufficient to cover monthly mortgage payments and maintenance costs but who lack the family wealth for a high downpayment. The amortization feature of the 30-year fixed-rate loan means the borrower knows when the final payment will be due and their family wealth grows as principle is repaid. Finally, most prime 30-year fixed-rate notes are prepayable, which means the homeowner can refinance their loan or sell without penalty.

The standard structure of the 30-year mortgage has opened homeownership to millions of families over the last seven decades. As a result of this financing tool, two out of three Americans own their own home today, the vast majority of whom relied on some type of mortgage to finance their purchase. Building wealth through home equity can fuel retirements, business ownership, and the advanced education of one's children. Those fortunate enough to own their home or land are able to pass their wealth to their children, a practice that has helped expand America's middle class.[2] Even without dramatic increases in home values, the home acts as a forced savings account that captures some of the income put toward house payments, which is unavailable for individuals who do not own their homes. Over the last 50 years until the most recent recession, wealth among American households grew steadily, peaking at $65 trillion in 2007.[3] While home equity does not account for the entirety of that wealth, a home is still the highest valued asset for most Americans. This is especially true for Hispanic and Black homeowners, for whom home equity makes up 65 percent and 59 percent of household wealth, respectively. For Hispanic households, no other asset type besides a home, *e.g.,* interest-earning assets at financial institutions constituted more than 10 percent of total net worth in 2005.[4]

Unfortunately, the benefits of homeownership have not been equally available to all. Historical discrimination in the distribution of land, unfair restrictions on FHA mortgage insurance and redlining, and exploitation by predatory subprime lenders has left communities of color with lower homeownership and wealth rates.[5] Latino and Black homeowners were more likely to receive exotic mortgage products, even when they had solid credit that warranted a sustainable 30-year fixed loan.[6] When the toxic mortgages began to reset and brokers and lenders could no longer maintain their refinance schemes, a recession ushered in record-high foreclosure rates. Since the dawn of the crisis in 2007, more than six million homeowners have lost their home to foreclosure.[7] The foreclosure crisis has been particularly acute among Latino homeowners. For example, nearly half of foreclosures in California have been on Latino families.[8] In fact, recent research revealed that wealth in White households exceeds that of Hispanic households by a staggering 18-to-1 ratio and by 20-to-1 for Black households a gap that is attributable largely to differences in home equity and the loss of homes through foreclosure.[9]

Our present foreclosure crisis demonstrates the importance of preserving the standard 30-year fixed-rate mortgage. Critics of the 30-year fixed note argue that families pay a premium in their interest rates for the benefit of extending the term. However, most families do not view their home as a strict financial transaction or a get-rich-quick scheme. Rather, they are investing in a nest egg and a community with the anticipation of long-term returns. Most homeowners are not in the position to play the markets or hedge interest rate risk. The predictability and security of a 30-year fixed-rate mortgage is worth a modest premium in the interest rate.

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[2] Melvin Oliver and Thomas Shapiro, *Black Wealth, White Wealth: A New Perspective on Racial Inequality* (New York: Routledge, Taylor & Francis Group, 2006).

[3] Chris Isidore, America's lost trillions, *CNN Money,* June 9, 2011, *http://money.cnn.com/2011/06/09/news/economy/household_wealth/index.htm* (accessed October 17, 2011).

[4] Paul Taylor, Richard Fry, and Rakesh Kochhar, *Wealth Gaps Rise to Record Highs Between Whites, Blacks, Hispanics* (Washington, DC: Pew Research Center, 2011).

[5] Meizhu Lui *et al., The Color of Wealth: The Story behind the U.S. Racial Wealth Divide* (New York: The New Press, 2006).

[6] Robert B. Avery, Kenneth P. Brevoort, and Glen Canner, The 2007 HMDA Data, *Federal Reserve Bulletin* 94 (December 23, 2008); and Debbie Gruenstein Bocian, Keith S. Ernst, and Wei Li, *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages* (Durham, NC: Center for Responsible Lending, 2006). For a review of predatory practices aimed at Hispanic families see Janis Bowdler, *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market* (Washington, DC: National Council of La Raza, 2005).

[7] Center for Responsible Lending, Snapshot of a Foreclosure Crisis, 2010, *http://www.responsiblelending.org/mortgage-lending/research-analysis/snapshot-of-a-foreclosure-crisis.html* (accessed October 17, 2011).

[8] Debbie Gruenstein Bocian *et al., Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis* (Oakland, CA: Center for Responsible Lending, 2010).

[9] *Wealth Gaps Rise to Record Highs.*

Paving the Way for Sustainable Homeownership

Research shows that families who lack the cash for high downpayments can be successful in a well-underwritten prime mortgage.[10] The Center for Community Capital compared low-income homebuyers who received flexible but responsible conventional prime mortgages with similarly situated borrowers who received subprime mortgages. Those with subprime loans have suffered foreclosure at a rate three to five times that of borrowers who received flexible yet responsibly underwritten 30-year fixed loans. In fact, not only were the borrowers with the responsible loans less likely to foreclose, they also gained an average of $20,000 in home equity as of 2009. NCLR's experience with Latino first-time homebuyers tells a similar story. Over the last 13 years, NHN counselors have helped more than 25,000 moderate-income families purchase a home with prime mortgages. Counselors overwhelmingly report that few, if any, of their clients who received counseling before they bought their home returned for foreclosure prevention counseling. This evidence shows that when families receive the right loan with the right support, they can be successful and sustainable homeowners and build wealth even with modest incomes and low downpayments.

Several decades of innovative affordable lending have taught us how to mitigate the risk of extending credit to first-time homebuyers, low-wealth borrowers, and underserved communities. For example, mortgage insurance a longstanding requirement by lenders and investors on home loans where the loan-to-value (LTV) ratios exceed 80 percent allows banks and credit unions to lend safely and responsibly to qualified families with higher LTVs. Analysis conducted on behalf of Mortgage Insurance Companies of America (MICA) of 43 million loans made between 2001 and 2008 with LTVs up to 97 percent found that those with mortgage insurance outperformed noninsured loans, and performed well considering the economic downturn.[11] Housing counseling is another excellent risk way to mitigate risk. Research shows that objective advice from an independent, trained housing counselor prior to purchase effectively reduces the likelihood of default.[12] Similarly, recent research has shown that counseling during a delinquency improves cure rates and lowers rates of redefault.[13] Finally, a homeowner's own savings can provide a cushion in times of unexpected financial distress. Modest-income borrowers would better positioned to manage unexpected expenses if they have some cash liquidity, rather than storing all of their cash savings in their home via a large downpayment.

Moreover, the affordable housing market continues to innovate with the 30-year fixed loan as a foundation. New tenure forms, such as community land trusts, lease-purchase, and shared equity mortgages, can help families take important steps toward ownership with far less risk overall to the lender, consumer, and the market. Affordability tools such as soft second loans and mortgage revenue bonds often used by housing finance agencies can reduce the upfront cost of realizing homeownership.[14] To achieve scale that is sufficient to move such options into the mainstream housing market, these innovative approaches require the same ingredients that made the affordable 30-year fixed mortgage a market standard: secondary market liquidity, credit enhancements, and a stable, competitive marketplace. Of course, deciding to buy a home is a major family decision and must come at a time when a family is financially prepared. Therefore, policymakers must also support a robust rental market that provides affordable options for future buyers and families for whom homeownership is not desirable or possible.

Despite all of the evidence demonstrating the importance and viability of affordable 30-year fixed-rate mortgages, this market staple is restricted in the current credit environment. The January 2008 Federal Reserve Senior Loan Officer Opinion

[10] Lei Ding *et al., Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models,* working paper (Chapel Hill, NC: UNC Center for Community Capital, 2010), *http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf* (accessed October 17, 2011).

[11] MICA regulatory comment letter on credit risk retention, August 1, 2011, *http://www.privatemi.com/news/pressreleases/attachments/MICA__QRM__Letter.pdf* (accessed October 17, 2011). Specifically, see attached analysis: Kenneth Bjurstrom, Johnathan Glowacki, and Tanya Havlicek, *Mortgage Insurance Loan Performance Analysis as of March 31, 2011,* July 28.

[12] Abdighani Hirad and Peter M. Zorn, A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling (Joint Center for Housing Studies, Low-Income Homeownership Working Paper Series, Boston, 2001).

[13] Neil Mayer *et al., National Foreclosure Mitigation Counseling Program Evaluation: Preliminary Analysis of Program Effects September 2010 Update* (Washington, DC: The Urban Institute, 2010).

[14] For a review of five successful examples, see David Abromowitz and Janneke Ratcliff, *Homeownership Done Right: What Experience and Research Teach Us* (Washington, DC: Center for American Progress 2010), *http://www.americanprogress.org/issues/2010/04/pdf/homeownership__done__right.pdf* (accessed October 17, 2011).

Survey revealed that a significant number of prime lenders had tightened their credit standards, and subsequent surveys show that little change has occurred over the last 3 years. The Community Reinvestment Association of North Carolina found that loan-level pricing adjustments (LLPAs) imposed by Fannie Mae and Freddie Mac add significant costs to loans and reduce access to credit, particularly for Latino and Black homebuyers.[15] Furthermore, challenges have surfaced among FHA loans, which have been the primary financing tool available to borrowers of color since the collapse of the mortgage market. The National Community Reinvestment Coalition revealed that national lenders were layering additional credit criteria on FHA mortgages, thereby restricting their availability.[16] Consequently, despite the average 30-year mortgage rate having dropped to below 4 percent, fewer borrowers are able to take advantage of the low rates and lower home prices.

The threats to affordable, long-term housing financing are not limited to today's credit crunch. Unfortunately, the future availability of affordable 30-year fixed loans for working families is in question. Earlier this year Federal bank regulators promoted the idea of a wealth standard in their proposed risk retention rule, which would unnecessarily cement high downpayment requirements in regulations. The idea of requiring a high downpayment for loans secured by Fannie Mae and Freddie Mac and those insured by FHA was also introduced by the Department of Housing and Urban Development and the Department of the Treasury in a white paper sent to Congress.[17] Such strict regulatory requirements will decrease the availability of responsible and affordable credit to qualified families. Critics of Fannie Mae and Freddie Mac are going further by pushing for a complete dismantling of our current secondary market system through privatization, even though lenders especially small community lenders say that they would not be able to offer fully amortizing 30-year notes in a completely private system.[18]

Recommendations

Rather than dismiss a proven finance tool such as the 30-year fixed-rate mortgage and affordability features such as low downpayments, policymakers should be exploring those factors that set families up for success. The conservatorship of Fannie Mae and Freddie Mac is neither desirable nor sustainable from a public policy or market perspective. However, we caution against throwing away portions of our housing finance system that work well. In a letter to President Obama, NCLR and 16 other civil rights organizations outlined a set of principles to guide housing finance reform in a manner that ensures equitable and sustained access to credit for all qualified homebuyers. I have attached a copy of this letter for the record.

Without the advantages of long-term fixed-rate financing, many qualified, middle-income families will be shut out of homeownership opportunities, particularly Hispanic and Black borrowers and other low-wealth households. Policymakers should take steps to strengthen the role of the classic, 30-year fixed-rate mortgage and other market innovations that build off its success. In addition to the principles outlined in the attached letter, NCLR offers three specific recommendations to the Committee:

- **Maintain secondary market liquidity for affordable 30-year fixed-rate loans that are made equally available to all qualified families.** The 30-year fixed mortgage is the foundation of affordable homeownership. A robust secondary market that provides liquidity throughout the Nation is critical to keeping this popular home financing tool broadly available to working families. The Federal Government must use its resources to facilitate a stable, liquid

[15] Adam Rust, *The New Hurdle to Homeownership: How Loan Level Pricing Changes the Cost and Access to Credit* (Durham, NC: Community Reinvestment Association of North Carolina, 2011), *http://cra-nc.org/sites/cranc.org/files/pdf/The%20New%20Hurdle%20to%20Home%20Ownership.pdf* (accessed October 16, 2011).

[16] National Community Reinvestment Coalition, *Working-Class Families Arbitrarily Blocked from Accessing Credit* (Washington, DC: National Community Reinvestment Coalition, 2010), *http://www.ncrc.org/images/stories/mediaCenter_reports/fha%20white%20paper-120810-final.pdf* (accessed October 17, 2011).

[17] U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, *Reforming America's Housing Finance Market.* Washington, DC, 2011, *http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf* (accessed October 18, 2011).

[18] See: Lew Sichelman, "The End of the 30-Year Fixed-Rate Mortgage?" *Urban Land,* June 22, 2011, *http://urbanland.uli.org/Articles/2011/June/Sichelman30yr* (accessed October 17, 2011). In this article, Sichelman quotes members of the mortgage industry asserting that the 30-year fixed-rate mortgage would become either extremely expensive or disappear altogether without the secondary market liquidity provided by Fannie Mae and Freddie Mac. Sichelman also quotes critics who question the benefits of fixed-rate financing and argue for a fully privatized housing finance system.

housing finance system that will extend credit and capital on an equitable basis to all borrowers and in all communities, with the goal of achieving parity between communities of color and Whites. Families should not be relegated to substandard mortgage products because a bank refuses to lend in their neighborhood or employs discriminatory practices. Such policy implementation should be further bolstered by support for a robust, integrated, and affordable rental market.

- **Support prepurchase housing counseling and other credit enhancements.** Prepurchase counseling has been shown to serve as a credit enhancement by reducing the likelihood of default. Yet funding for this proven method of reducing risk was eliminated by Congress and the administration for fiscal year 2011. Recently, the Senate Appropriations Committee passed the Transportation and Department of Housing and Urban Development appropriations bill with $60 million allotted for housing counseling. While this represents a serious cut from the industry high of $87.5 million in fiscal year 2010, it is a critical step in restoring the program. NCLR also calls on the private mortgage industry to step up its support for housing counseling. Lenders, investors, and mortgage insurers benefit from a well-educated consumer. The industry has long viewed housing counseling as a philanthropic endeavor, but we encourage financial institutions to create business partnerships with nonprofit counseling providers. Finally, credit enhancements such as housing counseling, mortgage insurance and shared equity models require the support of Fannie Mae and Freddie Mac to achieve scale. The entities should leverage proven and promising approaches in their current lending, and policymakers must ensure that this element is maintained as we reform our housing finance system.
- **Reduce barriers to financing experienced by today's borrowers.** Rigid credit markets are making it difficult for working families to obtain mortgages. This slows the recovery of the housing market and leaves neighborhoods at the mercy of absentee investors with little interest in the up-keep of the property or its impact on the surrounding community. These burdens could be reduced with the elimination of LLPAs and the use of proven underwriting criteria such as modest downpayments for counseled borrowers.

Thank you. I would be happy to answer any questions.

Civil Rights Statement of Principles for Secondary Market Reform

Equal access to mainstream financial services and affordable rental and owner-occupied housing is a critical step toward providing all families with access to wealth-building opportunities, good jobs, schools, transportation, health care, and other factors that determine positive life outcomes. Providing this access has been, and must remain, an important Government policy goal.

One of the lessons of the current financial crisis is that our Nation's housing finance system has not worked well for people of color and other underserved groups. Perverse incentives in the secondary market often drove unregulated brokers to target borrowers in communities of color with unsustainable loans. This fed a securitization regime so poorly understood and regulated that it ultimately destabilized the global economy. As the secondary market helped to drive this phenomenon, it also failed to make necessary investments in rental housing that met the needs of communities and opened opportunities for people.

Unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrowers creditworthiness determined the type and terms of the mortgages that were sold. All too often, families were denied the best credit for which they qualified, and their communities were flooded with unsustainable mortgage credit. As these unsustainable loans failed, the housing finance system failed to provide these families with the home-saving options that they were due. Instead of being able to use homeownership as the path to wealth-building and financial stability that our public policy promises, families have had their wealth stripped away and are facing financial setbacks that will take a generation or more to overcome.

It is because of this unfortunate history of exclusion of underserved communities from sustainable credit and housing options that civil rights organizations are invested in the housing finance reform debate and should be counted on as important civic partners. This debate is unfolding in the context of four decades of widening income and wealth inequality that have kept many borrowers from accessing the financial tools and options that provide an economic ladder to the middle class. Federal housing policy must reverse this and incorporate bold policy solutions to address inequality and segregation in the United States. It is in this spirit that we offer the following principles for secondary mortgage market reform. The principles were drafted by a group of more than 20 organizations that serve millions of members of underbanked communities throughout the United States, including African-American, American Indian, Asian-American, Pacific Islander, Latino, and low-income populations, as well as people with disabilities and the elderly. The points below are critical in shaping the future secondary mortgage market.

1. **Federal housing finance policy must align with and support long-standing Federal housing goals to protect against discrimination.** The secondary mortgage market must promote residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing for all.
2. **The Federal Government has a responsibility to ensure that the secondary market serves all borrowers in a fair and equitable manner and to foster the equalization of homeownership rates.** Despite clear demand from qualified families, the mortgage market does not reach all segments of borrowers and geographic areas. It is incumbent upon the Federal Government to use its resources to facilitate a stable, liquid housing finance system that will extend credit and capital on an equitable basis to all borrowers and in all communities, with the goal of achieving the same rates of homeownership among communities of color as among whites. While not all household heads must become homeowners, a commitment should be made to achieve similar homeownership levels across all communities. In addition, the system must be made accessible by a wide range of lending institutions for both owner-occupied and rental housing.
3. **A reformed housing finance system must eliminate the dual credit market.** Such a market has relegated people of color and other underserved groups and communities to riskier, higher cost forms of credit that strip wealth and undermine financial security. To accomplish this goal, reform of the secondary market must be coordinated with reform in the primary market for housing and other types of credit.
4. **Regulatory oversight of the housing finance system must be rigorous and comprehensive and must include effective fair lending enforcement.** Further, oversight and enforcement must extend to all secondary market entities, whether or not they avail themselves of any Federal guarantee or other support.
5. **Secondary market transactions must be transparent and accountable to the public.** Detailed, granular data about the operations of all secondary market entities must be made available to the public on a timely and consistent basis. This includes data about the race, gender, national origin, and other relevant characteristics of borrowers; how a loan was serviced, purchased, and securitized; and the terms and conditions of the loans.
6. **The system must have an affirmative obligation to offer capital and credit in communities devastated by the foreclosure crisis and offer access to families who were targeted for inappropriate and unsustainable mortgages.** It must engage with community-based financial institutions and community-based organizations to design sustainable solutions that are appropriate for specific locales.
7. **The housing finance system must provide capital for sustainable rental and ownership development in all communities.** Neighborhoods require affordable and sustainable rental and homeownership opportunities to thrive. Capital, especially that which comes with a Government subsidy or guarantee, should be directed to underserved areas and investments in opportunity-rich neighborhoods. This balance will provide the maximum range of housing choices for all, as there is not currently an adequate supply of affordable housing for underserved families.
8. **The housing finance system must support product flexibility and sustainable innovation and offer access to institutions of all sizes and in all geographic areas.** To do so requires that the secondary market avoid over concentration and that secondary market institutions have the ability to retain loans in their portfolio. Local institutions are often the first responders to local needs, adapting underwriting models to fit their clientele and funding innovation through their own deposit-based portfolios. Without a secondary market outlet, the volume of these loans will always be constrained. Further, because innovation is not always immediately scalable or easily standardized, it runs

the risk of being overlooked by large financial institutions or secondary market purchasers.

