National Association of Home Builders

A COMPREHENSIVE FRAMEWORK FOR HOUSING FINANCE SYSTEM REFORM

February 9, 2012

NAHB

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Executive Summary

The nation's housing market continues to suffer five years after the severe upheaval in world financial markets, retarding economic and job market recovery in the U.S. While some limited steps have been taken to address weaknesses in the framework for mortgage and broader financial transactions, no meaningful progress has occurred in implementing comprehensive reforms to the housing finance system to ensure that housing credit is available and affordable in the future and is delivered though a competitive, efficient, sound, safe and stable system. A healthy housing market is a cornerstone of a durable and strong U.S. economy and a vibrant and reliable housing finance system is essential to fulfilling the mandate of the Housing Act of 1949, which pledged a "decent home and suitable living environment for every American family."

On February 9, 2012, the Board of Directors of the National Association of Home Builders (NAHB) adopted policy outlining a comprehensive framework for housing finance system reform. NAHB believes the U.S. housing finance system should be multifaceted with both competing and complementary components, including private, federal and state sources of capital liquidity. The following are summaries of specific policy positions covering funding for both single family and multifamily housing, which are detailed more fully in the body of the white paper.

Transition Fannie Mae and Freddie Mac, in an orderly fashion over time, to a new securitization system for conventional mortgages backed by private capital and a privately funded federal mortgage-backed securities insurance fund.

NAHB believes that it is essential to have an efficient and stable secondary market where conventional single family and multifamily mortgages are aggregated and placed into diversified pools for securitization and sale to investors all over the globe. Portfolio lenders do not have the capacity, business model or dedication to adequately service the nation's demand for housing credit by keeping all loans in their portfolios. To achieve this, Fannie Mae and Freddie Mac should be gradually phased into a private-sector-oriented system, where the federal government's backing is explicit but its exposure is limited.

A significant portion of the conventional market will require a federal backstop to provide investors assurance that their principal and interest will be delivered as promised. Federal support to the conventional mortgage market of the future, however, should be limited to catastrophic situations where carefully calibrated levels of private capital and insurance reserves are depleted before any taxpayer funds are employed to shore up the mortgage market. This would be done by creating a privately funded insurance pool for conventional mortgage-backed securities (MBS) that would be similar to the insurance fund that secures savings deposits through the Federal Deposit Insurance Corporation (FDIC.)

Under this approach, private Housing Finance Entities (HFEs) would be chartered to purchase mortgages from loan originators and to package the loans into securities. The originators and HFEs would be required to maintain capital to cover a portion of the credit risk on the pooled mortgages, with private mortgage insurance required on higher loan-to-value mortgages. The originators also would pay premiums into an insurance fund that would provide additional protection to MBS investors. The federal government, which would stand behind the insurance fund, would ensure the fund was actuarially sound. This would provide securities investors a guarantee similar to that currently provided by the Government National Mortgage Association (Ginnie Mae).

HFEs could take on a range of forms. One possibility is to utilize the regional network provided by the twelve Federal Home Loan Banks (FHLBanks), which currently operate by making collateralized loans to, and mortgage purchases from, member financial institutions, funded by debt offerings. A parallel but completely separate framework could be created within the FHLBank System to purchase and securitize mortgages; mortgage banking companies would become special FHLBank members thereby providing a capital market outlet to these companies in addition to the commercial banks, thrift institutions, credit unions and insurance companies that currently use the FHLBank System.

The FHLBank System offers advantages of an already established regional network of housing finance cooperatives where each FHLBank could oversee the quality of loans purchased and ensure that participating institutions are adequately capitalized and have sufficient underwriting capacity and experience. Most FHLBanks have already developed this capacity through their existing mortgage purchase programs, where acquired loans are held in portfolio. This system would operate under the oversight of a federal regulatory agency to ensure that housing funds are reaching all markets and that all participants are operating in a safe and sound manner.

HFEs also could be created out of the infrastructure left behind by Fannie Mae and Freddie Mac, while the current holdings of these enterprises are transferred to a limited life facility.

The HFE conventional mortgage securitization system should operate under the oversight of a strong independent regulatory agency to ensure all aspects of safety and soundness. The agency also would oversee the federal conventional MBS insurance fund. The regulatory agency should be governed by a board similar to the body governing the FDIC with extensive expertise in the housing capital markets and housing finance needs.

Any changes to the housing finance system should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers, owners, and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is wound down and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

Restart a carefully regulated fully private mortgage-backed securities system.

HFEs would operate alongside a fully private MBS system. A key prerequisite to restarting the private-label MBS market is to ensure all participants operate under adequate regulation and have a continuing stake in the performance of the mortgages that are originated and sold.

