Statement

of

Basil N. Petrou

Managing Partner

Federal Financial Analytics, Inc.

For

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"A Legislative Proposal to Protect American Taxpayers and Homeowners by Creating a Sustainable Housing Finance System"

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It is an honor to submit this statement for the Financial Services Committee as it considers the discussion draft of the Protecting American Taxpayers and Homeowners (PATH) Act as released by Chairman Hensarling, Rep. Capito, Rep. Garrett and Rep. Neugebauer. I am Basil N. Petrou, managing partner of Federal Financial Analytics, a firm with a longstanding practice advising financial institutions on the business-strategy implications of federal policy. We do not lobby or represent clients and the views I herein provide are mine. They reflect testimony I was honored to provide this Committee on February 6th on Establishing the Proper Role for the Federal Housing Administration (FHA) in the U.S. Mortgage-Finance System, and I am very pleased to see that the discussion draft includes several of my recommendations to better target the FHA program to moderate income borrowers while at the same time reducing its risk to U.S. taxpayers. I am also strongly supportive of the legislation's effort to promote a full-scale return of private capital to mortgage securitization.

However, as I shall discuss below, I fear that the proposed approach to FHA will, in combination with that proposed for the government-sponsored enterprises (GSEs), pose a serious risk of a wholly unintended consequence: creation of a government monopoly for wide swaths of the residential mortgage market. Thus, I shall here outline what I believe would be a balanced approach to both FHA and GSE reform without the risk of this unintended consequence. In summary:

- The proposed approach to FHA reform has many strong features that will protect the taxpayer and promote FHA's mission. However, these reforms address only federal insurance at the loan level and, for as long as Ginnie Mae securities bear a 100% full-faith-and-credit guarantee, Ginnie Mae-guaranteed MBS comprised of FHA loans will drive out other potential providers of private capital for FHA-eligible mortgages unless the combined FHA premium and Ginnie Mae guarantee fee is significantly higher than that offered by the totally private market. Alternatively, the Committee could choose to provide the same Ginnie Mae guarantee to private credit enhancers of FHA-eligible mortgages or provide an alternative explicit federal guarantee that backstops targeted mortgages securitized through the new securitization platform created in the legislation.

- The proposed reforms to mortgage-securitization practice, in concert with the liquidation of Fannie Mae and Freddie Mac, are designed to create an alternative path to the secondary market. However, the new private structures are complex, untested and likely to prove impractical not just for community banks, but indeed for any regulated U.S. bank and bank holding company. Thus, to the extent the proposed approach succeeds, it may well advantage only “shadow” institutions, posing unintended, but severe, systemic risk.

FHA Reform

As noted, I strongly support many aspects of the proposed approach to FHA, which I believe will simultaneously better target the program to under-served market segments and reverse FHA’s financial deterioration and taxpayer risk. These sections of the bill would:

- income target the program for all but first-time homebuyers, promoting delivery of a full-faith-and-credit guarantee from the U. S. Government (USG) only to Americans who need continued access to a low downpayment mortgage which historically has been provided through a thirty-year, fixed-rate mortgage (FRM) without a prepayment penalty that may remain difficult to obtain without a USG backstop;

- reduction in the amount of the FHA guarantee to 50%, which will align lender and USG interests at the loan level (although not at the mortgage-backed security or MBS level as I shall discuss below);

- reduction in the base limit for FHA loans better to track actual U.S. house prices (although the high-cost limit remains so high as to promote USG dominance in key markets); and

- the goal of risk-sharing with the private sector, including with private mortgage insurance (MI). Again, however, I am concerned that the limited risk share between FHA and private credit enhancers as proposed will not address the expansion of the FHA’s role that results from the interaction between FHA and GSE reform proposals.

- I also believe the restructuring of FHA into a government corporation is an approach with the potential for better delivery of service to defined market segments. However, I strongly urge Congress to track the approach taken in other government corporations (e.g., the Overseas Private Investment Corporation) to stipulate clearly and strongly that the new corporation must price its services and structure its products at all times only to support borrowers not adequately served by private capital, with this determination made through the use of robust and transparent analytics.

GSE Reform

As noted, the measure's reforms at the FHA loan level do not solve for the problem of returning private capital throughout U.S. housing finance because FHA-backed loans are still packaged into MBS backed by Ginnie Mae and, thus, afforded a 100% full-faith-and-credit USG guarantee structured and priced in a manner that drives out potential alternative MBS backed by private capital. One need look only at the execution advantages now enjoyed by Ginnie Mae versus the GSEs – backed now by an "effective" USG guarantee – to see the gulf that will quickly occur if the bill does not address risk-sharing and other reforms throughout the mortgage-securitization structure, going beyond the loan level addressed in the FHA-related provisions.

The measure would liquidate Fannie Mae and Freddie Mac and replace them with a new system (including covered bonds) in which newly structured, better-regulated MBS would meet market needs. These are worthy goals, but I fear they cannot be accomplished as proposed.

In summary, my caution derives from the following concerns:

- The proposed replacement mechanism for private mortgage securitization (a "securities-based approach") is premised on complex MBS structures that have been tried only once with success in the market, when they structured subprime MBS with catastrophic systemic consequences. The measure seeks to solve for this with new regulation, but I do not believe regulation can conquer perverse incentives sure to be resurrected in highly-engineered financial products that, given the size of the U.S. mortgage market, will pose serious risk even if confined to a fraction of the market. I believe that the hard lesson of the financial crisis is that simple is safe and complex can prove cataclysmic because regulators are always at least one step behind the market. A simple guarantee by a regulated, capitalized private entity across the entire scope of an MBS is a transparent, safe, sound and proven approach to mortgage securitization.

- Under the new Basel III rules, banks will need to hold penalty levels of regulatory capital (more than dollar-for-dollar) if they hold the riskiest tranches of MBS. Regulators have decided that complex securitizations are simply too risky for regulated banks for the reasons noted above, especially if markets demand that banks hold the highest-risk tranches in hopes that this cures incentive-alignment risk. Under the new rules, tranched securitization is effectively barred for banks large and small. The bill's two-year delay of the rules might create a window in which this is not true, but all of the risks in complex, structured securitizations still remain and, perhaps, are magnified if there is a rush to a high-risk market during any such opening.

I note that the measure may hope to compensate for these problems by authorizing covered bonds. This structure has promise. However, even in nations with mortgage systems akin in some ways to the U.S. – e.g., Canada – they are small portions of the total mortgage market. Under appropriate prudential regulation, covered bonds are highly difficult prudently to offer because of the capital cost of the remaining asset and significant potential interest rate risk. The need for “substitute” assets in a covered bond also poses serious challenges to banks seeking – as they should – to bolster liquidity through larger holdings of high-quality assets.

Conclusion

While I am deeply concerned that the proposed approach to GSE reform has unintended risks, I strongly support the goals of the legislation:

- A stronger, better targeted FHA;
- A revitalized private secondary mortgage market; and
- Transformation of Fannie Mae and Freddie Mac.

I would be pleased to provide the Committee with answer to any questions you may have on the points made in this statement and to provide detailed recommendations on specific ways better to achieve these objectives. I hope that strong FHA and GSE reform can quickly become law, as continuation of the conservatorships and uncertainties in the current structure stalls long-overdue economic recovery.