The following organizations contributed to and support the principles above:

Center for Responsible Lending
David L. Bazelon Center for Mental Health Law
Kirwan Institute
NAACP
NAACP Legal Defense & Educational Fund, Inc.
National Community Reinvestment Coalition
National Council of La Raza
National Council of Negro Women
National Fair Housing Alliance
National Urban League
North Carolina Institute of Minority Economic Development
National Coalition for Asian Pacific American Community Development
PICO National Network
PolicyLink
Poverty and Race Research Action Council
The Leadership Conference on Civil and Human Rights
The Opportunity Agenda

PREPARED STATEMENT OF JOHN FENTON

PRESIDENT AND CEO, AFFINITY FEDERAL CREDIT UNION
ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

OCTOBER 20, 2011

Introduction

Good morning, Chairman Johnson, Ranking Member Shelby and Members of the Committee. My name is John Fenton, and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I appreciate the opportunity to share my views with the Committee on housing finance reform and the value of the 30-year fixed-rate mortgage to credit unions and our members. Thank you for holding this important hearing.

I am president and chief executive officer of Affinity Federal Credit Union, headquartered in Basking Ridge, New Jersey. I also serve as chairman and chief executive officer of Affinity Financial Services, LLC, a wholly owned subsidiary of Affinity Federal Credit Union. Affinity Financial Services provides diversified financial services, including insurance, investment products, and mortgage origination and servicing.

Prior to joining Affinity in 1995, I was president and CEO of Synergy Federal Credit Union from 1987 to 1995. I have also held the positions of vice president of administration and finance at East Bergen Teachers Federal Credit Union (1982–1987) and vice president of finance at the Clifton Savings and Loan Association (1975–1982).

Affinity Federal Credit Union was chartered on December 13, 1935, the year after the Federal Credit Union Act was passed and signed into law by President Roosevelt. It was formed as the W. E. Headquarters Federal Credit Union to provide cooperative credit and to serve employee-member needs of Western Electric Company.

In 1974, the membership base of the credit union was extended to include AT&T employees and the credit union changed its name to GHQ Federal Credit Union (General Headquarters).

In 1984, with assets of $93.7 million, headquarters were moved across the river from New York City to New Providence, New Jersey, and GHQ became the second largest credit union in the State of New Jersey. At the close of 1986, the credit union changed its name from GHQ to AT&T Employees Federal Credit Union (AT&T EFCU) to more accurately reflect the current membership.

In 1995, I was named the new President and CEO, and was charged to be a catalyst for change. Although serving a single sponsor for most of these 60 years, the announcement that AT&T would be split into three separate companies encouraged the credit union to adopt a new name and Affinity Federal Credit Union was chosen.

Today, Affinity is the largest credit union in the State of New Jersey with 21 branches, more than 137,000 members from more than 2,000 businesses and organizations, and total assets in excess of $2 billion.

As you may know, NAFCU is the only national organization exclusively representing the interests of the Nation's federally chartered credit unions. NAFCU-member credit unions collectively account for approximately 62 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding housing finance reform and the continuation of the 30-year fixed-rate mortgage.

Background on Credit Unions

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the Federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need-a niche credit unions fill today for nearly 93 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 § USC 1752(1)). While over 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as in 1934:

- credit unions remain totally committed to providing their members with efficient, low-cost, personal financial service; and,
- credit unions continue to emphasize traditional cooperative values such as democracy and volunteerism. Credit unions are not banks.

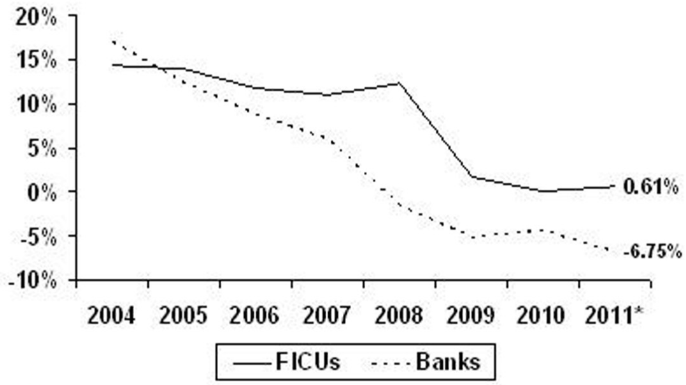
The Nation's approximately 7,200 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors-something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, Federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed, with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost of those services. Credit unions are second-to-none in providing their members with quality personal financial services at the lowest possible cost.

Credit Union vs. Bank Mortgage Lending

Credit unions were not the cause of the recent economic crisis, and an examination of their lending data indicates that credit union mortgage lending has outperformed bank mortgage lending during the recent downturn. This is due in part to the fact that credit unions were not the cause of the proliferation of subprime loans, instead focusing on placing their members in solid products that they could afford. The graphs below highlight how credit union real estate loan growth has outpaced banks during the downturn, and how credit unions have fared better with respect to real estate delinquencies and real estate charge-offs. The fourth graph demonstrates how credit unions are holding more long-term real estate loans as a percentage of total real estate loans than banks.

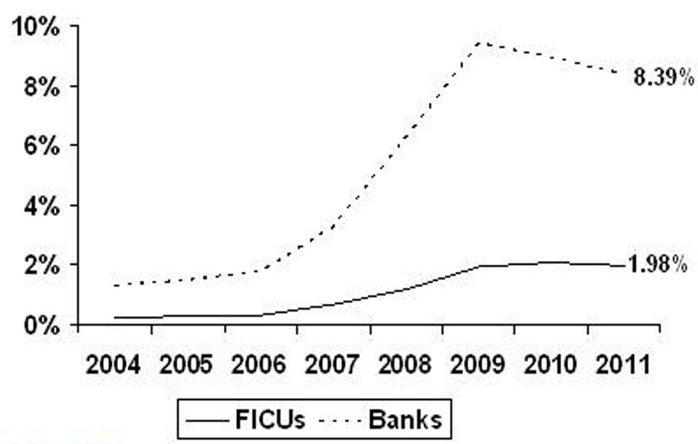
Real Estate Loan Growth



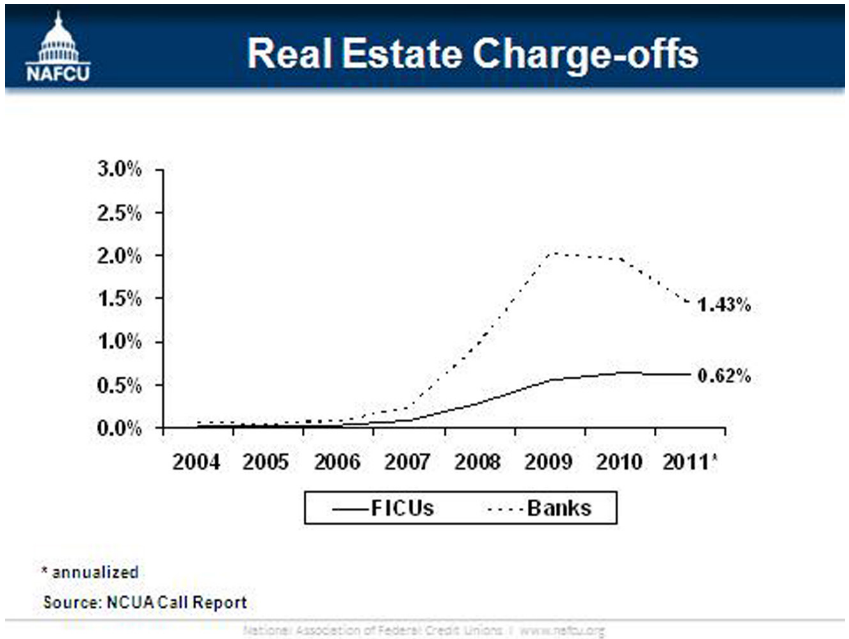
* annualized

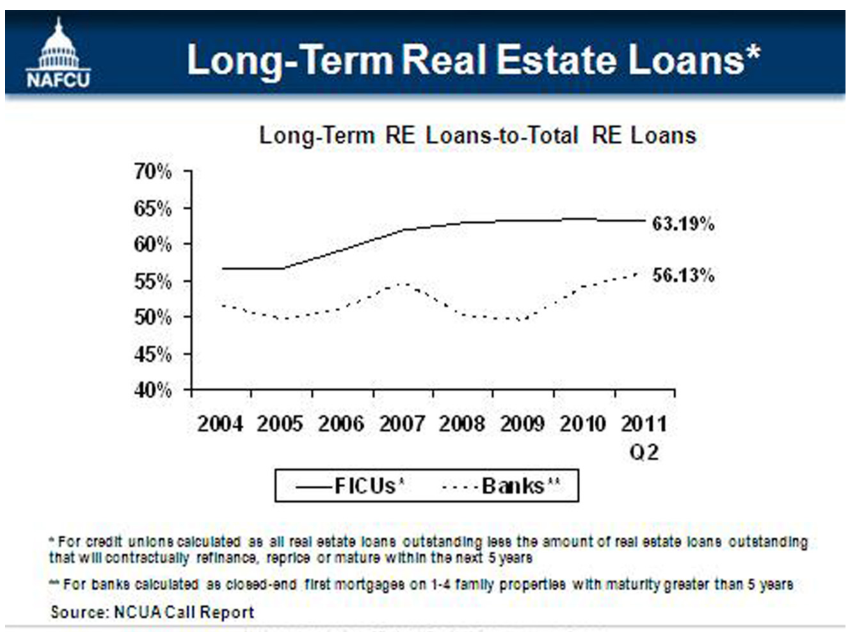
Source: NCUA, FDIC

Real Estate Delinquencies



Source: NCUA, FDIC





The 30-Year Fixed-Rate Mortgage

The 30-year fixed-rate mortgage (FRM) we know today had its origins in the reforms of President Franklin Delano Roosevelt's New Deal. Congress created the Federal Housing Administration (FHA) in 1934 as part of the *National Housing Act of 1934* (Housing Act) during President Roosevelt's first term. The goal of the Housing

Act was to enable home ownership for a broad sector of the American public. President Roosevelt's measure was in response to the Great Depression, which included a collapse of the banking system and subsequent mass foreclosures.

When the FHA was created, the housing industry was in dire straits. Millions of Americans lost their homes. Two million construction workers had lost their jobs. Terms were difficult to meet for homebuyers seeking mortgages. Mortgage loan terms were often limited to 50 percent of the property's market value, with a repayment schedule spread over three to 5 years, and ending with a balloon payment. America had become a Nation primarily of renters. Only 40 percent of occupied homes were owned.

At this time Fannie Mae and the Federal Deposit Insurance Corporation (FDIC) were also formed. The creation of these entities allowed the Government to restructure loan opportunities and create the 30-year fixed-rate mortgage (FRM). These entities have allowed tens of millions of home mortgages and tens of thousands of multifamily projects to come to fruition.

Prior to the introduction of the 30-year FRM, U.S. homeowners were at the mercy of adjustable interest rates. After making payments on a loan at a fluctuating rate for a certain period, the borrower would be liable for the repayment of the remainder of the loan (balloon payment). Before the innovation of the 30-year FRM, borrowers could also be subject to the "call in" of the loan, meaning the lender could demand an immediate payment of the full remainder. The 30-year FRM was an innovative measure for the banking industry, with lasting significance that enabled mass home ownership through its predictability. Congress gave credit unions the authority to offer 30-year mortgages in 1977.

Over the long-term, a 30-year FRM can be more expensive than an adjustable-rate mortgage (ARM). The ARM, however, is subject to fluctuations of a number of indicators in the market, and therefore carries greater risk to the borrower. Homebuyers who value more certainty in mortgage payments, and who can resist the lure of more risky but possibly cheaper financing, the 30-year fixed-rate mortgage offers the greatest long-term option, as it protects borrowers against interest rate spikes.

The FRM is the dominant instrument of mortgage originations. The FRM is regarded as a consumer-friendly instrument because it is straight forward, easy to understand, and provides for a predictable monthly payment schedule. The table on the next page outlines first mortgage activity (both new and outstanding) at federally insured credit unions for the first half of 2011. As you can see longer term fixed-rate mortgages (defined as greater than 15 years) make up the largest percent of the total loans granted and outstanding in terms of dollar amounts. Shorter term fixed-rate mortgages (15 years and under) are the next highest, buoyed by the current low interest rate environment. In 2009, during a higher interest rate environment, fixed-rate mortgages made up over 80 percent of the total loans made, with longer term fixed-rate mortgages accounting for over 55 percent of the total loans made by insured credit unions.

FICU First Mortgage Loans

As of June 30, 2011 (Source: NCUA 5300 call report)

	# of Loans Granted YTD	Amt of Loans Granted YTD (in $millions)	Percent of Total	# of Outstanding Loans	Amt of Loans Outstanding (in $millions)	Percent of Total	Delinquency Rate
Fixed-Rate							
>15 years	79,040	$13,908	41.5%	524,862	$82,179	36.2%	
15 years or less	83,451	$10,092	30.1%	662,815	$54,372	23.9%	
Other Fixed-Rate	2,762	$322	1.0%	13,281	$1,475	0.6%	1.71%
Balloon/Hybrid							
>5 years	9,178	$1,921	5.7%	98,098	$19,669	8.7%	
5 years or less	17,020	$3,248	9.7%	184,611	$34,618	15.2%	
ARM							
>1 year	9,651	$564	1.7%	75,859	$6,646	2.9%	3.29%
1 year or less	16,705	$3,472	10.4%	189,834	$28,301	12.5%	
Total	217,807	$33,527	100.0%	1,749,360	$227,261	100.0%	2.19%

With a fixed-rate mortgage, the lending institution assumes the risk associated with any interest rate increase. Having too many long-term fixed-rate mortgages in portfolio subjects the financial institution to greater interest rate risk, and can be cause for concern for examiners. At Affinity FCU we mitigate risk in our long-term FRM portfolio by hedging with interest rate swaps, caps, and matched borrowing. Selling on the secondary market to Fannie Mae and Freddie Mac is also an important risk mitigation tool. The securitization activities of Fannie Mae and Freddie Mac help lower the relative cost of the 30-year FRM and are an important factor in its viability.

Credit unions cannot raise funds from the capital markets, only from their members. The development of secondary markets for loans and mortgage backed securities (MBSs) through Government-sponsored enterprises (GSEs) was key to allowing credit unions to offer loans of longer terms. Credit unions were able to offer longer-term funding to match the terms of the mortgages and transfer some of that risk through loan sales to secondary markets. Without the Housing Act and the support of the GSEs, it is not clear that today's mortgage loans would have a 30-year term. Without a Government role in the secondary market, the 30-year FRM may still exist, but likely with higher cost to the consumer and scarce availability. The system of long-term fixed-rate mortgages financed through stable securitization has helped provide remarkable stability in the U.S. economy, as well as strong and sustainable homeownership.

There is no evidence that the recent economic downturn and collapse of the housing market was due to the presence of long-term fixed-rate mortgages, especially at credit unions. The success of credit unions during the economic downturn is evidence of this. Credit unions did not aid in the proliferation of subprime ARMs. Credit union loans are seen as quality loans, and their performance has backed that up. This is evidence that the 30-year FRM is not problematic by itself, and can be an important product for consumers and financial institutions. At Affinity FCU, we found that when our members got into trouble it was not from a particular first mortgage product; rather, it was likely from one of the following two factors: 1) loss of a job or unemployment; and 2) a decline in home value after a large amount of equity was pulled out in a line of credit.

The Future of the 30-year FRM

Full privatization of the secondary market is not a good option because the focus will shift away from the best interest of the consumer and overall housing market, to a business' bottom line. The existence of private label securitization of real estate loans was a significant factor in the recent housing market crisis. Going forward, a totally privatized secondary market will not allocate enough capital because of the inherent risks, both credit and interest rate, without some sort of Government guarantee. Without a Government role, 30-year (and other longer term) fixed-rate mortgages will become riskier propositions for credit unions. For safety and soundness reasons, additional risk will have to be passed on to the consumer. While some additional risk being borne by the consumer may not be a bad thing in and of itself, lack of a Government role as a stabilizing force in the secondary market would have a significant impact on the ability of credit unions to offer affordable, consumer-friendly mortgage products such as the 30-year FRM. We believe that it would further limit the availability of long-term, fixed-rate mortgage products, and substantially increase the costs of mortgages to the consumer.

It should be noted that the Government support for the secondary market does not only come from support and guarantees for the GSEs, but also in an indirect way when Government entities purchase mortgage backed securities (MBSs). This Government role in the market helps serve as a check on interest rates for the consumer. The loss of this Government role would likely drive up rates.

If the Government totally withdrew from the housing market, it could lead to an absence of, or at least a limited availability of, longer term FRMs. This would cause risk to be shifted back to the consumer and the cost associated with that risk would likely drive many low and moderate income consumers out of the homeownership market. Furthermore, not having an outlet to sell 30-year FRMs currently held in portfolio, if needed, could create additional risk for financial institutions such as credit unions.

The Housing Act, its creation of the FHA, and the resulting introduction of the 30-year fixed-rate mortgage, brought long-term stability to the American housing market and helped to stimulate economic recovery in the United States in the wake of the Great Depression. Accordingly, NAFCU believes that limiting the availability of the 30-year fixed-rate mortgage in these tough economic times will further drive down the already struggling housing market.

The 30-Year FRM and other products at Affinity Federal Credit Union

At Affinity FCU, we offer fixed-rate mortgage products in 10, 15, 20, and 30-year terms. Our 30-year FRM has traditionally been the most popular loan product with our members as it drives affordability and accounts for over 64 percent of our fixed-rate mortgage portfolio and nearly 48 percent of our overall loan portfolio. Our 15 and 20 year fixed-rate mortgages combined make up nearly another 22 percent of our total loan portfolio. This demonstrates a clear interest from our members in having a longer term fixed-rate mortgage product.

I should note that in the current record low interest rate environment, we are seeing increased interest in the shorter term fixed-rate products, as monthly payments are more affordable. This has also been seen in our adjustable-rate products, as people who have shorter timeframes may opt for the historic low rates of ARMs in this current rate environment. We believe it is important that any reforms do not try to limit financial institutions to offering only "plain vanilla" products. As member-owned institutions, credit unions have a strong track record of offering products our members want, working to place them in the right product for their needs. It is important that housing finance reform does not close the door on the ability of credit unions to match the member with the best mortgage product for them.

We also believe preference for mortgage products is somewhat generational. Post World War II and the baby boom generation tended to prefer the stability of long-term fixed-rate products, as many bought houses that they were going to live in for a number of years. Today, in a more mobile society, we see members who are approaching retirement or know they may be moving in a set time opting for a shorter term product to build faster equity when they buy or refinance. At the same time, we see many first-time or younger home buyers still opting for the stability of longer term fixed-rate products. It is important to note that few 30-year mortgages ever go to their full term, as homeowners will likely move, refinance or pay off the loan early long before loan maturity. Still, we have found that our members prefer the certainty of these longer-term fixed-rate products in their financial planning.