Reform operations and oversight of securities ratings firms by establishing an investor-oriented rating agency.

In addition, the operations and oversight of securities ratings firms must be reformed. One solution is the establishment of an Investor-Oriented Rating Agency (IORA) in which six to eight of the largest fixed income investors would come together to develop criteria for private MBS and then agree to purchase MBS that meet the established criteria. Moving the development of securities rating methodology from the issuer to the investor side of the market would remove conflicts of interest that stemmed from internal compensation incentives that encouraged revenue generation over accuracy and transparency of ratings, and ratings shopping by securities issuers that had ratings agencies competing to lower rating criteria. The founding fixed income investment companies would not be involved in the rating decisions of IORA in order to avoid conflicts of interest. Over time, the IORA ratings would gain market credibility and other investors would begin to rely on the ratings and purchase the private MBS rated by the IORA.

Continue the roles of the federal government housing agencies.

The housing finance support roles of the Department of Housing and Urban Development (HUD), Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture (USDA) and Ginnie Mae should be preserved. Efforts should continue to make the operations of these agencies more efficient and effective.

Enhance the roles of state and regional sources of housing funding.

State and local housing finance agencies utilize tax-exempt and taxable bonds as well as state and federal resources to offer a range of single family and multifamily funding programs. These agencies are uniquely positioned to assess community housing needs and should play an even more prominent housing finance role, including through new programs involving partnering with federal and private providers of housing capital.

The Federal Home Loan Banks serve twelve regions of the country, working with member institutions in their districts to provide housing loans and grants. Existing programs, such as the FHLBanks' mortgage purchase programs should be enhanced by allowing the FHLBanks to move beyond portfolio purchases to securitization and the FHLBanks should develop additional programs to leverage their strong understanding of regional housing conditions and needs.

Correct the operational and structural problems that produced the housing boom/bust.

It is extremely important to continue and complete steps to close the gaps in standards and oversight that allowed and facilitated the improper and illegal activities in financial and mortgage markets. A new framework must be established to prevent excessive risk taking and to ensure the safe and sound operation of the entire housing finance system so the recent debacle is never repeated. This should be done by:

- Reforming the appraisal system
- Prohibiting unsound mortgage products
- Ensuring the use of prudent mortgage underwriting guidelines
- Requiring sound mortgage securities structures and full transparency for investors
- Reforming mortgage servicing and modification/foreclosure procedures
- Imposing adequate oversight on previously unregulated segments of the mortgage and financial markets
- Ensuring that reforms are undertaken in a balanced and flexible manner so creditworthy borrowers are not disadvantaged

Overview: Importance to Americans of Housing Opportunity and a Vibrant Housing Finance System

The Housing Act of 1949 pledged a "decent home and a suitable living environment for every American family." NAHB believes this goal should be emphasized in U.S. housing policy and urges Congress and the Administration to reestablish housing as a major policy priority.

Past abuses, by nearly all participants in the financial industry, combined to have a tragic impact on the well-being of our country. The early stages of the economic downturn became evident in the housing finance arena due in large part to the origination of excessively risky mortgage products and an overly zealous securitization market. The resulting meltdown of the mortgage finance industry led, ultimately, to the crises in the financial markets as a whole. Consequently, today's mortgage finance system is in a state of uncertainty. There is no clear path for reform nor is there agreement on the components of reform. However, many agree reform is critical to the economic recovery of this nation. Legislation and regulation to address the past abuses should be designed to ensure transparency as well as safety and soundness in the housing finance system, but not be so restrictive as to prevent a return of home buyers, lenders, and investors to the marketplace.

America's future housing finance system must be designed to ensure that creditworthy borrowers have access to prudently developed and underwritten housing finance options and therefore are provided the opportunities bestowed in the Housing Act of 1949. Directly resulting from the recent negligence and mismanagement in the financial industry, millions in the U.S. are suffering from the loss of employment and are thereby increasing the burden on the national government to extend unemployment benefits and other backstops to citizens we can and should put back to work. No other industry in the country depends more on the U.S. labor force to manufacture its product than the housing industry. Homes are not manufactured overseas and shipped to the U.S to sell – we build and sell them right here in the U.S.A.

NAHB supports policies designed to ensure that the United States is the best- and most-housed nation in the world. The American dream of homeownership, as well as the availability of decent, safe and affordable rental housing, should continue to be supported by federal policy within reasonable, safe, and sound parameters.