Managing Interest Rate Risk

Recent trends in asset portfolios, coupled with the current interest rate environment presents a unique challenge to credit union management. Over the last few years, interest rates have fallen to record lows, credit unions have experienced vigorous share growth, and credit union participation in the mortgage lending arena has increased to historic highs. Given these trends, it is more important now than ever to have a solid risk management program. The National Credit Union Administration (NCUA) has been active in watching interest rate risk at credit unions from long-term fixed-rate mortgages, issuing a letter to credit unions on the matter as far back as September 2003 and issuing an interagency (along with banking regulators) interest rate risk advisory in 2010. Additionally, they are currently in the process of finalizing a new interest rate risk rule.

The low interest rate environment is an additional deterrent for attracting private capital. In any housing reform, Government support is going to be a necessity for the foreseeable future. Curtailing that support will lead to additional credit stress on individuals and further threaten the safety and soundness of the financial system. Rates will rise exacerbating an already stressed economy if lenders do not have readily available avenues to manage risk.

Credit unions hedge against interest rate risk in a number of ways, including interest rate swaps, caps, borrowing and selling products for securitization on the secondary market. Lenders, such as credit unions, must be able to manage risk. Funding low-rate long-term fixed-rate paper with short-term deposits is a recipe for disaster. Lenders must have continued and unfettered access to hedging mechanisms. Unfortunately, the three ways that lenders manage interest rate risk (loan sales, term FHLB borrowings and plain vanilla interest rate swaps) are in the crosshairs of public policy debates.

Some of the options put forth as part of housing finance reform such as tighter underwriting standards, increasing guarantee fees, reducing conforming loan limits, increasing downpayments and limiting FHLB borrowings all could impact lender access to risk management tools. These ideas must be carefully orchestrated so that lenders can manage risk, rates are kept at a level that supports the recovery and consumers have access to credit on reasonable terms.

Fannie Mae and Freddie Mac, as well as the Federal Home Loan Banks, are valuable partners for credit unions who seek to hedge against these interest rate risks by selling their fixed-rate mortgages to them on the secondary market. Because Fannie and Freddie will buy loans on the secondary market, the credit union is not only able to mitigate the risk associated with interest rates, but they are also able to reinvest those funds into their membership or institution by offering them new loans or additional forms of financial services. Without this relationship with Fannie and Freddie credit unions would be unable to provide the services and financial products that their memberships demand and expect.

It should also be noted that the Government plays an important role in helping to set standards and bring conformity to the housing market. The tools that Fannie and Freddie provide help smaller institutions, such as credit unions, make the conforming loans that are sought on the secondary market. Changing standards to eliminate or make conformity difficult could make it hard for credit unions to sell loans on the secondary market, constraining their ability to manage risk in this way.

Housing Finance Reform

In the 3 years since the Federal Government took control of Fannie Mae and Freddie Mac from their stockholders through conservatorship, the future of the Government-sponsored enterprises and the secondary mortgage market has become a topic of debate. The development and reform of housing finance policy is highly significant to NAFCU and credit unions.

In February, the Department of Treasury released a proposal that would ultimately wind down Fannie Mae and Freddie Mac by offering three different scenarios for moving forward with varying degrees of Government involvement. Several pieces of legislation, from comprehensive to piecemeal approaches, have also been introduced in the House and Senate.

NAFCU would like to stress the importance of retaining a system that provides credit unions with the secondary market access necessary to serve the mortgage needs of their 93 million members. As you consider legislative proposals, NAFCU would like to reiterate a core set of principles we believe must be considered to ensure that credit unions are treated fairly during any housing finance reform process:

- A healthy and viable secondary mortgage market must be maintained. A secondary mortgage market, where mortgage loans are pooled and sold to investors, is essential in providing the liquidity necessary for credit unions to create new mortgages for their members.
- To effectuate competition and ensure access for credit unions, there should be at least two Government Sponsored Enterprises (GSEs) that would perform the essential functions currently performed by Fannie Mae and Freddie Mac.
- The U.S. Government should issue explicit guarantees on the payment of principal and interest on MBSs. The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in the MBSs and facilitate the flow of liquidity.
- During any transition to a new system (whether or not current GSEs are to be part of it) credit unions have uninterrupted access to the GSEs, and in turn, the secondary market.
- Credit unions could support a model for the GSEs that is consistent with a cooperative or a mutual entities model. Each GSE would have an elected Board of Directors, be regulated by the Federal Housing Finance Agency, and be required to meet strong capital standards.
- A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding GSEs. Credit unions should be represented in such a body.
- While a central role for the U.S. Government in the secondary mortgage market is pivotal, the GSEs should be self-funded, without any dedicated Government appropriations. GSE's fee structures should, in addition to size and volume, place increased emphasis on quality of loans and risk-based pricing for loan purchases should reflect that quality difference. Credit union loans provide the high quality necessary to improve the salability of many agency securities.
- Fannie Mae and Freddie Mac should continue to function, whether in or out of conservatorship, and honor the guarantees of the agencies at least until such time as necessary to repay their current Government debts.
- NAFCU does not support full privatization of the GSEs because of serious concerns that small community-based financial institutions could be shut-out from the secondary market.
- The Federal Home Loan Banks (FHLBs) serve an important function in the mortgage market as they provide their credit union members with a reliable source of funding and liquidity. Reform of the Nation's housing finance system must take into account the consequence of any legislation on the health and reliability of the FHLBs.

A vibrant and responsive secondary market for 30-year fixed-rate paper and access to term funding through the FHLB system are essential for community-based lenders so they can manage risk, offer a continuing supply of credit to consumers and small businesses and support the economic recovery.

NAFCU strongly believes that any reforms must not disrupt the fragile housing finance system that is slowly beginning to recover. As you know, any such disruption could trigger a "double-dip" recession and such an occurrence will have a devastating impact on our country's economy as well as the global finance system. In addition, we believe it is critical that the essential functions of Fannie Mae and Freddie Mac are retained until taxpayer dollars that the Federal Government injected into the GSEs are recovered. The essential functions include, but are not limited to, purchasing and guaranteeing mortgages originated by credit unions.

Conclusion

The 30-year fixed-rate mortgage product remains the most popular mortgage product available today. As such, it is necessary for the health of our housing market and continued recovery of our economy that it remains readily available. The ability of credit unions to make these loans and mitigate their interest rate risk by selling these loans to GSEs on the secondary market is as important to economic vitality as their availability in the marketplace. By allowing credit unions to hedge against interest rate risk by selling these mortgages, credit unions are better able to serve their members by continuing to offer products and services they want and need.

We thank you for your time and the opportunity to testify before you here today on this important issue to credit unions and our Nation's housing market. I would welcome any questions that you may have.

PREPARED STATEMENT OF ANTHONY B. SANDERS, PH.D.

DISTINGUISHED PROFESSOR OF FINANCE
GEORGE MASON UNIVERSITY SCHOOL OF MANAGEMENT

OCTOBER 20, 2011

Mr. Chairman, and distinguished Members of the Committee, my name is Dr. Anthony B. Sanders and I am the Distinguished Professor of Finance at George Mason. It is an honor to testify before this Committee today.

The FRM occupies a central role in the U.S. housing-finance system. The dominant instrument since the Great Depression, the FRM currently accounts for more than 90 percent of mortgage originations. One reason why it enjoys enduring popularity is that the FRM is a consumer-friendly instrument. Not only does the FRM offer payment stability—the instrument provides a one-sided bet in the borrower's favor. If rates rise, the borrower benefits from a below market interest rate. If rates fall, the borrower can benefit from exercising the prepayment option in the FRM to lower their mortgage interest rate.

But these consumer benefits have costs. It is costly to provide a fixed nominal interest rate for as long as 30 years. And the prepayment option creates significant costs. If rates rise, the lender has a below market rate asset on its books. If rates fall, the lender again loses as the mortgage is replaced by another with a lower interest rate. To compensate for this risk, lenders incorporate a premium in mortgage rates that all borrowers pay regardless of whether they benefit from refinance. Exercise of the prepayment option in the contract also has significant transactions costs for the borrower and imposes additional operating costs on the mortgage industry.

Another major reason for the FRM's dominance is Government support and regulatory favoritism. The FRM is subsidized through the securitization activities of Fannie Mae, Freddie Mac and Ginnie Mae. Their securities benefit from a Government guarantee that lowers the relative cost of the instrument, which is their core product. These guarantees have a significant cost as the Government backing of Fannie Mae and Freddie Mac has exposed taxpayers to large losses.

Are the FRM's benefits worth its costs? Would the FRM disappear if Fannie and Freddie stopped financing it? Are there mortgage alternatives that balance the needs of consumers and investors without exposing the taxpayer to inordinate risk? These are important questions and the answer is that short-term FRM and ARMs have decided benefits to consumers and taxpayers over the vaunted 30-year FRM.

Benefits of FRMs

A long history of Government support is not the only reason for the FRM's dominance.[1] The instrument offers consumers several advantages. First and foremost, it provides nominal payment stability, which helps consumers budget and reduces the likelihood of default. The monthly payment on an FRM is the same throughout the

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[1] See Michael Lea and Anthony B. Sanders, 2011, "Government Policy and the Fixed-Rate Mortgage," *Annual Review of Financial Economics.*

life of the loan, whereas borrowers with ARMs can experience payment shock in a volatile interest-rate environment, making them more likely to default.[2] The FRM is also a simple instrument for borrowers to understand, which has lead to proposals that lenders be required to offer the instrument to consumers applying for a mortgage.

The option to prepay an FRM without penalty is another consumer advantage.[3] This feature effectively converts the FRM into a downwardly adjustable-rate mortgage. When market interest rates fall, the borrower can refinance into a new loan at a lower rate. When rates rise, the fixed-rate feature protects the borrower against rising mortgage payments. Thus, the FRM (as opposed to a short-term ARM, for example) shields borrowers from most interest-rate risk. But the risk does not disappear—the lower the risk for the borrower, the greater it is for the lender/investor.

Costs of FRMs

The instrument's supporters point out that it is easier for investors than consumers to manage interest-rate risk. It is true that lenders and investors have more tools at their disposal to manage interest-rate risk. But managing prepayment risk is costly and difficult and many institutions have suffered significant losses as a result (*e.g.,* savings and loans in the 1980s; hedge funds and mortgage companies in the 1990s and 2000s).[4] Furthermore, borrowers rarely stay in the same home or keep the same mortgage for 15 to 30 years,[5] so one can reasonably ask why rates should be fixed for such long periods (increasing the loan's cost and risk). Also, the taxpayer ultimately bears a significant portion of the risk through support of Fannie Mae and Freddie Mac.

One of the lingering questions about Government loan modification programs is why borrowers are refinanced into longer-term FRMs rather than less expensive ARMs, such as a 5/1 ARM.

Does the FRM Promote Financial and Housing Market Stability?

It has been argued that the FRM promotes financial- and housing-market stability. A system dominated by ARMs or short-term fixed-rate mortgages is more sensitive to interest-rate fluctuations than one dominated by the FRM and can contribute to boom-bust cycles in housing. Housing demand is more rapidly influenced by monetary policy with ARMs relative to FRMs. But FRMs hardly eliminate housing cycles. The United States has experienced pronounced housing cycles in most decades since World War II, including a massive housing boom and bust in the last decade. Min attributes the most recent cycle to the rapid growth in short-duration mortgages. In large part, the shortening average life of mortgages reflects the widespread exercise of the FRM prepayment option.

The FRM has a uniquely one-sided design that protects the borrower at the expense of the lender/investor. But such protection comes at a cost. Longer-term fixed-rate loans have higher rates than shorter-term fixed-rate loans in most interest-rate environments (Table 1). Having a range of fixed-rate terms allows the borrower to tradeoff monthly payment stability with overall mortgage affordability. For example, a mortgage whose interest rate is fixed for 30 years will usually have the highest interest rate, while a 3:1 ARM, whose interest rate is only fixed for the first 3 years, will usually have the lowest interest rate.

Also, prepayable mortgages have higher rates than non-prepayable mortgages. In effect, all U.S. mortgage borrowers pay for the option to refinance, regardless of whether they exercise it. This system differs from the Canadian and European systems. In those systems, the borrower receives a short- to medium-term fixed-rate loan without a free prepayment option. If the borrower wants to prepay for financial reasons (as opposed to moving), they must pay a penalty equivalent to the investor's or lender's cost to reinvest the proceeds at the new, lower market rate. The option's cost is thus individualized—borne by the individual exercising the option. In the United States, the option's cost is socialized, with all borrowers paying a premium

[2] ARMs have had a much worse default experience during the recession. In part, this reflects the predominance of ARMs in the subprime market. It also reflects a selection bias whereby riskier and more speculative borrowers went into ARMs.

[3] Prepayment is not costless, however. There are significant transaction costs associated with refinancing.

[4] The uncertainty about prepayment leads to considerable speculation on the future direction of mortgage rates that has little social benefit. Hedging also increases systemic risk through counterparty exposure. The huge hedge positions of Fannie and Freddie were one reason why the Government placed them in conservatorship in 2008.

[5] Over the past 50 years the average life of a 30-year mortgage has never been higher than 12 years (during periods of high interest rates) and often no more than 5 years (during period of lower interest rates).

in their mortgage rates (on average, around 50 basis points, or 0.5 percent). In effect, the prepayment option is a tax on all borrowers.

Because all borrowers pay for the prepayment option, borrowers who do not exercise the option effectively subsidize those who do. Most often, unsophisticated borrowers who are intimidated by the refinance process or who are credit impaired pay the subsidy. The latter group is most likely to benefit at the margin (*e.g.,* by lowering the risk of default) but least able to refinance.

The 30-Year FRM, Slow Principal Amortization and Negative Equity

The potential for negative equity with a slowly amortizing mortgage product is daunting. When the principal is very slow to pay down and house price drop suddenly (as they did during the housing bubble burst), The FRM can create negative equity for borrowers in a rising interest-rate environment as well. When interest rates rise, a house's value may fall. And the economic value of the mortgage falls. However, the borrower is still responsible for repaying the loan at par value (the nominal outstanding balance). The combination of falling house price and constant mortgage value can lead to or exacerbate negative equity. Homeowner negative equity can also produce significant economic costs in that they are less likely to move in order to change their housing consumption or to take advantage of job opportunities. Negative equity has made loan modifications under private and public programs quite difficult and would have been far less of a problem if short-term mortgages (and faster principal amortization) had been the pre-dominant mortgage design.

Rising interest rates cause other problems for FRM borrowers and investors. If rates rise because of expected inflation, FRMs create affordability problems for new borrowers.[6] Unhedged investors experience an economic loss on their holdings of FRM-backed securities when interest rates rise (they also do not benefit from a rate decline, as noted earlier).[7] Rising interest rates also create an extension risk (the risk that the average life of securities rises) for investors. As rates rise, prepayments slow and the effective maturity of the securities increases beyond that expected by investors.

Interest-rate Volatility and the 30-Year FRM

Volatile interest rates cause problems for both borrowers and lenders. Long-term fixed-rate instruments have greater sensitivity to interest-rate changes than shorter-term instruments do. Volatility in pricing also makes mortgage shopping more difficult for borrowers in that mortgage prices can vary significantly on a daily (or even intraday) basis.[8]

Interest-rate volatility also causes refinancing waves, which increase costs for mortgage originators and borrowers. As interest rates rise and fall, mortgage origination volume is subject to massive swings. Mortgage originators and servicers have significant costs associated with managing such volatility. For example, origination volume rose from less than $3 trillion in 2002 to nearly $4 trillion in 2003 and fell to less than $3 trillion in 2004. Thus, the industry had to increase capacity by 33 percent in 1 year and reduce it by 25 percent the following year. FRM refinancing was the main reason for this volatility. For mortgage borrowers, the cost of refinancing lies in the thousands of dollars they must pay in origination fees simply to lower their mortgage rates.[9] The effect of the 30-year FRM on prepayments can be seen in Table 1 where the Mortgage Bankers Association Refinancing Index has become more volatile with progressively declining interest rates; shorter-term mortgages do not have the volatility of prepayments than longer-term mortgages.

The FRM has also created significant costs for taxpayers. Until 1981, federally insured depositories were prohibited from offering ARMs. Predictably, when inflation and interest rates rose in the 1970s and early 1980s, reliance on this instrument effectively killed off the S&L industry. In 1982, approximately 80 percent of the S&L industry was bankrupt and insolvent due to the mismatch between FRM assets and the short-term deposits that funded them. A similar mismatch rendered Fannie

[6] This scenario occurred during the 1970s in the United States.

[7] Hedging uncertain prepayment is both costly and risky. It leads to considerable speculation on the future direction of mortgage rates that has little social benefit. Hedging also increases systemic risk through counterparty exposure. The huge hedge positions of Fannie and Freddie were one reason why the Government placed them in conservatorship in 2008.

[8] Mortgage shopping in the United States is also complicated by the use of points to adjust pricing. Borrowers are confronted with an array of rate and point combinations that differ across lenders. Points were introduced in the 1970s when market rates rose above FHA rate ceilings—another effect of Government regulation.

[9] Refinancing transactions costs could be eliminated with use of a "ratchet mortgage," in which the rate is automatically lowered without transaction costs.

Mae insolvent. When numerous thrifts eventually failed, the taxpayer picked up a significant tab to restructure the industry.[10]

Learning from the experience, banks and thrifts continued to originate 30-year FRMs, but only if the loans could be sold to Fannie Mae, Freddie Mac, or guaranteed by the Ginnie Mae. In other words, banks and thrifts did not retain the interest-rate risk that they created by originating the FRMs. Instead, investors absorbed the risk. As the ultimate risk bearers, private investors attempted to price and manage the risk (with varying degrees of success). The GSEs hold a significant portion of the FRM inventory,[11] so when interest rates rise, they may suffer large losses that will be borne by taxpayers.

The FRM's popularity and its Government backing produce another significant risk for the Government. In order to finance the FRM and allocate the interest-rate risk to investors, the Government—through FHA insurance and Fannie/Freddie guarantees—absorbs the mortgages' credit risk. Ironically, it was credit risk that led to the failures of Fannie and Freddie in the financial crisis. While part of their losses can be attributed to speculative investments in subprime and Alt-A backed securities (mostly non-fixed-rate mortgages), a significant portion of their losses have come from FRM defaults.[12] The Federal Housing Finance Agency now projects GSE losses to be $220 to $360 billion. A portion of these losses can be attributed to the policy goal of ensuring the FRM's availability through the Government's absorption of the credit risk.

Alternative Designs in International Mortgage Markets

The FRM is a unique instrument by international standards. Only one other country, Denmark, has a long-term, fixed-rate, prepayable (without penalty) mortgage.[13] Several other countries have long-term fixed-rate products (*e.g.,* France, Japan, and Germany), but the typical terms are shorter and prepayment is subject to penalty. Shorter amortization periods benefit both borrowers and lenders because borrowers accumulate equity faster.

A more common fixed-rate instrument is the rollover mortgage, which is the dominant instrument in Canada and several European countries.[14] Its interest rate is typically fixed for up to 5 years and "rolls" into a new fixed rate at the end of the term. The new rate is negotiated with the lender and is set at market. These loans also have prepayment penalties during the fixed-rate term but allow total repayment without penalty at the end of the term.

Adjustable-rate loans are the dominant instrument in a number of countries, including Australia, Spain, and the United Kingdom. Table 2 shows the types of mortgages available in different countries and how common each product is.

Many countries have had housing booms and busts during the last decade (*e.g.,* Australia, Denmark, Ireland, Spain). Yet only Ireland has had as severe of a downturn as the United States (Table 3). Some have attributed the U.S. housing cycle to a shortening of the duration of mortgages over the past two decades, which caused house prices to become more sensitive to interest rates. Low interest rates, ample credit and borrower demand clearly contributed to the boom—however, throughout the boom period a majority of loans were in fact fixed rates. Most of the reduction in average mortgage maturity was due to borrowers exercising the prepayment option in their FRM contracts. And much of the shortening was for cash-out refinances to facilitate consumption at the expense of wealth accumulation. The in-

[10] Although the popular press tended to focus on excessively risky nonresidential mortgage investments as the cause of the S&Ls' failure, the fact was that they were bankrupted by the asset-liability mismatch and tried to grow out of their earnings and capital problems through investment in high-risk assets.

[11] The GSEs hold whole loans in their portfolios. They also repurchase securities they guarantee-in effect investing in the cash-flow risk associated with funding callable mortgages with a blend of callable and non-callable debts of different maturities.

[12] Federal Housing Finance Agency (FHFA) projections of GSE losses found that most of the losses are due to their purchased loans rather than securities. See FHFA, "Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac," October 21, 2010 (Attachment to the Press Release FHFA Releases Projections Showing Range of Potential Draws for Fannie Mae and Freddie Mac).

[13] The Danes add a unique twist to the instrument in that the loan is backed by an individual mortgage bond. If rates rise, the borrower can buy the bond at a discount and cancel the loan with the lender. This feature facilitates automatic deleverage and reduces the likelihood of negative equity.

[14] Canada subsidizes mortgages through CMHC. The degree of support is far less that U.S. support for housing (around 50 percent insured and 30 percent securitized) and the Canada bond program was designed to eliminate the prepayment volatility because investors don't like it (through cash-flow swaps with private investors).

ability of households to refinance FRMs to reduce negative equity has exacerbated the current crisis as noted above.

The prepayment option on the 30-year FRM is far from free. While only some borrowers will actually utilize the prepayment option, everyone has to pay for it (even if consumers don't want it). Fannie Mae and Freddie Mac will only purchase prepayable mortgages, even though non-prepayable mortgages may be in many borrowers' best interests.

Are The Benefits of the FRM Worth the Costs?

The fundamental question remains: Are the benefits of the FRM worth the costs? All borrowers pay a substantial tax—50 basis points or more—for this instrument. Furthermore, taxpayers have absorbed substantial losses in order to support this instrument, first through the S&Ls and now through Fannie Mae and Freddie Mac. Should the Government subject taxpayers to the risk of another catastrophic meltdown to preserve the FRM? Are there alternatives that maintain some of the FRM's benefits while greatly reducing the costs?

If the Government abolished Fannie Mae and Freddie Mac, the FRM would **not** cease to exist. Private-label securitization in the United States and covered bonds in Denmark have funded this instrument in the past and are fully capable of funding it in the future. Investors are sophisticated enough to price both credit risk and interest-rate risk. Conventional wisdom suggests that U.S. investors won't accept both credit risk and interest rate risk for large volumes of mortgages and the reason is clear: private investors can get the Government to absorb the credit risk at a lower cost than would be charged by the private market. The loss experiences of Fannie and Freddie suggest that they were funding mortgages at below-market (risk-adjusted) rates. Without Fannie and Freddie, the FRM would still be offered by lenders, but not at a subsidized rate. The FRM would have a smaller market share, but it would not disappear, as some have asserted. Nor would the only alternative be a short-term ARM as international experience suggests.

What would emerge as the "standard" U.S. mortgage instrument without Government support of the FRM? A rollover mortgage similar to that offered in Canada and several European countries is the likely candidate.[15] This instrument offers borrowers short- to medium-term payment stability, and borrowers can manage interest-rate risk by adjusting the fixed-rate term upon renewal. Modern international experience does not bear out the assertion by some that borrowers would be unable to refinance. Borrowers could hedge the interest-rate risk by locking in a forward rate in advance of renewal. German lenders offer forward rates up to 5 years—certainly U.S. lenders could do the same, given the deep derivative market. Alternatively, borrowers can adjust the degree of risk by varying the length of the fixed-rate period.

A complete and robust housing-finance system should offer borrowers a menu of mortgage options, ranging from short-term ARMs for borrowers who can handle payment change to long-term FRMs for borrowers who value payment stability. To assert that the FRM is the preferred alternative for most borrowers is naive. Many borrowers have shorter-term time horizons and can handle some interest-rate risk. The reason borrowers select a longer-term fixed rate is the fact that Government guarantees subsidizes the rate. International experience does not support the assertion that the switch to shorter-duration instruments would lead to massive defaults if and when interest rates increase.

The prohibition of prepayment penalties on fixed-rate mortgages is also misguided. Borrowers should be given a choice—long-term versus short-term fixed rates, with and without prepayment penalties. The market will price the differences, giving price breaks to those borrowers willing and able to handle interest-rate risk. Following Canadian and European tradition, the imposition of a prepayment penalty should be limited. It should not apply to borrowers moving house and it should be limited in term.[16]

Summary

The private sector would continue to originate and hold/sell 30-year FRMs without Government guarantees if there was continued consumer demand, but it is hoped

[15] Canada supports its mortgage market through default insurance and cash-flow guarantees comparable to FHA insurance and Ginnie Mae guarantees in the United States. The market share of Government-backed mortgages is considerably less, however, with approximately 50 percent of mortgages backed by Government insurance and 25 percent of mortgages backed by guarantees. European countries (with the exception of the Netherlands) do not support their mortgage markets through insurance or guarantees.

[16] For example, the maximum term over which the penalty applies is 5 years in Canada and the Netherlands and 10 years in Germany.

that shorter-term mortgages and ARMs become more popular in the future. The most important result of a shift away from the FRM would be a reduction in taxpayer liability for mortgage risk. There is nothing so special about housing finance that Government should absorb the credit risk of the vast majority of the mortgage market or underwrite the interest-rate risk of that market. Two episodes of massive taxpayer losses should convince us of that fact.

Table 1. Interest Rate Volatility and Mortgage Refinancing

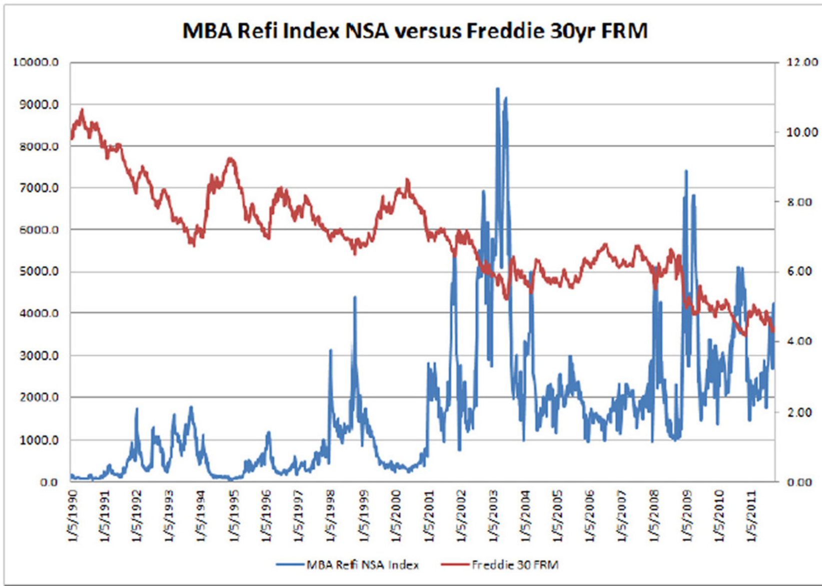

Table 2. Mortgage Design Concentrations by Country

	Variable rate	Short term fixed	Medium term fixed	Long term fixed
Australia	92%	8%		
Canada	35%		55%	10%
Denmark		17%	40%	43%
France	33%			67%
Germany	16%	17%	38%	29%
Ireland	91%		9%	
Japan	38%	20%	20%	22%
Korea	92%		6%	2%
Netherlands		15%	66%	19%
Spain	91%	8%		1%
Switzerland	2%		98%	
UK	47%	53%		
US	5%			95%
Source: Michael Lea, International Comparison of Mortgage Product Offerings, 2010.				

PREPARED STATEMENT OF PAUL S. WILLEN

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OCTOBER 20, 2011

Chairman Johnson, Ranking Member Shelby, and distinguished Members of the Committee, I thank you for your invitation to testify today. My name is Paul Willen, and I am a Senior Economist and Policy Advisor at the Federal Reserve Bank of Boston. I come to you today, however, as a researcher and not as a representative of the Boston Fed, the other Reserve Banks, or the Board of Governors. My main objective today is to lay out some basic facts about long-term fixed-rate mortgages. The main benefit of fixed-rate mortgages, according to proponents, is that they eliminate the possibility of "payment shocks" and thus would have prevented many of the foreclosures we have seen in the last 5 years. I will explain that, contrary to popular belief, payment shocks played little role in the crisis and, in fact, most borrowers who lost their homes in the last 5 years had long-term fixed-rate mortgages. I will also discuss how long-term fixed-rate mortgages have been widely used throughout American history, including the years immediately preceding the Great Depression, and were as ineffective at preventing foreclosures in the 1930s as they are now.

"Payment Shocks" Did Not Cause the Crisis

One popular theory places mortgage payment shocks at the heart of the crisis. According to this theory, the explosion of foreclosures that started in 2007 occurred because borrowers took out complex mortgages with fluctuating payments. Borrowers who took the loans either did not realize the payments could increase, did not expect the payments to increase, or thought they could sell or refinance before the payments increased. The theory suggests that, when payments went up, borrowers found themselves facing unaffordable increases in monthly mortgage costs, the aforementioned payment shocks, for which foreclosure was the unfortunate outcome. According to the theory, long-term fixed-rate mortgages would have largely mitigated the crisis because long-term fixed-rate mortgages guarantee a fixed payment for the life of the loan.

But the data refute that theory. The data say that payment shocks played, at most, a minor role in the crisis. As you can see in Table 1, we studied 2.6 million foreclosures and, for 88 percent of them, the payment when the borrower defaulted was the same or lower than the initial payment.[1] In other words, in only 12 percent of foreclosures—less than one out of eight—did the borrower suffer any payment shock at all prior to defaulting. Why didn't payments go up? It turns out that almost 60 percent of the borrowers who lost their homes had fixed-rate mortgages. This fact alone should dispel the misconception that a fixed-rate mortgage is inherently safe. But even borrowers who had adjustable-rate mortgages saw payments stay the same or go down. Why? Because contrary to popular belief, adjustable-rate mortgages do not only adjust up; if interest rates fall, payments either fall or stay the same. Starting in 2007, as in most recessions, interest rates fell. Indeed, in 2010, borrowers who lost their homes were almost as likely to have seen a payment reduction as a payment increase.

If payment shocks don't cause foreclosures, what does? Our research has shown that life events such as job loss, illness, and divorce have been at the heart of this crisis all along, even before unemployment surged in the fall of 2008. It may seem counter-intuitive that life events can explain the surge in defaults in 2007, because there was no underlying surge in unemployment or illness that year. To better understand, one needs to know how falling house prices and life events interact to cause default. Foreclosures rarely, if ever, occur when borrowers have positive equity, for the simple reason that a borrower is almost always better off selling the house than defaulting. Thus, detrimental life events have no effect on foreclosures when prices are rising. Consider that in 2001, after 6 years of rising house prices, Massachusetts suffered a fairly severe recession which led to a large increase in delinquencies, but the number of foreclosures fell to a record low. You can see this evidence in Figure 1. On the other hand, when house prices fall, some borrowers can no longer profitably sell. It is then that disruptive life events—which are always present, even in normal times—take a toll. Thus we do not need to have a surge in life events to get a surge in foreclosures. Rather, a fall in house prices, as we

[1] "Defaulted" here refers to the first default in the delinquency spell that led to the foreclosure.

have seen, will trigger a foreclosure surge. The problem is only amplified by rising job loss and other disruptive life events.

It does turn out that fixed-rate mortgages default less often than adjustable-rate mortgages, but that fact reflects the selection of borrowers into fixed-rate products, not any characteristics of the mortgages themselves. In 2008, my colleagues and I showed that even accounting for observable characteristics of the loans—such as credit score, loan-to-value ratio, payment-to-income ratio, change in house prices, and change in payment—borrowers were more likely to default on adjustable-rate mortgages than on otherwise similar fixed-rate mortgages.[2] The difference in default rates existed even for pools of loans where adjustable interest rates *fell,* further confirming that it was unobservable characteristics of borrowers, not of mortgages, that caused the difference. One possible explanation is that borrowers who intended to sell did not value the long-term certainty of fixed rates, gravitated to adjustable-rate loans, and those borrowers were the ones most likely to default when prices fell.

Long-term Fixed-rate Mortgages Were Widely Used Before the Great Depression

The misconception that long-term fixed-rate mortgages are inherently safe has a long history. It is widely believed that the absence of long-term fixed-rate mortgages prior to the Great Depression was a major contributor to the ensuing foreclosure crisis. Again, the facts do not bear this out. As you can see in Table 2, building and loan societies accounted for 40 percent of U.S. residential lending during the Depression. Almost all loans from building and loan societies were long-term fixed-rate mortgages that provided for full amortization. As with the most recent crisis, it was the *combination* of falling house prices and massive economic dislocation that caused the foreclosures, something a fixed-rate mortgage is powerless to stop.

The facts also disprove a closely related narrative about the Depression, which is that policymakers invented long-term fixed-rate mortgages, or were the first to use them widely. In fact, building and loan societies, the first of which began lending in 1831, always originated long-term fixed-rate mortgages and were, for much of the pre-depression era, the largest single source of funding for residential mortgages.

I hope these findings add insight to your work as policymakers. Thank you again for the opportunity to appear today; I would be happy to address any questions.

Table 1: Loans Prior to the Delinquency Spell that Led to Foreclosure

Percent of loans with...	2007	2008	2009	2010	All Years
payment increase	12%	17%	11%	9%	12%
payment reduction	0%	0%	4%	8%	4%
no change	88%	82%	85%	83%	84%
fixed rate	38%	48%	62%	74%	59%
adjustable rate, prior to reset	44%	32%	20%	15%	24%
adjustable rate, payment reset same or lower	6%	2%	7%	2%	5%
Observations (thousands)	374	641	874	756	2,646

Source: Lender Processing Services and author's calculations.
Note: Sample is all first-lien mortgages originated after 2005 on which lenders initiated foreclosure proceedings from 2007 to 2010.

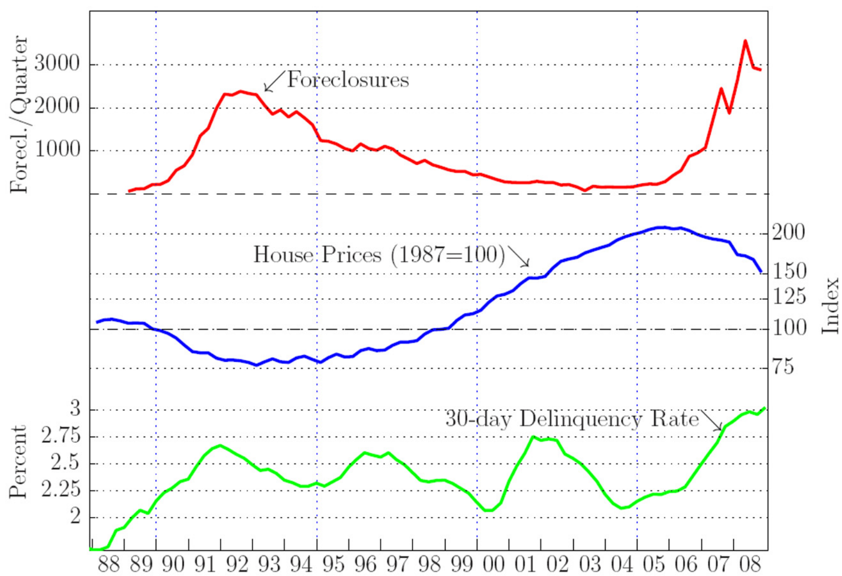
[2] "Just the Facts: An Initial Analysis of the Subprime Crisis." With Chris Foote, Kris Gerardi and Lorenz Goette. 2008. *Journal of Housing Economics,* 17(4):291–305.

Table 2: Mortgage Market on the Eve of the Great Depression

Type of Loan (1925–1929)	Mutual Savings Banks	Life Insurers	Building and Loan Societies	Commercial Banks	Individuals and Other
fully amortizing		14.3	94.6	10.1	
partially amortizing		61.5	0	38.3	
non-amortizing		24.1	5.1	50.3	
Percentage of Market (1929)	10.5	11.8	40.3	12.1	25.2

Source: Grebler, Blank and Winnick (1956).
Note: Market percentage is dollar-weighted. Building and loan societies were the main source of funds for residential mortgages and almost exclusively used long-term, fixed-rate, fully amortizing instruments.

Figure 1: Massachusetts House Price Growth, Foreclosures, and Delinquencies (January 1989 to December 2008)



PREPARED STATEMENT OF SUSAN E. WOODWARD PH.D.

PRESIDENT, SAND HILL ECONOMETRICS

OCTOBER 20, 2011

The focus of this hearing is the potential risk and unfairness of 30-year fixed-rate loans. While these loans are appealing to borrowers for their simplicity and certainty, they have the potential for problems elsewhere in the economy, ultimately falling on taxpayers. Let's go directly to the risk issues first.

The critics of the 30-year fixed-rate loan argue that this is unfair for households to get the benefits of reduced risk of fixed-rate loans while the taxpayers bear the risk. This criticism forgets that ***homeowners are taxpayers too.*** If we consider the situation over the lifetime of homeowner/taxpayers, there is nothing unfair about it. Indeed, it is a very desirable piece of social risk-sharing.

First, we need a few facts:

1. While the homeownership rate is between 65 and 70 percent right now, a much higher fraction of households, close to 85 percent, become homeowners at some point in their lifetime.
2. Individual incomes tend to rise over time, and peak at about age 55.
3. Home-owning households on average have higher incomes than non-homeowning households, and as a result pay more taxes.

This means that the overlap between homeowners and taxpayers is even higher than the 85 percent lifetime ownership rate. The people who benefit from our mortgage finance systems are thus the same people who pay taxes when problems arise. People benefit from the availability of a fixed-rate mortgage when they are young and have greater need for the security it provides, and the same people potentially bear a cost when they are older and have more income. The same folks who benefit from the availability of a 30-year fixed-rate loan are the ones who potentially could bear some costs from it. This is a fair tradeoff and one that most taxpayer/homeowners and potential homeowners ought to find an appealing part of national housing policy.