NAHB believes that the U.S. housing finance system should be multifaceted with both competing and complementary components, including private, federal and state sources of capital liquidity. The system should support a reasonable menu of sound mortgage products for both single family and multifamily housing, governed by prudent underwriting standards and adequate oversight and regulation. This white paper contains recommendations covering:

- establishing a new secondary market system for conventional mortgages with a federal government backstop for catastrophic circumstances
- restarting a fully private mortgage-backed securities market
- reforming securities ratings procedures
- continuing the role of federal government housing agencies
- enhancing the activities of state and regional sources of housing funding
- correcting operational and structural flaws in the housing and financial markets

A New Securitization System for Conventional Mortgages

The housing finance system currently is under a cloud of uncertainty. The federal government, through the Federal Housing Administration (FHA), Fannie Mae and Freddie Mac, is currently accounting for nearly all mortgage credit flowing to home buyers and rental properties. Fannie Mae and Freddie Mac continue to operate under conservatorship with a lifeline to Treasury, an arrangement that greatly limits their ability to respond to market developments and needs. Even with the current heavy dose of federal support, fewer mortgage products are available and these loans are being underwritten on much more stringent terms. There is no clear picture of the future shape of the conventional mortgage market.

The uncertainty of today's temporary housing finance system is not desirable and cannot continue indefinitely. Policy discussions are underway on what should become of Fannie Mae and Freddie Mac following the current, still-indefinite conservatorship period. A key consideration is how to get from the current structure to a future arrangement without undermining ongoing financial stabilization efforts and disrupting the operation of the housing finance system.

Mortgage-backed securities are an essential component of the housing finance system and a stable and reliable conventional secondary mortgage market requires a federal government backstop.

A reliable and adequate flow of affordable funds is necessary in order to achieve the nation's housing and economic goals. Establishing a finance system that provides liquidity for the housing sector in all markets throughout the economic cycle is a prerequisite to achieving housing policy objectives. NAHB believes that a high priority should be assigned to creating an efficient, vibrant and stable secondary market for conventional mortgages. Securitization is key to meeting the housing finance needs of a healthy and growing economy. Banks and thrifts should continue to play a mortgage finance role through portfolio lending, but these institutions do not have the capital capacity, business model or dedication to adequately service the nation's mortgage credit requirements by holding all of their loans on their books. It is important to have a highly reliable method of attracting funds to the U.S. mortgage market from investors throughout the world.

NAHB has concluded that an effective system for securitizing conventional mortgages requires a federal government backstop. Investors, particularly those beyond our borders, require such a promise to secure the obligations they purchase. This fact is amply demonstrated by the need for federal government support to maintain the flow of mortgage money during the current housing recession. While NAHB agrees that private capital must be the dominant source of mortgage credit, the future housing finance system cannot be left entirely to the private sector. The historical track record clearly shows that the private sector is not capable of providing a consistent and adequate supply of housing credit without a government backstop.

A federal backstop is needed to ensure that 30-year fixed-rate mortgages are available at reasonable interest rates and terms.

NAHB believes federal support is particularly important in continuing the availability of the 30-year, fully amortizing, fixed-rate mortgage (FRM), which has been a staple of the U.S. housing finance system since the 1930s. Borne out of the Great Depression, the 30-year FRM has played a pivotal role in helping to increase the national homeownership rate so that today two out of three Americans own a home of their own.

The 30-year FRM has become an industry standard for several reasons:

- **Affordability.** These loans are geared toward affordability; 30-year terms lock in low monthly payments, allowing households with average incomes to comfortably budget for their home loan.

- **Inflation protection.** Knowing their monthly housing costs will remain the same year in and year out regardless of whether interest rates rise provides households with a sense of financial security and also acts as a hedge against inflation.

- **Long-term planning.** Many young buyers know that as their incomes rise, their housing costs will stay constant and become less of a burden, enabling them to prepare for other long-term obligations, such as college tuitions and retirement savings.

- **Tax advantages.** In most instances, all of the interest and property taxes borrowers pay in a given year can be fully deducted from their gross income to reduce taxable income. These deductions can result in thousands of dollars of tax savings, especially in the early years of a 30-year mortgage when interest makes up most of the payment.

The key to the sustainability of the 30-year FRM is a securitization outlet because originators (banks and thrifts) do not have the capacity to hold such long-term assets which are funded with short-term deposits. Fannie Mae and Freddie Mac provided the securities vehicle along with an implicit government guarantee for investors. It is not clear whether a private housing finance system would be capable of supporting this type of product without some government backing. At a minimum, the cost of 30-year FRMs would increase under a private system and mortgage underwriting requirements would likely be far more stringent.

As the private market transitions to assume a greater role, a strong federal backstop is necessary to maintain a stable and adequate supply of credit for home buyers and to ensure that the 30-year FRM remains readily available to first-time home buyers and working American families. Otherwise private financial institutions will turn the 30-year mortgage into a luxury product, with high interest rates, fees and downpayments that would price millions of middle-class households out of the market.