So that's my first point: Yes, the 30-year fixed-rate loan potentially has some cost to taxpayers, but since taxpayers are virtually all homeowners too, there is nothing unfair about this situation.

As an aside, somewhat more equity in lending institutions could also provide an additional buffer between mortgage finance and taxpayers.

Adjustable-rate loans have different problems, problems that are both individual households and to the wider economy. These problems appear to be more difficult to address than the potential problems of the FRM.

The problem with ARMs is that the standard design is flawed. ARMs fail to link payment changes to household income changes. The designers of ARMs saw this problem and put in caps on the rate adjustment, typically 2 points for a given year and 5 for the life of the loan. This moves the ARM is the direction of being fixed rate. Nonetheless, the threat to household budgets is still substantial. For example, suppose the rate of inflation picked up from say, 2 percent to 4 percent, moving the homeowners' rate from 4 percent to 6 percent. The likely change in the borrower's income is the current rate of inflation—6 percent. But the borrower's payment will rise 25 percent! Only affluent households with a lot of room to maneuver can tolerate this level of cash-flow uncertainty. People are not choosing badly when they opt for a fixed-rate loan.

In addition, the ARMs can pose risks to the economy too. The recession of 1980–1982 would have been much worse, with much higher levels of mortgage defaults and an even bigger collapse in economic activity, if all borrowers had had ARM loans. How bad the macroeconomic damage can be from U.S.-style ARM loans in a recession with all ARMs is something we don't know, an experiment we have never performed.

For both fixed-rate and adjustable-rate loans, risk arises mainly from fluctuations in the rate of inflation, so let's talk about inflation uncertainty.

If the rate of inflation remains low, as it has since 1987 when the Federal Reserve made a new commitment to a low and stable inflation rate, changes in interest rates pose little threat to either borrowers or lenders, and thus little to taxpayers either. On the other hand, with inflation this stable, the 30-year fixed-rate loan presents no risk either. With low and stable inflation, the 30-year fixed-rate loan is better because it is simpler and easier for borrowers to understand. Borrowers do not have to struggle to understand the indexes that underly ARM mortgages, and they do not have to understand the potential fluctuations in these, nor do they need to worry about exotic features of their loan that may have escaped their attention.

The FRM creates problems when the rate of inflation is higher than was expected. Lenders in the United States have, they have funded long-term fixed-rate mortgages with either deposits or with other borrowing that is shorter-term than the mortgages. If the rate of inflation picks up, the cost of the short-term funding for them rises. The value of the assets fall, but the value of the liabilities does not, and the institution is potentially insolvent. Taxpayers can potentially be asked to bail out the insolvent institutions, and they were once. Though as another aside, the lenders who failed mainly failed because of the risks they took when they were "de-regulated" in the early 1980s. Those who stuck with their old portfolios recovered without bailouts.

When this happens, the homeowners have a gain, while lenders and the taxpayers potentially have a loss. These net out to zero. And as I pointed out before, the homeowners and the taxpayers are the same folks. The benefits are larger earlier in their lives, and the potential costs come at a later point when they are paying more taxes. This is a good trade, there is nothing unfair about it.

Now on to the second issue: Do we need Government support for the 30-year fixed-rate mortgage?

I believe the answer is Yes.

The two most important innovations in mortgage finance in the 20th century were undertaken by the Federal Government. The first was the creation of a long-term, amortizing, fixed-rate and prepayable mortgage loan. Loans of this type were made available by FHA just after FHA's creation. Mortgage loans available before this were shorter in term, usually 5 to 10 years, and were not amortizing. They were what we would today call "balloon" loans. FHA also provided, and still provides, insurance on these loans, which serves the function of making lenders more willing to lend against residential property.

The second innovation was the creation of a secondary market via Ginnie Mae. Ginnie was and is an astounding success. Ginnie Mae's role is to package already-insured FHA loans into securities that are liquid and tradable. Ginnie's creation in 1968 lowered FHA borrowing rates by 70 basis points. Given that the long-run real interest rate on mortgages is about 4 percent, this is a substantial savings to homeowners. There is no cost to taxpayers from this re-packaging of FHA loans. The loans were already fully insured, and this insurance is paid for by FHA borrowers. The additional risk from packaging the loans into securities is trivially small. So we get a big benefit from a Government program that has no cost to taxpayers.

Why is the benefit so large? Because all parts of the financial market, including lenders themselves, prefer to hold a liquid asset than an illiquid one. It is that simple. By packing the loans into securities, illiquid whole loans are transformed into liquid securities that lenders are happy to hold at lower yields.

Ginnie was such a success that the thrifts immediately created Freddie Mac, to perform the same function for the conventional mortgage market. Fannie expanded into creating securities somewhat later, but it became the most important part of Fannie's function also.

Could the private market not create such an entity? Yes, it could, and once it did. When the thrifts created Freddie Mac, they copied the Ginnie design for themselves. I would not expect this to happen again now. When Freddie was created, even the largest thrift had only a tiny share, less than 1 percent, of the market. Both the larger and the smaller lenders had much to gain from better capital market access and more liquid assets. But now, with a few large lenders dominating mortgage lending, we should expect that the large players would not voluntarily create an institution to the benefit of their smaller competitors. These barriers to cooperation are much larger now than they were in 1968.

The private market has done some securitization of mortgages outside of our three large institutions, but it has not created the market-wide benefits that securitization through Ginnie, Freddie and Fannie has. The reason is that these one-off securitizations are designed to make today's issue sellable, not with the view of creating an effective, liquid market for all lenders. If we are to have institutions that perform a function similar to what Ginnie Mae, Freddie Mac and Fannie Mae do, in re-packaging mortgages into liquid securities, we need some push from the Government to make sure they exist.

I would hope to see one major reform to Fannie and Freddie or their successors: create a restraint so they could not again provide funding to new and unproven ideas like subprime lending. Ginnie Mae stood by and shrunk mightily as subprime expanded, while Freddie and Fannie rushed in. Ginnie's strategy was by far the better.

To make sure I cover everything of interest, I will address the Committee's specific questions for this hearing.

1. What would the national housing market would look like in the absence of the FRM, taking into account the accessibility and affordability of credit for the average middle class American family as well as the importance of stable finances?

Without some Federal support, specifically the support of the secondary market for FRMs, there will be a lot more adjustable-rate loans. We can expect a variety of ARMs, tied to different indexes, with different re-set periods, different caps, and different margins, much like the ARM market that was active prior to the financial crisis, but larger, with more varieties.

The 30-year fixed-rate loan is unquestionably easier for households to understand than any adjustable-rate mortgage. This simplicity is not in dispute. Even with the 30-year fixed-rate loan, we have substantial evidence that there is still borrower confusion. The terms that borrowers get demonstrate this confusion. The borrower confusion levels can only be higher on ARMs.

Survey work of mortgage borrowers indicates that essentially none of them understand the indexes to which adjustable-rate loans are tied. Finance is difficult and arcane, and people stay in school a long time to learn it. The London Interbank Borrowing Rate (Libor)? The 1-year Treasury rate? A twelve-month moving average of the 1-year Treasury rate? We cannot expect any ordinary household to understand where any of these interest rates come from or to have any idea of what is the likely variation in such interest rates over the next 30 years. Only the most sophisticated households would understand them. Even Ph.D. economists have a difficult time predicting the level and volatility of interest rates. The average household will not understand what risk it is undertaking with an ARM. It will be more work for regulators to oversee an all-ARM market to try to curb abuse by lenders.

And of course we will not be free of potential macroeconomic problems coming from the mortgage market. If the inflation rate rises, and ARMs reset higher, there will be households unable to make their payments and who will default. The full force of this remains to be seen and will depend on the nature of the ARM loans that are outstanding.

2. The Committee would appreciate your thoughts on the benefits of long-term fixed-rate financing for homeowners in positive and negative economic times.

When times are good and inflation is low, there is still a benefit to the FRM because it is simpler for borrowers to understand. Mortgage finance is difficult enough on even fixed-rate loans, and it is more difficult on ARM loans. With an all-ARM market, lenders and finance professionals have more tools and varieties to take advantage of borrowers who are not financially sophisticated.

In tougher times, the benefits of the FRM are less subtle. If the rate of inflation rises, the standard ARM loan puts borrowers in a difficult situation because their payments rise much faster than their incomes do. The simple result is more mortgage defaults.

3. Please also identify pieces of our current system that are necessary if the 30-year fixed-rate prepayable mortgage is going to continue to be widely available.

To begin, we should keep FHA mortgage insurance and the Ginnie Mae program for securitizing FHA (and VA) mortgages. They provide a source of stability and a continuous demonstration of what is possible in effective and constructive mortgage finance. In addition, we need Government backing for a at least one entity to provide securitization to the conventional market, and entity like Freddie Mac between 1970 and 1989. The portfolio role of Fannie Mae and the post-1989 Freddie Mac are not clearly essential. We have solid evidence that effective securitization lowers rates for borrowers about 70 basis points. The benefit of the portfolios in addition is not established.

The secondary market entity could charge for a Federal backstop, and could include private mortgage insurance, much as it has for 40 years. The important feature is not for the Federal Government to assume all of the risk, but to provide an institution that effectively provides liquidity in the secondary market.

4. Finally we would like you to discuss any concerns that you may have regarding interest rate risk for both borrowers and lending institutions, how that risk can best be mitigated and by whom.

Lending institutions are well-informed specialists in assessing interest rate risk. Thus, the real key to avoiding insolvent lenders is high levels of capital. There seems to be general agreement now that bank capital standards ought to be higher than they were before the financial crisis, to make insolvency less likely from mortgage defaults and interest rate fluctuations as well.

As for risks posed to the taxpayers, the first line of defense is well-underwritten home loans that borrowers can afford. The second line of defense is the equity in lending institutions. The third line is for the Government to bear some risk, as it does through deposit insurance. Taxpayers are nearly all home owners too, so the folks who potentially pay for any risks of FRMs also get the benefit of them. This trade of benefit for risk is fair and constructive for society.

This issues I discuss here I have also discussed at greater length in a paper that I wrote for the Joint Center for Housing Studies at Harvard last year. I attach that paper as well.

The Future of the Capital Markets: Connecting Primary Consumer and Mortgage Credit Markets to Global Capital

Susan E. Woodward *

Prepared for the Joint on Housing Studies Center Symposium, February 18 & 19, 2010 draft of August, 2010

Policy Issues: The Roles Fannie Mae and Freddie Mac Emerging from the Financial Crisis of 2008

There are three moving forces that are central to understanding the role of Government-sponsored institutions in the mortgage market. Understanding these forces helps clarify the features of the GSEs that are most important and should be preserved. Briefly, these forces are:

1) The 30-year, fixed-rate, pre-payable mortgage likely would not exist without Government support.
2) The original and still most important support provided to the 30-year fixed-rate loan is the encouragement, by regulation and capital standards, to depositories and the GSEs to hold these loans.
3) Securitization of mortgages through a standardized process lowers mortgage interest rates by a substantial amount. Securitization by Wall Street has never been nor should be expected to be similarly successful.

Each of these forces is discussed in detail. There is one more important feature, only recently learned, that makes the GSEs more than useful:

4) Without the Government-sponsored institutions, Ginnie, Fannie, and Freddie, the current financial crisis would be much worse than it has been.

1. The special role of the 30-year, fixed-rate, prepayable residential mortgage.

The 30-yr fixed-rate pre-payable mortgage is a creature of the Federal Government. This loan design was created by Government fiat by FHA in 1934. Prior to its introduction, residential mortgage loans in the United States had terms of 5 to 10 years and were *not* amortizing—they were what we would today call balloon loans, simple short-term copies of the ordinary bonds issued by Government and corporations, which paid interest regularly until maturity, at which time the principal amount was refunded.

Other developed countries have also encouraged residential mortgage markets with amortizing long-term loans (20 to 30 years), but in all others (save one small special case, Denmark), these loans all have adjustable rates and re-price at least every 5 years. The United States is unique in supporting a residential mortgage that is long-term, amortizing, *fixed-rate,* and pre-payable. The pre-payability is a feature of State law in all 50 States.

The 30-year fixed-rate mortgage created by FHA was intended to calm down both sides of the residential credit market and encourage the resumption of borrowing and lending. Real estate lending troubles were at the center of the sharp decline in economic activity that we call the Great Depression, though we cannot blame real estate "bubbles". Instead, it was the conscious and deliberate monetary policy of the time that led to a profound deflation (the price level fell 30 percent in 3 years between 1930 and 1933) that precipitated the decline in real economic activity.

In addition to the sharp rise in unemployment caused by this decline in the price level, the deflation also disturbed the relationship between assets and liabilities of borrowers. The dollar (nominal) price of real assets and wages fell with the overall price level, while debts were denominated in dollars, and still owed in dollars. The deflation increased the real value of these nominal debts. The situation can be thought of as dollar prices of assets declining while dollar prices of debts stayed fixed, raising debtors' indebtedness. Or it could be thought of as real values of assets staying fixed while real values of debt rose. Expressed either way, borrowers were in trouble.

Borrowers were in trouble because even if they were still employed, their dollar incomes fell 30 percent (unless they were Government employees, whose incomes stayed the same in dollar terms) along with the price level while the dollar obligations on their debts remained the same. Borrowers could not pay their mortgages nor could they refinance them.

* Thanks to Barry Zigas and to the reviewers at the Joint Center for suggestions and improvements. All remaining errors are my own.

The FHA-insured 30-year mortgage succeeded in calming both sides of the market. Lenders were more willing to lend because FHA took the risk of default. Borrowers were more willing to borrow because the loans were long-term and did not require them to refinance before the loan was paid off in the way the earlier 5 to 10 year term, nonamortizing loans did. Both sides felt more secure.

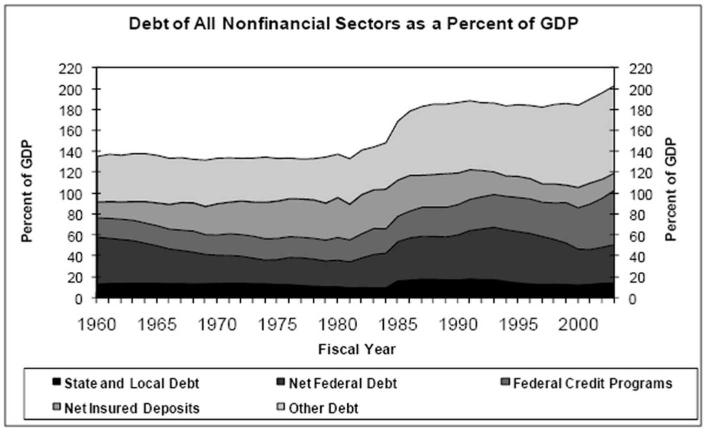
The biggest risk the Government was taking by insuring FHA mortgages was not the particular default risk, but the risk of a large change in the price level. It was the change—decline—in the price level between 1930 and 1933 that bankrupted borrowers, caused widespread default, and thus bankrupted banks too. It was anticipated at the time of FHA's creation that the price level would be stable long-term, because the dollar was still tied to gold. It was believed at that time that so long as we were on the gold standard, a serious inflation could not occur.

Why was the Government willing to take on the risk of mortgage default when private insurers were not? A short and easy answer was simple desperation to get markets to resume borrowing and lending. But a deeper answer is that the insurer—the Government—also had control over the most important variable that could influence defaults (and had caused the eruption of defaults that had just occurred)—the price level. Anyone who borrows or lends in dollar (nominal) terms is betting on the future value of the dollar, which is the same as betting on the rate of inflation, to be determined largely by future monetary policy. Borrowers gain from inflation rates higher than expected, because inflation erodes the real value of their debt. Debtors lose from inflation higher than expected, because inflation erodes the value of their assets. Borrowers lose from deflation, because a deflation raises the real value of their obligations, while debtors gain. Some have suggested that the Fed has a mismatch issue (liabilities and assets have different durations). Of course the Fed has a mis-match issue; unlike others with a mismatch issue, the Fed has control over future rates of inflation, and consequently future interest rates.

But a change that is very extreme in ether direction creates problems for lenders, especially leveraged lenders such as U.S. depositories, and thus the economy in general. If deflation is so extreme that borrowers can no longer meet their dollar-denominated obligations, as in the Great Depression, defaults by borrowers cause lenders to become insolvent. If inflation is so extreme that the equity of financial institutions is wiped out (because an increase in the long-run inflation rate lowers the value assets by more than it lowers the value of liabilities), as it was for many Savings and Loan Associations in the late 1970s and early 1980s, institutions again fail from insolvency. These two kinds of insolvencies are very different, but they both result in stress on the financial system when institutions cease to be trusted and cease to trust each other, and hence do not transact. Both kinds of insolvencies are (and were) the result of conscious, deliberate monetary policy.

Thus, economies that are large and complex have never had, and I imagine never will have, truly *laissez-faire* credit markets because the single most important player, the monetary authority, has the power to redistribute wealth between borrowers and lenders, and more. In the United States, close to 70 percent of nonfinancial credit (nonfinancial credit is the sum of borrowings by businesses, households, and governments at all levels, with intermediaries netted out) is touched by Federal policy through an assortment of policy tools: the Federal Government's own debt, the tax-exemption of interest on municipal bonds, all borrowing intermediated through insured depositories, loans held by and guaranteed by the Government-sponsored enterprises (including the Farm Credit system), plus various other direct and guaranteed Government lending programs (including FHA and VA mortgage insurance and guarantees).

This astounding figure—close to 70 percent of nonfinancial credit—has prevailed since at least the end of WWII. The chart below shows the layers from 1960 to 2004. The bottom layer is tax-exempt municipal debt. The second layer is the U.S. Treasury's own debt. The third layer represents debt intermediated through government credit programs, including GSE debt and securities, plus all other Federal agency debt plus loans guaranteed and insured by the government. The fourth layer represents credit intermediated through insured deposits, with holdings of three lower layers—Treasuries, municipals, GSE debt and securities, and other loans insured or guaranteed by the U.S. Government netted out. The top layer represents debt intermediated by organizations with no special tax treatment and no guarantees, and consists mainly corporate bonds, other corporate borrowings, plus some non-depository consumer credit. In 2004 the total touched by Federal policy was roughly 120 percent of GDP, with total nonfinancial credit equal to 200 percent of GDP. Thus, as of 2004, the fraction of nonfinancial debt touched by Government programs was about 60 percent, slightly lower than the historical average, which is closer to 70 percent. For earlier data, see the 1986 Economic Report of the President, page 191.



The level is even higher right now, with the Government owning large chunks of the equity in banks and investment banks, which were previously in the 30 percent of the credit market not tied to the Federal Government (mainly corporate bonds and other corporate nonbank borrowings) as well as other assets, but I have not toted up the numbers lately. Anyone who thinks that the United States has a *laissez faire* financial system is simply ignorant of the proportions of the Government role in credit markets.