NAHB supports the transition of Fannie Mae and Freddie Mac, in an orderly fashion over time, to a new securitization system for conventional mortgages backed by private capital and a privately funded federal mortgage-backed securities insurance fund.

While a significant portion of the conventional market will require a federal backstop to provide investors assurance that their principal and interest will be delivered as promised, federal support to the conventional mortgage market of the future should be limited to catastrophic situations where carefully calibrated levels of private capital and reserves are depleted before any taxpayer funds are employed to shore up the mortgage market.

This would be done by creating a privately funded insurance pool for conventional mortgage-backed securities (MBS) that would be similar to the insurance fund that secures savings deposits through the Federal Deposit Insurance Corporation (FDIC.) The FDIC fund is capitalized by the financial institutions benefitting from the deposit insurance but the federal government is committed to ensuring that the fund is solvent regardless of economic conditions.

Housing finance entities should assume the function of securitizing single family and multifamily conventional mortgages.

Under this approach, private Housing Finance Entities (HFEs) would be chartered to purchase conventional mortgages from loan originators and to package the loans into securities. The originators and HFEs would be required to maintain capital to cover a portion of the credit risk on the pooled mortgages, with private mortgage insurance required on higher loan-to-value mortgages.

The originators would also pay premiums into an insurance fund that would provide additional protection to MBS investors. The federal government, which would stand behind the insurance fund, would ensure that the fund was actuarially sound. This would provide securities investors a guarantee similar to that currently provided by Government National Mortgage Association (Ginnie Mae). The federal government would only expend funds to continue payments to MBS investors in a catastrophic event where the insurance fund is depleted. The intent is for the government to be in a limited secondary position to reduce the risk to tax payers.

Federal Home Loan Banks could be HFEs.

HFEs could take on a range of forms. One possibility is to utilize the regional network provided by the twelve Federal Home Loan Banks (FHLBanks), which currently operate by making collateralized loans to, and mortgage purchases from, member financial institutions, funded by debt offerings. Each FHLBank is a cooperative enterprise, which is owned by the commercial banks, thrift institutions, credit unions and insurance companies that utilize the FHLBank as a source of funds.

Member institutions purchase FHLBank stock to secure membership rights and are required to increase stock holdings in proportion to their borrowing. This arrangement ensures that a FHLBank’s capital reserves expand and contract in relation to its lending activity. The principal business of the FHLBanks is extending to members loans, called advances, which are collateralized by mortgages and other eligible assets in the portfolios of borrowing institutions. Most FHLBanks also have operated or participated in mortgage purchase programs, where the FHLBanks buy mortgages from member institutions to hold in portfolio. FHLBank advances and mortgage purchase activities are funded by debt offerings for which all twelve FHLBanks are responsible on a joint and several basis and which are managed by an Office of Finance.

A parallel but separate framework could be created within the FHLBank System to purchase and securitize mortgages; mortgage banking companies would become special FHLBank members thereby providing a capital market outlet to these companies in addition to the commercial banks, thrift institutions, credit unions and insurance companies that currently use the FHLBank System.

The FHLBank System offers advantages of an already established regional network of housing finance cooperatives where each FHLBank could oversee the quality of loans purchased and ensure that participating institutions are adequately capitalized and have sufficient underwriting capacity and experience. Most FHLBanks have already developed this capacity through their existing mortgage purchase programs. This securitization system could be managed through a new Office of Securitization and operate under the oversight of a federal regulatory agency to ensure that housing funds are reaching all markets and that all participants are operating in a safe and sound manner.

HFEs also could be created out of the infrastructure left behind by Fannie Mae and Freddie Mac, while the current holdings of these enterprises are transferred to a limited life facility.

<u>HFEs should deal only with well understood and well-tested mortgage products.</u>

HFEs would deal in mortgages with well understood and reasonable risk characteristics. Single family operations would include standard 30-year FRMs and adjustable rate mortgages (ARMs). Fannie Mae's and Freddie Mac's multifamily platform, including mortgage loan products and underwriting standards, should be retained and transferred to the new HFE framework. Both organizations have a track record of discipline in underwriting multifamily housing loans of all types and sizes, with their loans performing significantly better than loans originated for sale through private mortgage-backed securities. This successful approach to risk management should not be lost in the transition.

<u>Strong regulatory oversight is required.</u>

The HFE conventional mortgage securitization system should operate under the oversight of a strong independent regulatory agency to ensure all aspects of safety and soundness. This agency would also oversee the federal conventional MBS insurance fund. The regulatory agency should be governed by a board with a structure modeled on that of the FDIC, where members would be required to have extensive experience in and/or knowledge of housing capital market transactions and issues and housing finance needs.

<u>The transition to the new conventional mortgage market should be carefully planned and executed.</u>

The housing sector is struggling to regain its footing and begin contributing to a recovery in economic output and jobs. The current environment is rife with instability and uncertainty. Many markets throughout the country, however, have returned to a position where consumers are shopping for new homes and housing production can begin to move back to more normal levels.

It is critical that the housing finance system facilitate this emerging recovery rather than stifle it. Under these circumstances, finding a means of moving to a new secondary market framework may be as great, or greater, a challenge as developing the new conforming conventional secondary market structure. Congress should carefully consider and address the short-term, unintended consequences that could occur during the transition to a new housing finance system.

Any changes should be undertaken with extreme care and with sufficient time to ensure that U.S. home buyers, owners and renters are not placed in harm's way and that the mortgage funding and delivery system operates efficiently and effectively as the old system is abandoned and a new system is put in place. Every effort should be made to reassure borrowers and markets that credit will continue to flow to creditworthy borrowers and that mortgage investors will not experience adverse consequences as a result of changes in process.

Renewal of a Private Mortgage-Backed Securities System

HFEs would operate alongside a fully private MBS system. A key prerequisite to restarting the private-label MBS market is to ensure all participants operate under adequate regulation and have a stake in the performance of the mortgages that are originated and sold.

<u>NAHB supports restarting as quickly as possible a carefully regulated, fully private mortgage-backed securities system.</u>

In 2011, legislation was introduced in the House and Senate with detailed provisions for structuring a fully private MBS system. Congressman Scott Garrett (R-NJ) and Senator Bob

Corker (R-Tenn) both emphasized transparency, standardization and high-quality mortgage products as critical components of a MBS system that would instill the investor confidence necessary to attract investors back to the private mortgage market. In addition, the Dodd-Frank "Wall Street Reform and Consumer Protection Act" (Dodd-Frank) contains a number of provisions aimed at securing financial market stability and providing greater transparency to investors.

Dodd-Frank also addressed, to some degree, flaws in the securities ratings process which has been roundly criticized for misrepresenting private MBS characteristics and performance. This failure continues to weigh heavily on the minds of investors and is a significant factor in the lack of private MBS activity.

NAHB supports reforming operations and oversight of securities rating firms by establishing an investor-oriented rating agency.

It is widely believed that improper actions of securities rating agencies played a significant role in the severe dislocations that have occurred in the mortgage and financial markets. Internal compensation incentives encouraged revenue generation over accuracy and transparency of ratings and ratings shopping by securities issuers encouraged rating agencies to compete for business by lowering rating criteria.

The operations and oversight of securities ratings firms must be reformed. One solution is the establishment of an Investor-Oriented Rating Agency (IORA) in which six to eight of the largest fixed income investors would come together to develop criteria for private MBS and then agree to purchase MBS that meet the established criteria. The founding fixed income investment companies would not be involved in the rating decisions of IORA in order to avoid conflicts of interest.

Moving the development of the securities rating methodology from the issuer to the investor side of the market would remove conflicts of interest inherent in a system in which investment decisions were based on ratings obtained and paid for by the issuers who would profit from a high rating. Over time, the IORA ratings would gain market credibility and other investors would begin to rely on the ratings and purchase the private MBS rated by the IORA.

Federal, State, and Regional Sources of Housing Funds

Government agencies have been an important support for housing for many years and continue to play a vital role in meeting affordable housing needs in America today. With the private market pulling back, these agencies have stepped up to fill the gap.

NAHB recommends continuing the roles of the federal government housing agencies.

The housing finance support roles of the Department of Housing and Urban Development (HUD), Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture (USDA) and Ginnie Mae should be preserved. NAHB believes steps should be taken to make the operations of these agencies more efficient and effective.

NAHB recommends enhanced roles of state and local housing finance agencies as a source of housing funds.

State and local housing finance agencies have proved critical in helping communities continue to meet the needs of consumers who have faced hardships in the face of less credit availability.

State and local housing finance agencies utilize tax-exempt and taxable bonds as well as state and federal resources to offer a range of single family and multifamily funding programs. These agencies are uniquely positioned to assess community housing needs and should play an even more prominent housing finance role through the development of new programs for new, for-sale housing and multifamily rental homes. This should include partnering with federal and private providers of housing capital.

NAHB recommends expanding the role of the Federal Home Loan Banks in the housing finance system.