Only a country that is optimistic about its ability to control the price level long-term would consider encouraging or insuring a long-term, fixed-rate, prepayable mortgage. The thrift crisis (which, in retrospect, looks fairly tame), demonstrated that such a policy could turn out to be costly, and costly as a result of the Government's own monetary policies. The thrift crisis did not occur because the people who owned and ran the thrifts were incompetent or witless. It was the result of deliberate policy choices on the part of the U.S. monetary authority to raise the rate of inflation above what had been previously expected. Thrifts were encouraged—by deposit insurance and capital requirements—to make the loans that policymakers wanted them to make. I am not suggesting that policymakers knew, when they encouraged lenders to make these loans, that they were going to raise the rate of inflation, but only that it was changes in Government policy with respect to inflation rates that "caused" the thrifts to become insolvent. The equity holders of the thrifts benefited from Government support in good times, and suffered from it when inflation rates rose.

We have no evidence that a long-term fixed-rate residential mortgage loan would ever arise spontaneously without Government urging. Other developed countries that support long-term adjustable-rate loans have not spontaneously developed, in the private realm of the mortgage market, long-term fixed-rate loans for household borrowers. The development of such a loan has happened only once on a large scale, here in the United States.

The point of this discussion about the uniqueness of the long-term fixed-rate residential mortgage and role of the Government in the credit markets is to demonstrate that pleas for "free market" forces in credit markets should be dismissed out of hand. The United States does not have a "free market" in credit, especially residential mortgage credit, nor does any other large or developed country. The most important innovations in the mortgage market in the last 80 years—introduction of a long-term amortizing loan, creation of national liquidity facilities for regional lenders (Fannie Mae), introduction of a liquid secondary markets in mortgages (Ginnie Mae and Freddie Mac), and the contract designs to support loan servicing in securitized markets—were all undertaken by institutions that were either explicitly part of the Government or had important Government ties. The largest private innovations, adjustable-rate loans and subprime loans, cannot be said to be such great successes. Among the private innovations, the creation of credit scores appears the most constructive and successful.

What about the possibility of giving up the long-term fixed-rate loan, and getting along with only adjustable-rate loans, as do nearly all other developed countries?

At one point in the early 2000s, well before any hint of the subprime crisis but after the dotcom recession was over, Alan Greenspan, noting that long-term fixed-rate mortgages were a source of systemic risk in our financial markets, suggested that one way to eliminate this systemic risk was for borrowers to simply have adjustable-rate mortgages instead. He noted that ARMs have lower interest rates on average (which is true). The extreme public outcry made him abandon this suggestion with alacrity. People were not interested that Canada, the United Kingdom, France, Germany, and many other countries seemed to achieve high rates of home ownership despite having only adjustable-rate loans. (It turns out that Greenspan himself had a fixed-rate mortgage. Why? He said he liked the certainty. Bernanke has a fixed-rate mortgage also, same reason.)

Americans are evidently comforted by their 30-yr fixed-rate loans. Long-term fixed-rate loans are more expensive than ARMs even when the credit risk is assumed by a Government-related entity such as FHA or Fannie or Freddie. This is because all residential loans are prepayable, and the lender or investor takes the risk of a prepayments arising from fluctuations in interest rates. Lenders thus charge a premium to cover this risk. It is not small: on average it is about 125 basis points. Borrowers cannot disclaim their right to prepay a fixed-rate loan, so the only way for them to avoid paying a premium for pre-payability is to have a loan with an adjustable rate.

Nonetheless, borrowers clearly prefer fixed rates. It appears that borrowers should only choose adjustable-rate loans when 1) they are sufficiently affluent that a substantial change in their mortgage payment would not seriously disrupt their personal finances (as in the jumbo market, which until recently was about half fixed rate, half ARMs), 2) when nominal interest rates are very high and the term structure is steep, making payments on ARMs far lower than on fixeds, as in the early 1980s, and 3) when borrowers are confident they will reside in a given house only for a short time. When interest rates fall, ARM borrowers overwhelmingly refinance from adjustable rates to fixed rates. Even in the present crisis, default and delinquency rates on fixed-rate mortgages are about half than those on ARMs, even in the prime market. This appears to be more of a self-selection phenomenon than the result of ARM resets. Anyone suggesting, as Greenspan did, that we abandon rather than accommodate the long-term fixed-rate prepayable residential mortgage would be in for serious grief. Americans now seem to regard the availability of long-term fixed-rate mortgages as part of their civil rights.

2. The role of Government support in the continued existence of the 30-year fixed-rate residential mortgage.

The original and still most important support provided to the 30-year fixed-rate loan is that U.S. bank regulations encourage depositories to make and hold these loans. The GSEs were also encouraged to hold 30-year fixed-rate loans by being allowed low capital requirements on substantial portfolios of both whole loans and MBSs. Depositories and the GSEs still hold the majority of 30-year fixed-rate loans and mortgage-backed securities (MBSs) based on them. (Many depositories hold MBSs of loans they originated themselves and securitized through Fannie or Freddie.)

The importance of depositories and the GSEs is readily apparent in the figures on the holdings of MBS. In particular, defined-benefit pension plans, which are by nature long-term investors, seem natural candidates to be holders of long-term mortgages, but they are not. They hold substantial amounts of Fannie and Freddie debt (straight bonds), but essentially none of the MBSs. Pension plans fund long-term real (inflation-adjusted) annuities. Evidently the prepayment risk of long-term fixed-rate pre-payable loans, which fall in value when the rate of inflation rises, and prepay when the inflation rate (and interest rates) fall, is incompatible with this goal. Fixed-rate mortgages are a worse fit than plain bonds for insuring inflation risk because they fall in value more when the rate of inflation and interest rates rise, but do not enjoy a symmetric rise in value when interest rates fall because they instead prepay.

Default risk in mortgages is largely diversifiable, but prepayment risk is not. Even in the current recession, the geographic variation in property value changes and defaults is substantial. By the OFHEO purchase-only indices (as of December, 2009), national house prices are down just over eleven percent from their high in early 2007. The census division with the largest decline is the Pacific, down 28 percent (on a seasonally adjusted basis), and the one with the smallest decline, West South Central, down 1.2 percent, is hardly down at all. Defaults are highly concentrated in the sand States (California, Arizona, Nevada, and Florida), which are suffering from a combination of the largest price declines as well as the largest explosions of subprime lending. (The combination is not an accident.) Aside from the current crisis, both real estate price changes and defaults have been geographically concentrated. When defaults are geographically concentrated, holding a nationally distributed portfolio diversifies much of this risk.

On the other hand, prepayment risk is a systemic risk. Changes in interest rates influence the behavior of borrowers in all 50 States. Prepayment risk can be transferred to another party, but not eliminated. For example, when an investor buys Fannie Mae or Freddie Mac bonds, the interest paid on loans held in portfolio ultimately pays the interest on the bonds. Thus, the bondholders bear ordinary interest rate risk but not prepayment risk, and the equity holders of Fannie and Freddie bear the prepayment risk on the portfolio loans.

Even REMICs (Real Estate Mortgage Investment Conduits) just re-shuffle prepayment risk, they do not eliminate it. When a REMIC takes the form of being tranched (sliced) by prepayment priority, the earliest-paying tranche will perform much like a short-term bond, while the later-paying tranches will bear even more prepayment risk than would an ordinary, un-REMICed, untranched pool of mortgages. By contrast, in normal times, default risk is diversified away in a big national pool of loans.

The systemic nature of prepayment risk brings us back again to the issue of where prepayment risk comes from. When interest rates fall, borrowers prepay and refinance. When interest rates rise, average mortgage life lengthens and existing mortgages and mortgage securities become less valuable. Interest rate fluctuations do not come primarily from random, uncontrollable forces, but from deliberate policy choices of the monetary authority. Inflation is, in the first analysis and the last analysis and most analyses in between, a monetary phenomenon. It is appropriate that the Government have some role in allocating and insuring this risk given that it has substantial control over it.

By allowing federally related institutions to make and hold mortgages of this design, the taxpayers bear the systemic risk, both from prepayments and from unusual levels of defaults, (rare, but happening now). Taxpayers bear this risk through their liability for taxes to make good on the promises made through deposit insurance and guarantees behind Ginnie, Fannie, and Freddie, and deposit insurance. The benefits of this system accrue mainly to homeowners. Given that nearly all income taxes are paid by homeowners, and that nearly all homeowners begin their home ownership with a mortgage, it is mainly homeowners who benefit and also homeowners who bear the risk of the arrangement. Thus, the beneficiaries (homeowners) and the bearers of risk (the taxpayers) are ultimately the same folks, but at different points in their lives. This system gives people a hand up when they are young and cash-constrained, and has the potential to cost them something, more if they are big successes in making money, later in their high-earnings years if problems arise. It is not hard to imagine that most people regard this as a satisfactory tradeoff.

3. The role of the GSEs in securitizing mortgages

The GSEs promote liquidity and therefore low interest rates by:

1) standardizing mortgage terms,
2) standardizing loan servicing, and
3) standardizing mortgage-backed securities.

All three factors help to produce a market of homogeneous securities that trade at a low cost in a liquid market.

The first mortgage-backed securities (MBS) were created as part of a new Government program, Ginnie Mae, in 1968. At that time, they were called pass-through securities because they passed interest and principal payments on mortgage loans through to security holders. The Budget Task Force of 1968 was assigned responsibility for getting Fannie Mae's debt off the Federal budget to make the Federal debt, which had been growing fast in the 1960s, look smaller. Fannie began in 1938 as a Government agency able to buy and sell mortgages from depositories, then in 1954 was reorganized as a cooperative among the lenders who sold mortgages to Fannie. The plan in 1968 was to reorganize Fannie into a stockholder-owned corporation, with stock that could be owned by the general public, not just by banks. To achieve this, the FHA mortgages on Fannie's books were packaged into securities guaranteed for timely payment of interest and principal by the full faith and credit of the Federal Government, to be sold to the general public. FHA loans were already federally insured, so the additional assumption of risk for the Government was *de minimis.*

The creation of Ginnie Mae in 1968 lowered FHA borrowing rates by a startling 60 to 80 basis points. Given that the real (inflation-adjusted) interest rate on FHA loans is in the range of 4 to 5 percent, this is a substantial, not trivial, reduction. The reduction in the interest rate was not the result of additional Federal assumption of risk, but of a genuine improvement in market design. The decline appears to be attributable to two things. First, by securitizing loans through Ginnie, lenders turned illiquid whole loans into liquid securities, which they were willing to hold at lower yields. Second, the existence of a national secondary market disseminated high-quality information about price and made the pricing of mortgages both lower and tighter nationwide. In sum, the additional cost of risk assumed by the taxpayers was tiny, but the benefits were substantial.

The benefit was so obvious and large that the thrifts immediately wanted an institution to perform the same function for their conventional mortgage loans. (Fannie had traditionally done more business with commercial banks than with thrifts.) Thus, in 1970, Freddie Mac (The Federal Home Loan Mortgage Corporation) was created to securitize conventional mortgages. Freddie was organized as a cooperative among the thrifts, with ownership and governance through the Federal Home Loan Bank System, also owned and operated by the thrifts.

FHA insurance for mortgages had introduced some uniformity in mortgage instruments as lenders met FHA standards in order to get FHA insurance. Freddie Mac further standardized the conventional mortgage market, which until then had many practices that differed by State. While some differences across States still remain (mainly with respect to loan foreclosure and its interaction with personal bankruptcy), mortgage lending rates are more uniform across States now than they were prior to the creation of Freddie.

The details of the contracts created to make Ginnie and Freddie work well should command a great deal of respect. One of the issues securitization created was: who would do the back office work (servicing) on securitized loans and how could we assure it was done well? When the lender held the loan and serviced the loan, there was no conflict of interest. Separating servicing from ownership of whole loans was a challenge. The solution for Ginnie was to assign 44 basis points (0.44 percentage points) of interest, calculated as a fraction of the outstanding principal balance, as income to the servicer. Today we would call this an interest rate strip of 44 basis points. The creators of Ginnie knew well that this was more than servicing should cost, and intended for it to be. They predicted, correctly, that servicers would bid and pay for the right to collect the 44 basis points. The investment necessary to purchase the rights to the servicing (which tends to run about 1.25 percent of loan principal) would thus manifest itself in the price servicers would pay for servicing, which would represent the difference in the present value cost of servicing and the present value of the 44 basis point interest strip.

The investment made by the servicer to purchase the interest/only strip becomes a hostage to exchange to assure the performance of the servicer. And of course, the longer the expected life of the loan, the higher the present value of the interest rate strip, so the servicer has a vested interest in preventing foreclosures on loans. Servicers were also required to collect money monthly from borrowers to be deposited into escrow accounts to pay homeowner property taxes and hazard insurance. This helped borrowers meet their obligations by turning the otherwise lumpy (from a time passage point of view) payments for taxes and insurance into smooth monthly payments. One of the stupidest features of the subprime lending debacle (and there were many) was that most subprime loans had no tax and insurance escrows. Yet the borrowers had quite low credit scores, indicating that they were struggling to keep their personal finances in order. These borrowers needed escrows more, not less, than prime borrowers.

A further discipline to the secondary market is that Ginnie, Freddie, and Fannie all monitor servicer performance. Ginnie can simply seize a servicing portfolio (without compensation) and sell it to another servicer. Fannie and Freddie have the right to force a servicer who is not performing to sell its portfolio (usually at a loss, since a nonperforming portfolio will need some investments to be returned to satisfactory performance) to an approved servicer. This threat gives servicers another reason to maintain high standards of performance. Exercise of the threat is fairly rare.

This set of contracts to support MBSs crafted "by the Government" has endured as the basic servicing contract on prime loans to today.

Fannie Mae soon followed by creating securitization programs also after Ginnie and Freddie were up and running. Until 1970, Fannie had made a secondary market in mortgages only by buying them for its portfolio, and issuing bonds to fund them. Freddie Mac was focused entirely on securitization, and had only a small portfolio of loans (roughly $25 billion) until it was "privatized" in 1989 by FIRREA. Post-FIRREA, Freddie underwent a reorganization similar to that of Fannie in 1968, in that the thrifts were no longer Freddie's owners and directors, but Freddie's stock became public and traded on the New York Stock Exchange. Freddie quickly accumulated a portfolio nearly the size of Fannie's.

Why can't Wall Street replicate the success of Ginnie, Freddie and Fannie? The presumption of Federal backing is not the only difference between them and Wall Street. There are other differences that are more important. Other differences are:

1) Ginnie, Freddie & Fannie all have standardized loan contracts.
2) All three all have standardized servicing agreements.
3) All issue large and homogenous pools of loans.
4) Wall Street securitizers do not take into account the benefits of additional liquidity they could add to the rest of the market by creating similar securities, in other words, they do not internalize the benefits of additional liquidity to the rest of the market.
5) Ginnie, Fannie, and Freddie all suppress inefficient information production in the secondary market for its contribution to market liquidity. Wall Street wants more unique securities, more sources of disagreement, not fewer.

Ginnie, Freddie and Fannie all have standards for loans they will securitize, for both loan structure and loan servicing. I have heard bank lobbyists complain that Freddie and Fannie have "commoditized" mortgage lending. Yes, yes they have, and with great benefits to mortgage borrowers. This standardization or commoditization lowers costs to borrowers and causes them little inconvenience.

In contrast, Wall Street did not attempt to create any standards, and packaged many varieties of loan designs with varieties of servicing agreements and little by way of reporting conventions. At the June, 2009 conference at the Federal Reserve Bank of Kansas City, a former subprime investment banker on a panel complained bitterly about the absence of a standard servicing and reporting agreements in subprime lending, and appealed for a Federal intervention to create one. When such an appeal comes to pass, there are no Republicans left.

Wall Street is happy to securitize smaller pools, and eager to get deals done before customers disappear. Without the patience to assemble large pools from different lenders, liquidity in the secondary market later is sacrificed. Liquidity is further sacrificed by tranching the pools into even smaller and more unique securities, with the expectation that each security can find a home where the risk taste best aligned and its value is highest. Wall Street also values knowing which pieces are owned by whom, so that it can arrange deals when someone wants to buy or sell. (In *Bonfire of the Vanities,* there are characters described as earning their living out of simply knowing who owns which bonds. This is not entirely fiction.)

When a new mortgage-backed security is created, there is potentially an externality for the entire MBS market. If the security is very much like existing securities, the entire market becomes a little bit more liquid. The entire market benefits from the additional liquidity. By being large entities with many outstanding securities, Freddie and Fannie internalize this externality. They do not want a novel security because it would not create the same liquidity benefits for the rest of the book. By contrast, the private-label securitizers are indifferent to creating more liquidity in the rest of the market. They are focused only on creating a security they can sell to someone today. Rather than seeking to make a market more liquid, investment bankers are instead always looking for "a man with an ax"—an investor with a specific investment desire that can be carved out of a pool of loans, leaving a residue that must be packaged and affirmatively "sold".

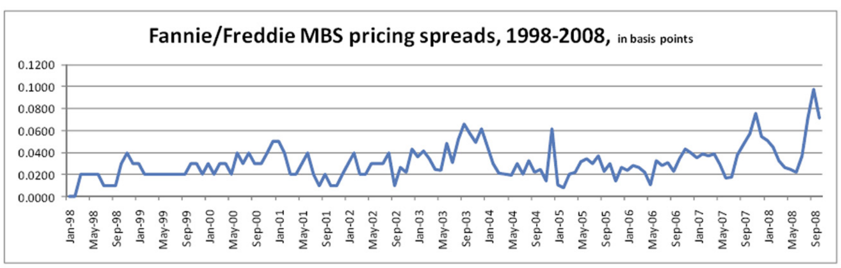
In additional important difference relates to how the GSEs suppress inefficient information production by limiting what information is disclosed about individual mortgage pools. Prepayment speeds differ by coupon and also with geography. Some areas are growing, others are contracting. Borrowers move and prepay more in growing markets than in stable markets. Some areas have higher turnover, and loans prepay when people move, Ginnie, Fannie, and Freddie's MBSs all efficiently suppress information about the location of mortgages in individual MBS pools. Ginnie and the GSEs keep the MBS market liquid despite some geographical differences in prepayment speeds by ***not revealing*** the geography of loans in any given MBS . . . Wait! What about market transparency?

More transparency is not always better. This can be understood easily in a similar arrangement seen in the municipal bond market. A structure used for promoting liquidity in the municipal bond market is a random call feature used for bonds that fund small but long-lived projects. Take a dam, for example. Bondholders are repaid from citizens' water bills. If the issue is large, such bonds are often structured in sets that repay at different times, for example, 10 years, 11 years, and so on up to 40 years. For smaller projects, each slice may be too small to find a liquid market. Instead, the entire issue is given the same maturity, but a specified fraction of it is called at random for repayment each year. The investors buy many such issues, and thus have a good idea of when on average they will be repaid, and thus easily tolerate the uncertainty of individual issues, and value the greater liquidity.

Suppose that right after the bonds were sold, the issuer spun the wheel to select the call date of each bond. Would it be efficient to release the information early, prior to the call? NO! Once the call dates were known, the bonds would degenerate into the tiny, illiquid serial bonds that the market was trying to avoid. What's more, the issuer and the investors *agree* that the best arrangement is not to reveal early. This is a clear case where the optimal level of information is not the fullest information.