The FHLBanks serve twelve regions of the country, working with member institutions in their districts to provide housing loans and grants. Changes to the housing finance system must be undertaken in a manner that will not diminish the favorable cost of funds for the FHLBanks or impair the role of the FHLBanks in supplying liquidity to institutions providing mortgage and housing production credit, support for community and economic development, and resources to address affordable housing needs. The FHLBanks should continue their current activities to serve as an ongoing key liquidity source for institutions providing housing credit.

Existing programs, such as the FHLBanks' mortgage purchase programs should be enhanced by allowing the FHLBanks to move beyond portfolio purchases to securitization and the FHLBanks should develop additional programs to leverage their strong understanding of regional housing conditions and needs.

Correcting the Operational and Structural Problems that Produced the Housing Boom/Bust

It is extremely important to continue and complete steps to close the gaps in standards and oversight that allowed and facilitated the improper and illegal activities in financial and mortgage markets. A new framework must be established to prevent excessive risk taking and ensure the safe and sound operation of the entire housing finance system so the recent debacle is never repeated.

NAHB recommends reforming the appraisal system.

Many housing industry participants believe the current appraisal system is fundamentally flawed. This view has garnered increased support as the ongoing turmoil affecting the housing and credit markets has brought greater focus to the importance of fair and accurate appraisals.

In response to criticism that lax appraisals contributed to the crisis in the financial industry there has been an industry-wide effort to reform the appraisal system. The effort has resulted in lenders, secondary market participants, and banking regulators all implementing new, more restrictive appraisal policies which have become a major impediment to the housing market recovery. On top of this, an extreme downward bias has been imbedded in the home valuation process.

Rather than apply more restrictive appraisal policies, the industry should explore ways to improve the quality of appraisals – particularly as they are applied to distressed markets. Home builders are concerned with appraisals that solely use comparable sales to determine value rather than also considering the cost or income approaches. In particular, it is important to consider giving greater weight in distressed markets to alternative means of valuation, such as the cost-based approach. Using comparable sales to determine an appraised value in distressed markets too often is leading to homes failing to appraise at the sales price or even construction cost.

Specifically, NAHB believes it is urgent to implement reforms in the following areas of the appraisal process:

- Strengthen education, training and experience requirements for appraisers of new home construction
- Improve the quantity and quality of data for new construction
- Develop new appraisal standards and best practices for conducting appraisals in distressed markets
- develop a process for expedited appeals of inaccurate or faulty appraisals
- Strengthen oversight of appraisal activities

NAHB supports prohibiting unsound mortgage products.

The origination of unsound mortgage products, whether or not they are explicitly guaranteed or insured by the government, has the potential to impact the market broadly if borrowers default at excessive rates. Between the years of 2000 and 2006, nontraditional mortgage products, initially developed to meet the needs of select borrowers, were originated widely and often without adequate documentation, sound underwriting and clear disclosures to the consumer. These mortgages came to epitomize the definition of “unsound” by virtue of their dependence on unbridled inflation, inability to withstand market forces and the propensity to default at high rates when property values began to slide.

In fact, “Nontraditional Mortgage Products” were the subject of guidance issued in October 2006 by the FDIC, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Federal Reserve), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA.) Rather than prohibiting the use of these products, the Agency guidance focused on mitigating the high risk associated with these products. The guidance encouraged providers of these products to use prudent underwriting practices such as consideration of a borrower’s repayment capacity and giving borrowers sufficient information to clearly understand the loan terms and the risks related to the product.

More recently, industry participants, regulators, and Congress began to take steps to define the parameters of products that would be considered “sound” and underwriting guidelines that would be considered “prudent.” Discussions have centered around identifying features of a Qualified Mortgage (QM) and a Qualified Residential Mortgage (QRM) for purposes of industry-wide consistency and transparency. The definition for a QRM primarily focuses on what loan characteristics define a safe and sound mortgage product. Broadly, QRMs are loans with characteristics that have been proven to have low default rates historically. Similar discussions are underway regarding commercial loans, including those for multifamily rental properties that are packaged into Commercial Mortgage-Backed Securities (CMBS). QMs will be defined by the Consumer Financial Protection Bureau (CFPB) and will be defined more specifically based on the underwriting guidelines that should be followed to ensure that a loan can be considered safe and sound for a consumer.

In 2011, NAHB commented on proposed rules regarding both QM and QRM. NAHB generally is supportive of the concepts to encourage lenders to originate high quality mortgages by verifying consumers have a reasonable ability to repay (QM) and requiring lenders to retain an interest in the ongoing performance of the mortgage (QRM.) However, both comment letters expressed significant concerns with the details of the proposed rules which NAHB does not believe accurately reflected the intentions of Congress as outlined in Dodd-Frank. Furthermore, NAHB emphasized significant negative ramifications from the proposed rules and recommended the rules be re-proposed.

NAHB supports the use of prudent mortgage underwriting guidelines.

A critical component of prudent underwriting is to assure the borrower's ability to repay the mortgage. This is a cornerstone of the definition of a QM. The determination of a borrower's ability to repay must be based on the following factors: the borrower's current and expected income and other financial resources excluding equity in the dwelling which secures the loan; employment status; payment of the loan based on a fully amortizing payment schedule and the fully-indexed rate; payment of any simultaneous liens; payment of applicable taxes, insurance and assessments; the consumer's current obligations; the borrower's debt-to-income ratio or residual income; and the consumer's credit history. Prudent underwriting guidelines should allow for reasonable flexibility by lenders and the acknowledgement that "one size does not fit all."

Lenders also rely on the FICO score to predict a borrower's likelihood of default. NAHB is concerned there is too much reliance on FICO – an algorithm that is not clearly understood by consumers, lenders and regulators. A borrower's creditworthiness should be determined based upon sound, accurate data and sufficient documentation to ensure qualified borrowers are not excluded from obtaining a mortgage.

NAHB supports requiring sound mortgage securities structures and full transparency for investors.

The MBS market played a growing role in the housing finance markets up through 2007. In particular, origination of subprime mortgages grew to an estimated 20 percent of mortgage originations due largely to the profitability of asset-backed securities. However, in the analysis of the collapse of the markets, this sector particularly has been maligned. The willingness of investors to purchase securities backed by nontraditional mortgage products and then slice, dice and repackage them into new structures perpetuated increasingly unsound securities and was a significant factor leading to the systemic breakdown of the financial system. It is clear from many of the regulatory reforms proposed in Dodd-Frank, and many of the legislative bills proposed subsequently, that full transparency and disclosure of the structure of securities and the origination requirements of the mortgage products within the securities will lead to a better product for investors going forward.

NAHB supports reforming mortgage servicing and modification/foreclosure procedures.

The industry continues to be overwhelmed with the volume of delinquent loans, loans in foreclosure and foreclosed homes. Various initiatives have been put in place to incent servicers to help more borrowers with modifications, forbearance, short sales, and deeds-in-lieu, but none appear to have provided the comprehensive, large-scale solution the industry needs. Many of the initiatives are short-term solutions for the current crisis and do not address the heart of the issue which, as it has become increasingly clear, requires significant overhaul regarding how mortgages are to be serviced in the future to prevent a recurrence of the problems we are facing today.

Improvements in mortgage servicing, including foreclosure processing, is essential to returning to a stable housing market. A uniform procedure for handling delinquent or distressed loans will provide clear direction to lenders and borrowers and allow for a more efficient and fair foreclosure process. The industry regulators have been diligently working toward this objective, but have not yet reached a solution.

The Federal Reserve, OCC, FDIC, and CFPB are planning to establish national mortgage servicing standards to promote the safe and sound operation of mortgage servicing and foreclosure processing. The agencies have stated their efforts will include engaging Fannie Mae, Freddie Mac, private investors, consumer groups, the servicing industry, and other regulators. National mortgage servicing standards are widely supported within the industry.

In April 2011, the OCC issued guidance to national banks requiring servicers, among other practices, to establish a single point of contact for borrowers and to establish procedures to end dual tracking, i.e. to ensure foreclosure actions stop when a borrower is approved for a trial or permanent modification. The OCC examiners determined that deficiencies and weaknesses in the foreclosure process had negative consequences for borrowers and the housing market.

The FHFA directed Fannie Mae and Freddie Mac to establish consistent policies and processes for the servicing of delinquent loans owned or guaranteed by each agency. Together, they developed and issued new standards for mortgage servicers regarding the management of delinquent loans, default prevention and foreclosure time frames. The standards, reinforced by new incentives and compensatory fees, require servicers to take a uniform approach for homeowner communications, loan modifications and other workouts, and, when necessary, foreclosures. The requirements defined under this Servicing Alignment Initiative became effective October 1, 2011 with a new Standard Modification that became effective for borrower evaluations beginning January 1, 2012.

Two issues that have presented a significant challenge to servicers trying to help borrowers find the best resolution to their mortgage concerns must be addressed. First, the pooling and servicing agreements (PSAs), which establish the obligations and authority of the servicers, should include a clear and consistent protocol for handling non-performing loans including, for example, the right to negotiate extensions of the loan term, interest rate reductions and principal reductions. Providing such criteria will ensure that the servicer can take the most effective actions without fear of litigation and will ensure all steps in the foreclosure process have been legally executed.

In addition, second mortgages should be incorporated into the protocol for handling non-performing loans. Addressing total borrower housing debt so that first mortgage loan modifications are accompanied by modifications or restructuring of second liens will create a more effective process.