In principle, the value of a set of MBS could be either increased or decreased by revealing information that distinguishes them from one another. More pieces might accommodate a greater variety of investors with pieces precisely tailored to their risk tolerance. Or, it could be that liquidity concerns dominate, and that a larger, more homogeneous, more liquid market in MBSs tightens spreads and lowers prices. There are different ways of homogenizing risk, including pooling risk (MBSs vs. whole loans, even S&P 500 futures contracts vs. individual stocks in the S&P 500) (see information theorist Hal Varian's provocative *ideas on subprime koolaid*), providing ratings (professional opinions on risk to make clear where similarities lie), and providing insurance (assignment of risk to a professional evaluator of risk for a fee). Each has its pros and cons.

The experiment to show which is more important in the market for MBS on conventional prime mortgages has been done: Some years ago Freddie Mac was persuaded (by Wall Street!) to reveal more about the geography of its MBS pools on the theory that this would make the pricing more "accurate" and securities more valuable. Since then, Fannie's securities (MBSs) have consistently sold for a slightly higher price than Freddie's *because Freddie tells the market more* about each one, and hence the Freddie MBSs are less perfect substitutes for each other, and a bit less liquid. The Fannie MBSs trade as if they are more alike because the market has no information with which to make distinctions among them. The really interesting thing is that the market unambiguously *prefers* the security about which it is *less* informed. Over the period since 1998, the current coupon yield for Freddie MBSs has been above that for Fannie MBSs by on average 3 basis points, (with a standard deviation of 1.5 basis points). From January 1998 to December 2008, the yield on the Freddie security was never below that on the Fannie security. And this is despite the feature that the Freddie securities pay the security holder a few days earlier, which in principle should make them more valuable. Yes, more transparency makes the securities of ***lower,*** not higher, value, on average. Below are data from 1998 to 2008 on Fannie/Freddie yield spreads.



It is only three basis points on average, but it is a bitter three basis points, making business slightly less profitable for Freddie.

So perhaps the Freddie securities are more "accurately" priced, but they are without question less valuable as a result because they are less similar. From a social point of view, the bottom line is in the pricing: the securities are less valuable when more transparency is provided, and all things considered, investors and borrowers both gain when the additional information is not disclosed. The losers are the market makers and those who would be in the know about who holds the different securities and make money trading in the secondary market based on their special knowledge. These are the same folks who created and made markets in subprime mortgage-backed securities.

But surely not all detail should be suppressed. What kind of information should be suppressed, what kind should be transparent? To be efficiently suppressed, information should have the following properties:

- The information should be about factors that are not systemic.
- The risks should not be too large.
- The risk should diversify away when investors hold a variety of different issues.

The arrangement of municipal bonds with random calls for repayment is ideal because the risk is perfectly diversifiable. The suppression of information about prepayments is not perfect, but it is an improvement over full information, says the market.

Even in the market for the U.S. Treasury's own securities there is a tension between giving Wall Street what it wants by way of maturity variety versus keeping borrowing costs low for the taxpayers. Wall Street always wants Treasury's new borrowings to be new securities, distinct from prior issues, so that the new bonds are not perfect substitutes for older ones. In many cases, what would be efficient is for Treasury to re-open an existing issue (especially if it is trading at a high price relative to the rest of the yield curve) and sell additional bonds into it. Wall Street intermediaries prefer a larger number of unique issues in order to keep trading spreads wide and to put themselves in the position of having superior information about who owns which bonds.

Wall Street also fought the introduction of Treasury Inflation-Protected Securities. IBankers complained that there is little trading in them (or was in the United Kingdom, where similar bonds existed already.) About this, they are right, the trading volumes are low. The volume is not low because there is no interest in these bonds, but because they such satisfactory assets that buyers just hold them, and do not trade them much. Nonetheless, on any given day, nearly all TIPS trade with a spread at the minimum tick—1/32, (one thirty-second of 1 percent of par value) indicating that despite the low volumes, market markers feel they face very little risk in maintaining an inventory. The low trading volumes in combination with the narrow spreads do not mean this security is socially useless, but that it is especially useful.

If the securitization operations of Freddie and Fannie were shut down, and all securitization was left to Wall Street, we would see a market in which:

1) Fewer mortgages will be securitized.
2) We will see a wider variety of types and sizes of securities.
3) Buyers will have to do more diligence before purchasing any given security.
4) Market-making spreads will be wider.
5) Mortgage interest rates for borrowers will be higher.

The only beneficiaries of this alternative system would be the intermediaries. Both investors (ultimate holders of the MBS) and homebuyers would be worse off. And of course, if Ginnie is still standing (I have heard no pleas to dismantle Ginnie except from AEI), more business will go to FHA and Ginnie.

Without Freddie and Fannie, it would be in the interest of mortgage lenders to create a consortium or cooperative amongst themselves to securitize mortgages. It would be an organization much like Fannie or Freddie today, but perhaps more successful in resisting the lure of subprime securities. Both Fannie and Freddie were run conservatively in their co-op days. But I do not expect mortgage lenders to be able to create such an organization. First, there is a conflict of interest between large lenders, who could securitize at least some loans themselves, vs. smaller banks, who would likely have to sell loans to the larger banks for securitization; that conflict is larger now than when the largest bank had only 1 percent of all bank assets (roughly 1989). All lenders would benefit, but the small banks would benefit more and the large banks less, thus, strategically, the large banks have an interest in blocking a co-op. This appears to be the conflict of interest that inhibited the Federal Home Loan Bank system from creating a third GSE. We should not imagine that a co-op created among the banks would be free of Federal responsibilities, because the members would all be insured depositories.

What about the portfolios?

F&F both have substantial portfolios of loans. Their portfolios are close to three-quarters of a trillion dollars each, and the difference between the interest earned on the portfolio and interest paid on the bonds that fund the portfolio is their largest source of income. I do not have a strong opinion on how large the F&F portfolios should be. But experience tells us that any attempt to whittle down the GSE portfolios will raise mortgage interest rates at least temporarily. In addition, decreasing the size of Fannie and Freddie's portfolios will not lead to a reduction of risk exposure by the Federal Government, the goal of most who advocate such changes. Instead, it would largely result in an increase of holdings of mortgages and MBS by depositories.

In other words, the 30-year fixed-rate loans are not likely to leave the Federal umbrella, but only move to another place under it. Reducing the portfolios would not be without pain for the mortgage and housing markets. Even in the early 1990s, when the mortgages held by the dismantled insolvent thrifts had to find new homes, mortgages rates were clearly elevated by this displacement. It seems unlikely that policymakers would choose any time soon to force F&F to divest their portfolios, as this would just depress mortgage values and force already beleaguered banks to mark down their assets once again. If the portfolios of F&F are to be whittled down, the least disruptive option may be to simply not have them buy any more loans for portfolio. As loans in the existing portfolios mature, the portfolios will shrink.

One caution on dismantling the portfolios of Fannie and Freddie comes from looking at who is in favor of this policy. The main proponents, not only of dismantling the portfolios but eliminating Fannie and Freddie altogether, are the large commercial banks, the other natural home for mortgages. The large banks are in the best position to be able to securitize mortgages in F&F's absence (thought the market would not likely be as efficient, because securities would not be as standardized and homogenous). They expect, correctly, that smaller banks would have to sell mortgages to them to access the secondary market. Theirs is the voice we hear in the Wall Street Journal. (I remain puzzled as to why the WSJ should be more enthusiastic about large commercial banks with unambiguous Federal support of deposit insurance than with other financial institutions with similar Government backing.) Another F&F combatant is the American Enterprise Institute, whose opposition is more understandable, since it is funded by contributions. It is important to remember that commercial banks are not exactly "free market" institutions, but owe much of their access to inexpensive funding to deposit insurance (which they pay for) and to Federal regulation.

If Freddie and Fannie were as well-capitalized as the average mid-size bank, they would be no more risky than the average mid-size bank. In retrospect, the risk taken on by Freddie, Fannie, and the largest commercial banks was substantially greater than that taken on by mid- and small-size banks, who seem to have avoided making or buying any subprime loans.

Covered Bonds

Covered bonds, used by Denmark to fund its long-term fixed-rate mortgages, (and by some other countries to fund long-term adjustable rate mortgages) have been promoted as superior to asset-backed securities. The "coverage" of covered bonds is overcollateralization. In practice, they are nearly identical to asset-backed securities and to the arrangements we have had for many years, especially to Fannie and Freddie MBSs. Essentially, nothing is achieved with covered bonds that could not also be achieved with higher capital requirements for Fannie and Freddie. Covered bonds are, like asset-backed securities, backed by the cash-flows on a pool of assets, in the case of the mortgage market, a pool of mortgages. And covered bonds, like F&F MBSs, have more resources behind them than just the mortgages in their pools to cover losses.

There are two differences between covered bonds and the MBSs issued by F&F, both essentially cosmetic. One is that the mortgages backing the bonds remain on the balance sheet of the issuer. Whether the assets are off the balance sheet is irrelevant so long as the MBS have recourse to assets on the balance sheet. F&F MBS do have such recourse. Another is that the pool of assets backing the covered bond is usually larger in principal value than the bonds themselves, so that the security is explicitly overcollateralized. The MBSs issued by F&F are implicitly overcollateralized because they are guaranteed against default by F&F, but not backed by any particular pool of loans. If the default losses on a given MBS were sufficiently large, F&F are obliged to make up the difference from reserves and other assets. All of the reserves against losses and equity of F&F are ultimately available to the MBS holders. Thus, in essence, F&F MBSs are already over-collateralized.

So long as the securities outstanding are MBSs guaranteed by F&F, and the experience on the mortgages behind them (in terms of defaults and prepayments) are well-disclosed, and the other assets are also fully disclosed, it should make no difference whether the securities are called covered bonds or MBSs or whether the recording of the securities is on the balance sheet or in some other section of their regular reports. Covered bonds are not "the answer" or even a very interesting suggestion, or all that different from what Fannie Mae & Freddie Mac have done lo these many years. The only interesting variation is how much "coverage" is desired. Coverage is essentially an issue of capital, leverage, and capital standards.

Another disadvantage of covered bonds in the United States would be that where these bonds are used, they are issued by large banks. In countries that have only a few large banks, and essentially no small ones, this creates no comparative disadvantage. In the United States, with its many smaller banks, the small banks would have to either sell through the large banks or create a co-operative entity through which to sell covered bonds together. This cooperative entity would have to look a lot like either Freddie or Fannie.

And finally, covered bonds are evidently not the panacea claimed by some. Both Spain and the United Kingdom use covered bonds to fund mortgages yet both were also fraught with problems in real estate lending in the recent crisis.

Do we need to return to substantial downpayments?

Offering mortgages to borrowers with good credit histories but small downpayments was not the core of the financial crisis, instead it was offering any mortgage to people with poor credit histories, in large numbers, in concentrated areas. Even with the large decline in property values in some areas, borrowers with good credit who do not lose their jobs, become ill, or get divorced are very unlikely to default, even if their downpayments were slim. A careful study by Willen *et al* of all mortgages made in Massachusetts prior to the 1991 recession found that only 6 percent of the prime borrowers who had negative equity defaulted over the next 3 years.[1]

Credit scores are a new feature in the mortgage market. They were hardly present in 1990, but almost universal by 1996. Prior to 1996, lenders mainly used high downpayments as their defense against default. What lenders learned with credit scores is that they could make even high LTV loans to borrowers with good credit, and these borrowers would keep paying even if their houses were underwater.

A factor that made the subprime crisis worse than other housing crises is that the expansion of credit to a new, previously not-served set of borrowers was so large that it moved house prices. Prices have fallen most in areas where they rose most, and these are the same areas in which subprime borrowers were over-represented.

At present, the prime mortgage book is in worse shape (higher delinquencies) than in most years, but still in much better shape than the subprime mortgage book. As of June, 2009, the "seriously delinquent" rate for prime conventional mortgages (either held by or securitized through Freddie or Fannie) is 3.2 percent, while the rate for securitized subprime loans is 23.7 percent. And of course, the prime book is only performing as poorly as it is because of the contraction in real activity caused by the subprime mess and the subsequent bank panic.

Ownership Structure

There are many possibilities for the structure of Fannie and Freddie going forward. Some can be easily ruled out as undesirable, while others area worth more study.

Among the possibilities are:

1) A single entity with Government ownership and control as for FHA and Ginnie Mae.
2) A cooperative among lenders, as Fannie and Freddie once both had.
3) A cooperative among borrowers, similar to the organization of the Farm Credit System or the Credit Union system, or even to borrower-owned and controlled mutual insurance companies.
4) A shareholder-owned, profit making institutions, subject to limitation on activity by charter and to regulation, as in their old structure.

A Government program like FHA?

FHA and Ginnie Mae are playing a large and important role right now, with a market share of originations in 2008 of 25 to 30 percent. For some years, FHA has operated at a disadvantage to the conventional market because of the rigidities inherent to being part of the bureaucracy. First, FHA originations are slower than originations that go through F&F. According to FHA's *January 15, 2009, report* on recent originations, average processing time was 2.5 months, roughly 10 weeks, from application to closing, even though most transactions used streamlined systems. FHA was slower to create automated underwriting systems, introducing them only after Freddie and Fannie both had systems in place.

Second, FHA is more vulnerable to exploitive behavior on the part of lenders. Fannie and Freddie have more flexibility for discouraging exploitation by lenders. F&F can also adjust guarantee fees to reflect its experience with a given lender, while FHA insurance premiums are one-size-fits-all. There have been episodes of lender exploitation of FHA (seller "gifts" of downpayments to borrowers, implicitly raising the loan-to-value ratios and default rates) that required legislation to fix

[1] Christopher Foote, Gerardi, Kristopher, and Willen, Paul, (2008, June) "Negative Equity and Foreclosure: Theory and Evidence", *Public Policy Discussion Papers,* Federal Reserve Bank of Boston.

that would have been promptly corrected by internal policy adjustments at Freddie and Fannie.

Third, Fannie and Freddie can innovate more nimbly than can FHA and Ginnie Mae. Both built automated underwriting systems (Desktop Underwriting and Loan Prospector) and only well after these were in place did FHA begin to work on such a tool. Even now, FHA lenders will often consult either DU or LP before approving even an FHA loan.

Among the 6300 non-subsidized loans analyzed in the FHA closing cost study, nearly a thousand had explicit fees charged to borrowers for use of either DU or LP, (charges varied from $10 to $150). Such tools unquestionably speed the loan approval process. It is unlikely that FHA would have built such a tool without the nudge from Fannie and Freddie having built such systems.

Pure Government ownership and operation for Fannie and Freddie is not a good idea. FHA and Ginnie Mae are both purely Government operations. The good features of their structures lie in their simplicity. They have strict constraints on what business they can and cannot do, and what loans they are allowed to insure and securitize. They are subject to maximum loan size limits that vary with property values in different areas, they can insure and securitize only the simplest loans (30-year fixed and simple ARMs), they can insure and securitize only new loans, no seasoned loans, and lenders from whom they will accept loans are subject to approval standards and to strict servicing guidelines. These limits have successfully constrained the risks that they take.

But FHA and Ginnie Mae perform better because they compete with Fannie and Freddie, and match at least some of their innovations. If all of the securitizing entities were Government bureaucracies, the performance would not be as good as we get from a mix of the two.

A lender co-operative?

Time was when F&F were organized as lender cooperatives. Fannie began as a Government agency in 1938, and was reorganized as a co-op, primarily of commercial banks, in 1958. It was reorganized again as a public company in 1968. Freddie was a co-op among the thrifts, run by the Federal Home Loan Bank Board, from its creation in 1970 until FIRREA in 1989. In 1989, the largest commercial bank in the United States had less than 1 percent of bank assets. While U.S. banking is still competitive today, it is considerably more concentrated now, and a handful of large banks now hold close to half of bank assets and do more than half of mortgage lending. The conflict between smaller banks and larger banks with respect to how the GSEs should be run would be greater now than it was in their former co-op days, and makes the lender co-op idea a worse structure for today than it was in the past. Any co-operative would be likely be dominated by the largest banks.

There are good reasons *not* to allow the largest banks to run the GSEs to the disadvantage smaller banks. Smaller banks deserve an important place in our banking system. There is accumulating evidence that smaller depositories treat their customers in a less exploitive way than do newer, larger, and less regulated financial institutions. In particular, they are less inclined to exploit financial confusion on the part of borrowers. See *Stango and Zinman, Buck and Pence,* who examine evidence from the Survey of Consumer Finances, and *Agarwal et al.* on the mortgage counseling experiment in Illinois, and the FHA Closing Cost report, *http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf*.

The spectacle Wells Fargo's recently exposed overdraft scam (re-arranging the timing of presentations to maximize overdraft charges), described by the judge as manipulative and hidden in a facade of phony disclosures, should make us all wary of rules that would operate to the advantage of large banks. It seems hard to imagine that a small institution, one in which the executives and programmers at the bank know depositors personally, and look them in the eye regularly, could have put in place such an exploitive scheme.

How many GSEs should we have?

One might think that with only two organizations securitizing mortgages, we would see tacit collusion and monopoly pricing such as we get when two gas stations sit on opposite corners.

The gas station paradigm is instructive. If one station lowers its price, its rival across the street sees that price change at least as soon as any customer. The rival can respond right away by lowering price also. The first mover sells no more gas than the rival, he just sells the gas for less. Thus, there is no incentive to lower price when the rival sees the change at least as soon as the customers do.

This paradigm does not fit F&F. Freddie and Fannie do not post their guarantee fees in the way that gas stations post prices. Each deal is negotiated, customized, and secret. The ultimate results are seen only in quarterly summaries of business activity. Thus, customers ***do*** know price before rivals do, and know many about the details about their own deals that are not known by rivals. Cutting price ***does*** generate more business. Two GSEs thus reach an outcome close to what we would expect from perfect competition.

On the other hand, the more operators we have in the secondary market, the harder it is to maintain the standardization and homogeneity of securities that give us more liquidity and lower mortgage rates. Two GSEs appear to give the maximum benefit of standardization and liquidity, but still give us competitive pricing.

In principle, the Federal Home Loan Bank system could have created a third securitizing GSE. It did not, despite some efforts in that direction. I imagine that the reason the FHLB system failed to create another securitizing GSE is that there are conflicts of interest among the members about how the entity should be structured, with larger institutions wanting more power than smaller ones. They have a collective action problem. They all would benefit from having their own securitization facility, but since some would benefit more than others, the plan is blocked by those who would get less. They cannot create a facility only for some members, and have been unable to negotiate their way to creating a facility appealing to all.

Ownership by private shareholders versus a borrower cooperative

The new charters for Freddie and Fannie should 1) establish higher capital requirements for Fannie and Freddie, and 2) have different capital requirements for different lines of business, in particular higher-default risk business, and 3) price the Government guarantee. It seems unlikely that we can alter asset markets to entirely avoid price bubbles (we seem to have had them from time to time as long as we have had asset markets, and they can be produced in experimental settings too), either in the stock market or the housing market, and once upon a time, in tulip bulbs. But if our financial institutions are less levered, the bursting of a price bubble is of less consequence. The dotcom recession of 2001 was driven primarily by the fall in asset values after the world realized that the internet was going to deliver far more value to consumers than to sellers. The 50 percent margin requirement (think of it as a capital requirement) plus the centralized clearing arrangements that monitor account values continuously and cashes out accounts that fall below required margin limited the fallout of the decline in asset values. The decline in stock values hardly touched the banking system. Housing was hardly involved in that recession, as single family construction chugged right along. This tells us much about how to limit a contraction in one sector from doing damage to other sectors.