NAHB supports reform of foreclosure processes and practices, including:

- Reducing the number of homeowners going into foreclosure by:
    - Improving loan modification programs, such as the Home Affordable Modification Program (HAMP), and requiring principal reductions when net present value tests support this option. Principal reduction should be paired with shared appreciation or other conditions to avoid the risks of moral hazard,
    - Implementing further adjustments to refinancing programs, such as the Home Affordable Refinance Program (HARP) and FHA Short Refinance, to allow for greater participation,
    - Requiring second mortgages to be incorporated into the protocol for handling non-performing loans and eligibility criteria for loan modifications.
- Establishing national servicing standards that include clear procedures for handling non-performing loans.
- Encouraging states to develop best practices for handling non-performing loans so that servicers, investors and borrowers understand the rules.
- Persuading America’s financial institutions to take more effective loan modification actions and to institute reforms in mortgage servicing to help home owners who are in financial need avoid foreclosure if they have behaved responsibly in handling their mortgage and other financial obligations.
- Compelling banks to engage in transparent and effective forms of communication with borrowers to avoid unnecessary financial distress.

- Promoting alternatives to foreclosures, such as short sales and deed-in-lieu of foreclosures, and encouraging states to make these processes more efficient.
- Convincing financial institutions and their regulators to implement more effective asset sales procedures and more diligent property maintenance practices.
- Implementing program and policy changes to reduce the inventory of Real Estate Owned (REO) properties, such as:
    - Permitting for-profit companies to fully participate in all aspects of the disposition of the REO properties, including the purchase, management, leasing, and rehabilitation of the properties,
    - FHFA and FHA establishing financing options for builders and investors to purchase REO properties and increase the caps on the number of Fannie Mae and Freddie Mac loans an investor can finance,
    - Modifying existing federal housing programs, such as the FHA Section 203(k) program, to allow investor participation in disposing of REO properties,
    - Facilitating the creation of investor lease-to-own programs that can be operated at scale,
    - Revising Fannie Mae, Freddie Mac and FHA condo policies to provide needed liquidity to reduce the excessive inventory, such as flexibility with regard to owner-occupancy ratios, investor ownership ratios, pre-sale requirements and delinquent Home Owners Association assessments,
    - Granting state housing finance agencies additional authority to assist troubled mortgage borrowers and speed the absorption of foreclosed homes.

NAHB supports imposing adequate oversight on previously unregulated segments of the mortgage and financial markets.

Certain sectors of the financial markets have come under additional scrutiny since the mortgage market crisis began. This is especially evident for those segments of the mortgage and financial markets that previously were unregulated. Examples include mortgage brokers, servicers, hedge funds and private equity funds, and financial institutions.

The “Secure and Fair Enforcement for Mortgage Licensing Act of 2008” (SAFE Act), was passed on July 30, 2008. This federal law gave states one year to pass legislation requiring the licensure of mortgage loan originators according to national standards and the participation of state agencies in the Nationwide Mortgage Licensing System and Registry (NMLS). Additionally, the Federal Reserve has implemented the “Loan Originator Compensation amendment to Regulation Z” that applies to mortgage brokers and the companies that employ them. The goal is to prevent loan officers from steering borrowers to riskier types of mortgages or a higher-than-average interest rate in order to make a higher commission.

The Securities and Exchange Commission (SEC) has focused on protecting investors by increasing transparency, disclosure and reporting through eliminating the exemption from SEC registration for investment advisors of certain hedge funds and private equity funds.

The Volcker Rule, formally titled “Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds” amends the Bank Holding Company Act of 1956 to prohibit insured depository institutions and their affiliates from, 1) engaging in proprietary trading; 2) acquiring or retaining any equity, partnership or other ownership interest in a hedge fund or a private equity fund; and 3) sponsoring a hedge fund or a private equity fund. The intent of the rule is to eliminate the current wide-spread practice of banks using insured deposits for trading purposes unrelated to serving clients.

Oversight should include enhanced review and enforcement including substantial civil fines, recoupment of attorneys' fees and costs, claw-back of profits for violations and aggressive criminal prosecution of material infractions. A private civil cause of action to enforce violations may be an effective additional tool.

NAHB believes it is important to continue to closely monitor financial market transactions to identify and address other areas where risky behavior may go undetected.

National Association of Home Builders
1201 15th Street NW
Washington, DC 20005
T 800 368 5242
www.nahb.org

Contact Information:

David Ledford
Senior Vice President
Regulatory Affairs
dledford@nahb.org
202-266-8265

Jim Tobin
Senior Vice President
Government Affairs
jtobin@nahb.org
202-266-8258

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