Given the big decline in house prices beginning in 2007, it was inevitable that we would have a big decline in residential construction (the high prices resulted in over-building, and when soaring vacancy rates made the over-building apparent, prices fell). Residential construction is a sufficiently large fraction of real activity that its contraction by half would mean a recession, all by itself. Through the third quarter of 2008, more than all of the shortfall in GDP was attributable to the decline in residential construction. Did the credit crisis make things worse? Certainly, yes. On average, recessions that included banking panics have been worse than recessions without banking panics. The dotcom recession of 2001 involved no financial panic, mainly because the assets that fell in value (stocks) were held with at most 50 percent borrowed money, and even this money was subject to closely monitored margin rules. Higher capital requirements can make the popping of price bubbles less consequential.

So we need higher capital requirements in financial institutions, and especially to turn pseudo-insurance companies (AIG and other writers of credit default swaps) into bona fide insurance companies, so that they are subject to capital regulation. That's the easy part.

What about shareholder ownership, as prevailed until the crisis?

When then were taken over last summer, F&F were owned by private shareholders, both had stock traded on the New York Stock Exchange, both operated as profit maximizers subject to constraints in the form of capital requirements and restrictions on their business activities imposed by regulators, and some directors appointed by the president instead of by shareholders.

Two problems arose with this arrangement. First, there was no force to help F&F resist buying pieces of subprime mortgage securities and whole Alt-A loans. They could not securitize these mortgages directly, but they were not precluded from buying the higher-rated pieces. They did buy Alt-A loans for portfolio securitized them also. Their prime books are suffering in the current conditions, but the crippling losses have come not from their traditional business but from the subprime and Alt-A exposure.

Second, F&F both have outstanding research shops, and each had the resources to do more research for the benefit of borrowers, for example, by helping to develop clear and standardized disclosures. But their main contact was with lenders, and both thought of lenders as "their customers". Until very recently, F&F were reluctant to do any research on disclosure or comprehension of mortgage issues by borrowers, and this was part of a general reluctance to "get between" lenders and the lender's customers, the borrowers. Even Web site tools making loans easier to analyze brought forth lender complaints from lenders that "this was not their job". Lenders attitudes have changed since then, and the lenders are now eager for any help on assuring that borrowers understand the deal. It would be good to institutionalize these changes in attitude before the current crisis is forgotten.

As an example of work F&F did not do because the lenders were "their customers" is became apparent in an episode involving yield-spread premium analysis. When the first "yield-spread premium" disputes were being litigated, the data being examined in the case was made available to both plaintiff's and defendant's experts for independent research. One expert sought to cooperate with staff economists at one GSE, who eagerly began examining the data. Previously, the GSEs only had HUD–1 data on very-low-credit quality loans, and on small samples of standard loans. When the parent of the defendant, a big GSE customer, got wind of this activity, it was promptly halted.

Seven years later, this data plus another important set of data collected by FHA for its Closing Cost Report has told the same story about how mortgage brokers price discriminate and exploit borrower ignorance of financial matters more aggressively than do direct lenders, especially than small depositories and credit unions, who treat their borrowers with more benevolence. It is not a story that makes Americans feel proud of how financial institutions treat their citizens, with minorities, the less-well-educated, and older people charged more than others, other things equal. The GSEs could have been at the forefront of this research. The economic staff was capable and eager, but leadership blocked their efforts. In mid-July, 2009, the Board of Governors of the Federal Reserve voted to prohibit all practices that tied agent compensation to the interest rate on the loan, essentially banning yield-spread premiums.

So a serious issue is how to make sure, in the long run, not just while the crisis is in recent memory, that the GSEs have borrower interests, not lender and broker interests, close to their hearts. One possibility is a borrower-owned mutual. For example, the Hartford insurance company is a mutual insurance company, essentially owned by its insureds. However, insurance companies have another overlay of governance from the State regulation of insurance that assures they are adequately reserved. Credit Unions are another form of mutual organization, with depositors owning and controlling them. Credit Unions are among the most benevolent of our financial institutions. Not only do they set prices to merely cover costs, not to extract all the market will bear, but they reach out to borrowers to help them be better borrowers, weaning them from payday loans and excessive credit card debt. On the other hand, the credit unions' secondary market facilities, organizations that pooled loans from individual credit unions and took them to Fannie and Freddie for securitization, did not escape the lure of subprime. Like Freddie and Fannie, the credit unions did not make any subprime loans, but their secondary institutions did buy some subprime securities, and have losses as a result.

Making the MBS guarantee explicit and charging for it could impose discipline. If the guarantee is priced, there must be a regulator to price it. And with the pricing will come guidelines as to what is allowed in the pools. While Government organizations that price loan guarantees are not perfect, they do not seem as vulnerable to deliberate underpricing in order to "maintain a place in the market" as Fannie and Freddie were, especially with respect to their Alt-A loans. FHA's market share fell into the low single digits, as the rest of the market boomed and moved into subprime. In retrospect, FHA's policies look quite sound. Turns out there was some logic to all that paperwork.

The issue of organization and governance deserve more study. I do not know enough about where control of mutual insurance companies really resides, or even how credit unions are controlled, to offer a completely firm opinion on structure. It seems that a return to the structure where the GSEs are owned by outside shareholders but regard lenders are "their customers" is not a good idea. A change that puts borrower concerns ahead of lender concerns is in order. There are several ways to move in this direction, the issue is important and deserves more study.

The GSEs outside of single-family.

Multi-family construction is generally less sensitive to the level of interest rates than single-family because owners of rental units are either individuals with accumulated wealth or corporate entities, for whom cash constraints are not so binding as on households. What volatility is present in multi-family construction seems to come from spurts of activity generated by new tax credit programs. Credit conditions for multifamily fluctuate with the likelihood that intended condominiums will turn into rentals.

So far, Fannie Mae's multifamily book has not generated much by way of losses in this recession. Delinquency rates are up from historical levels, but by absolute standards, they are still quote low (0.36 percent in April 2009, vs. 0.09 1 year ago). Freddie Mac's multi-family book is even better, with delinquencies at 0.12 percent vs, 0.03 percent a year ago. But rental markets are softening, rents are down, vacancies are up, and collections down. Fannie's multi-family holdings are $174 bn, and Freddie's $91 bn.

Freddie and Fannie's multi-family underwriting is conservative. Fannie requires a 125 percent debt-service ratio, 20 percent downpayment minimum, and makes 10-year loans. More than 50 percent of the multi-family book is now held in portfolio, but recent new production is mainly being securitized. Multi-family loans are not bundled with single family, but securitized in separate MBS.

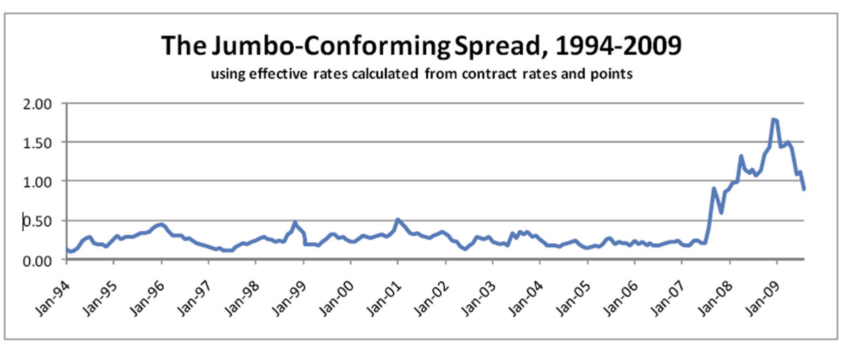
Fannie and Freddie provide about three-quarters of all multi-family lending, and the buildings they finance are occupied primarily by elderly and low-to-moderate income households.

In all GSE activity, as well as in all activity in depositories, there is at least a small amount of subsidy coming from Federal backing, either explicit or implicit. The case for a GSE role is thus more difficult to make for multi-family lending than for single-family. On the other hand, given the success of both in underwriting these loans, there seems little reason to inhibit this activity.

It is very difficult to make a case for the GSEs to have a role in commercial property lending. Underwriting in commercial property is more difficult than in either multifamily or single-family residential. In commercial property busts, the critical factor is nearly always slackening demand on the part of commercial renters, not the difficulty of obtaining credit. Given the heterogeneity of commercial properties, it does not appear that what the GSE's have to offer, other than credit with the Government's good name, would contribute very much.

How big a difference do Fannie and Freddie make?

Most of the time, rates on mortgages that were eligible for purchase or securitization by Freddie or Fannie have been cheaper than larger, ineligible loans ("jumbo" loans) by 25 to 40 basis points. When the credit crisis began, one of the early manifestations of it was a widening of the jumbo-conforming spread, out to 180 basis points (that's 1.8 percentage points) and higher. The gap still stands at about 100 basis points today (March, 2010).



The still-gaping jumbo-conforming spread calls for further comment on our present situation. All of the discussion here has been about the role of Freddie and Fannie in normal times, and what they can contribute when markets are otherwise performing smoothly. Though there are signs of return to normalcy—house prices rose in May and June as reflected in both the FHFA house price indices and the Case-Shiller house price indices—the situation is still far from normal.

In 2008, FHA insured nearly 30 percent of new mortgage originations, up from only 3 percent in 2006. In the first quarter of 2009, Ginnie Mae did 26 percent of mortgage securitizations (FHA plus VA), Fannie and Freddie did the other 74 percent, and there were no new private-label securitizations. The FHFA Mortgage Interest Rate Survey has ceased reporting rates on adjustable-rate loans because there are not enough of these for statistical reliability. Corporate and municipal spreads are narrowing, but still wide. Lending standards of all kinds are more strict now than for many years.

During the financial crisis, our Government-created mortgage institutions have made the difference between a bad recession and something much, much worse, especially with respect to housing. Essentially, credit has continued to flow, but almost entirely through FHA and Ginnie, Freddie, and Fannie. In 2008, mortgage originations totaled about $1.5 trillion, of which 89 percent were either FHA and VA or conventional, conforming, prime loans. The other 11 percent were mainly jumbo prime, with a sliver of subprime and Alt-A loans. Nearly all of these new originations were securitized. Loan securitizations were 74 percent Freddie and Fannie, and 26 percent FHA/VA. There were no private-label securitizations (data from *Inside Mortgage Finance*).

While most of this discussion was about the operation of the GSEs in more normal economic environments, the role of the GSEs in the crisis deserves attention also. Their presence makes a bigger difference, not a smaller one, in times of great confusion and uncertainty in financial markets. One way of thinking about the wide credit spreads we see today is that rates are not necessarily so high for the usual borrowers, but that rates for the Government are unusually low. It is a great irony of the crisis that although it was caused by United States policies (with contributions from the United Kingdom and a few others), it provoked a great increase in the world's desire to hold U.S. Treasury bonds.

Evidently the world has more confidence in the ability of the U.S. Government to collect the eventual taxes to refund its own bonds than it has in the ability of individuals and businesses to repay their debts. There is an element of irrationality in such beliefs, because the very borrowers who are deemed less credit-worthy as individuals or businesses are the same as those who will pay the taxes to refund the bonds. It makes sense for the Government to use its superior standing in the credit market to make credit flow to non-Government entities. There are no structures more successful for doing this than the housing credit institutions we created in the twentieth century. Mere depositories would have done much less. Such a role was not contemplated for them (with the exception of FHA, which was created in a crisis specifically to make credit flow).

Nonetheless, they have served and made the crisis less painful than it otherwise would have been. Thus, in deciding what to do about them as we go forward, we should acknowledge another advantage to their existence.

RESPONSE TO WRITTEN QUESTION OF SENATOR SHELBY FROM JANIS BOWDLER

Q.1. In your testimony you state that pre-purchase counseling has been shown to reduce the likelihood that a borrower will default. You advocate increased funding from both the public and private sectors to make financial counseling more available to borrowers before they buy a home.

- Given the benefits that you have found to borrowers from this counseling, do you support mandatory counseling for borrowers using Federal Government programs, like FHA, prior to them receiving a mortgage?

A.1. Pre-purchase housing counseling from independent, objective third-parties delivered in a timely manner and in a one-on-one setting is highly effective. The model is based on the commonsense notion that information is most effectively absorbed during a "teachable moment." That is, the critical knowledge a family needs to navigate the mortgage market is delivered at a point in time when 1) they are most receptive to the information (because it is relevant to a near-term decision) and 2) they have enough time to act on the information. It is critical to distinguish between this kind of high-impact housing counseling and less effective models, such as a generic classes or online courses delivered moments before signing mortgage papers. This kind of "check the box" model does not empower consumers or inform their decisionmaking.

Housing counseling agencies approved by the Department of Housing and Urban Development (HUD) are well-positioned to offer timely advice to home seekers and to first-time homebuyers. However, cuts to the HUD budget have endangered the infrastructure of nonprofit housing counseling programs. HUD funding is the backbone of the housing counseling program on which nonprofits leverage other private funding. For example, as a designated HUD Housing Counseling Intermediary, NCLR matches HUD funds with private, philanthropic, and local dollars 10 to one. Ideally, a well-rounded mix of funding streams would support a robust and independent network of private nonprofit housing counseling organizations. While many banks support housing counseling providers with grant funds, they have not put in place a fee-for-service model. Such a model would ensure counselors are compensated for delivering a mortgage-ready borrower that is less likely to default. Many housing counseling organizations also support having their clients pay a modest fee for receiving counseling. Most fees are determined on a sliding scale based on income and cover the cost of a credit report and materials. The housing counseling industry is at a critical juncture. We urge Congress to continue their long-standing support for a proven Federal program, and we urge the banking industry to make a more formal commitment to ensuring their clients have access to independent housing counseling services.

Each year hundreds of thousands of first-time homebuyers enter the market. While all first-time homebuyers can benefit from a timely session with a certified housing counselor, HUD-approved housing counseling agencies could not meet this demand on the current resources and financial infrastructure. We would support mandatory counseling for some mortgage programs so long as they were paid for by the industry members that stand to benefit and were supported by Federal funds. For example, we would support mandatory housing counseling for first-time homebuyers using Federal Housing Administration (FHA) mortgage insurance if FHA paid nonprofit counseling groups for producing a borrower less likely to default.[1] Given FHA's high default rates attributed to seller-financed downpayment scams, counseling would have been a prudent investment for borrowers and FHA. To be clear, we recommend that FHA fees be administered separate from grant funding provided through the HUD Housing Counseling Program. FHA, Fannie Mae, and Freddie Mac should also consider incentives for borrowers to seek out counseling, such as discounts on interest rates, fees, and private mortgage insurance. NCLR made a similar recommendation to Federal regulators on the risk retention rule.

In summary, NCLR supports mandatory counseling with adequate private and public resources to meet the demand. A mandate without an infrastructure sufficient to meet demand would create a vacuum that would quickly be filled by sham operations looking to take advantage of borrowers required to receive a service. The onslaught of foreclosure rescue scams should serve as a cautionary tale in this regard. However, NCLR is committed to working with Congress, HUD, and our partners in the mortgage industry to establish funding streams that support a robust, nonprofit pre-purchase housing counseling infrastructure. Finally, we underscore that to be effective, counseling must be delivered early in the home-shopping process (at minimum prior to signing a contract). With this as the foundation—timely, objective housing counseling readily available and supported by a robust mix of income streams—NCLR would support a combination of mandatory counseling and incentives for obtaining counseling for first-time homebuyers.

RESPONSE TO WRITTEN QUESTION OF SENATOR SHELBY FROM ANTHONY B. SANDERS

Q.1. The theory that the 30-year fixed-rate mortgage is always the best product for American consumers presupposes that Americans move into a home and live there for 30 years with one mortgage. In reality, Americans move often, and they refinance often. Other

[1] Congress has invested millions of public dollars into creating a solid housing counseling infrastructure. Families that participate in pre-purchase counseling sessions are less likely to default on their mortgage, preventing foreclosures and future claims. However, since the removal of the housing counseling requirement, fewer borrowers seek out or are informed of this free service. For more information: Janis Bowdler, *The Role of Federal Housing Administration Mortgage Insurance in Revitalizing Latino Homeownership,* presented to 111th Cong, 1st. sess., 2009, *http://www.nclr.org/index.php/publications/the_role_of_fha_mortgage_insurance_in_revitalizing_latino_homeownership/* (accessed January 2012).

types of mortgage products offer lower interest rates and the ability to build wealth in a home more quickly. Even the adjustable rate products can be fixed for periods of time greater than the average time that Americans typically keep their mortgage.

- Given these facts of American life, would many consumers be worse off if they purchase a 30-year fixed-rate mortgage?

A.1. Did not respond by publication deadline.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM PAUL S. WILLEN

Q.1. In a recent speech, Eric Rosengran, President of the Boston Fed, noted that "the U.S. gets less effect from the movement of short-term, monetary policy interest rates compared to countries where the primary mortgage financing instruments are floating-rate loans." This suggests that the 30-year fixed has contributed to our weak economy because it has reduced the effectiveness of Fed monetary policy.

- Could you provide us with some additional thoughts as to how the effectiveness of U.S. monetary policy might be enhanced if the United States were less reliant on the 30-year fixed-rate mortgage?

A.1. Did not respond by publication deadline.

Q.2. The theory that the 30-year fixed-rate mortgage is always the best product for American consumers presupposes that Americans move into a home and live there for 30 years with one mortgage. In reality, Americans move often, and they refinance often. Other types of mortgage products offer lower interest rates and the ability to build wealth in a home more quickly. Even the adjustable rate products can be fixed for periods of time greater than the average time that Americans typically keep their mortgage.

- Given these facts of American life, would many consumers be worse off if they purchase a 30-year fixed-rate mortgage?

A.2. Did not respond by publication deadline.

RESPONSE TO WRITTEN QUESTION OF SENATOR SHELBY FROM SUSAN E. WOODWARD

Q.1. In your testimony you state that "the 30-year fixed-rate loan potentially has some cost to taxpayers, but since taxpayers are virtually all homeowners too, there is nothing unfair about this situation." Unfortunately, missing from your analysis is the fact that when a mortgage is not repaid, the guarantee is not paid by homeowners to homeowners, but rather by taxpayers to the Wall Street banks and investors that hold the mortgage.

Do you believe that such taxpayer bailouts of Wall Street investors are "fair" to U.S. taxpayers?

A.1. Any holder of a mortgage security, whether it is a bank or an individual investor, is just an intermediary. The only risk borne by these intermediaries who buy Government-backed mortgage securities is prepayment risk, and the returns they earn over the long haul are commensurate with the prepayment risk. All homeowners get the benefit of Government support to the mortgage market in the form of superior alternatives for home borrowing. The benefit is present at all times. The taxpayers bear the default risk, and pay taxes to cover it in increasing proportion to their incomes. I believe that nearly all taxpayers and homeowners regard this as a socially beneficial arrangement.