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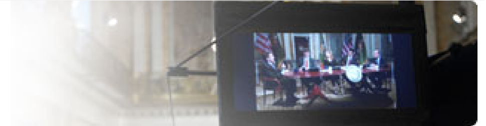

Remarks by Counselor to the Secretary for Housing Finance Policy Dr. Michael Stegman Before The North Carolina Bankers Association 2014 American Mortgage Conference

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As prepared for delivery

RALEIGH, NC – Thank you so much for that kind introduction, Thad. It is a treat to come home to participate in this important conference and to be able to personally recognize you for your 37 years of consequential leadership of the North Carolina Bankers Association.

Not only have you done an outstanding job of serving member interests to an extraordinary degree, but you have also made the North Carolina Bankers Association a powerful and influential voice in national policy debates around banking, financial regulation, and reform.
And by example, you have made the name of this great organization and its members synonymous with community service and compassion for the less fortunate among us. Congratulations, Thad.

I come here with an appreciation for the view held by many in this room that North Carolina families, communities and the state's economy have paid, and continue to pay a dear price for the risky lending that for the most part occurred elsewhere in the country.

The plausibility of this argument is reflected in the fact that over the course of the financial crisis, North Carolina home prices fell by about 15 percent compared to a decline of 21 percent nationally and nearly 50 percent in the frothiest markets, according to Federal Housing Finance Agency's index of home purchase transactions.

Since the depths of the crisis, average home prices in North Carolina have almost made up all of the lost ground, with the latest data indicating they were 4 percent below peak levels, compared to 7 percent below peak levels nationally and still 25-30 percent below peak levels in areas that experienced the largest bubbles in home prices.

Nevertheless, the State's economy took a disproportionate hit—losing more than 335,000 jobs from peak to trough, or 8 percent of peak employment, more than the 6.3 percent shed nationally.

Since the economy's low-point in February 2010, North Carolina has regained more than 300,000 of those lost jobs, bringing us closer to a breakeven point. While we are not completely out of the woods yet, I believe that Treasury has played a significant role in helping North Carolina's recovery.

Through the Troubled Asset Relief Program, or TARP, we injected capital and liquidity into North Carolina financial institutions to stabilize the banking sector, build confidence, and avert a potential collapse of the entire system. Of the 33 small- and mid-sized North Carolina banks that received a combined $3.7 billion of TARP support, all but one has repaid Treasury. The remaining bank continues to pay dividends on its Community Development Capital Initiative program investment today.

And, while the value of single-family residential loans held on balance sheets of North Carolina-headquartered banks continues to drop, data indicate that this decline is primarily attributable to portfolio run-off by the largest institutions.

Smaller Tar Heel banks are actually seeing growth in this asset class. For example, banks with assets of less than $10 billion have increased their holdings of single-family residential loans by 13 percent between 2011 and the second quarter of 2014, while large banks have reduced their holdings by 17 percent over the same period.

Moreover, like the broader banking industry, smaller North Carolina banks have a strong capital position from which to grow their lending activities with an average Tier 1 common capital ratio of about 20 percent.

The bottom line is there is strategic opportunity in residential lending for North Carolina regional and community banks given their strong balance sheets and appetite for residential credit.

Treasury also provided $111 million of capital support and liquidity to the North Carolina Housing Finance Agency through our New Issue Bond Program, enabling it to finance mortgage loans to first-time homebuyers during the crisis.

Using resources from our Hardest Hit Fund, NCHFA has also helped over 17,000 families and provided over $300 million in assistance to unemployed homeowners make their mortgage payments while they look for a job or retraining. This program has had remarkable outcomes with over 99 percent of borrowers assisted by the program retaining ownership of their home 24 months after first receiving assistance.

While these data are encouraging, we are acutely aware that the housing recovery is uneven and that pockets of continuing distress exist even in states and markets that have experienced significant gains.

This is why Secretary Jack Lew recently announced an extension of our Making Home Affordable programs through 2016 including our loan modification programs, and we will continue to look for additional ways to refine and improve the types of aid available to homeowners experiencing financial hardship.

And, while we are still committed to helping struggling families and healing local housing markets, given the breadth and depth of the ongoing housing recovery, we believe now is the time to reform the housing finance system and begin the thoughtful transition to a safer, more sustainable housing marketplace instead of waiting until the next crisis to address this

important issue.

Housing Finance Reform Update

As you know, working with Congress to enact long-term housing finance reform legislation consistent with the President's principles has been a focus of Treasury since the onset of the financial crisis.

A few days ago marked the sixth anniversary of Fannie Mae and Freddie Mac entering conservatorship. As I have said before, this status quo is unsustainable, leaving taxpayers at risk and many credit-worthy borrowers underserved. We owe the American people better.

The critical flaws in the legacy system that allowed private shareholders to reap unlimited profits while leaving taxpayers shouldering enormous losses cannot be fixed by a regulator or conservator. It requires legislation.

For those who think that the GSEs' structural problems are a thing of the past, inaugural GSE stress test results published in April by the Federal Housing Finance Agency pursuant to requirements of the Dodd-Frank Act reveal the folly of those beliefs.

Under an economic stress scenario similar to the most recent crisis, forecasted credit losses for the GSEs would be so great that they would have to draw up to an additional $190 billion on Treasury's commitment over a two-year period.

This is slightly greater than the total amount that American taxpayers have been forced to invest in these companies from the time they entered conservatorship. Absent legislative reform, we could end up with history repeating itself.

And, let me be clear: given this unresolved state of affairs, the only thing that gives capital markets and global investors confidence in the GSEs going forward is Treasury's unconditional commitment to backstop them with up to $258 billion in additional capital support in the event of another economic crisis, a commitment for which the GSEs are not paying.

This is undesirable and unsustainable. These companies must be wound down in an orderly fashion as part of comprehensive housing finance reform.

As you know, this past May marked a significant and encouraging milestone in this regard. The thoughtful bipartisan efforts by Senate Banking Committee Chairman Johnson and Ranking Member Crapo have solidified points of broad agreement on the principles that should underlie the future housing finance system.

Among others, these include preservation of the 30-year, fixed-rate mortgage and a liquid TBA market; a central role for private capital in taking first loss mortgage credit risk; the extension of an explicit, and actuarially priced, government guarantee on qualified mortgage-backed securities; the enhancement of secondary market liquidity through a single securitization platform and security; the separation of the system's securitization infrastructure from private credit risk-taking firms; the need for a mechanism to ensure affordable access to the system; and the establishment of a countercyclical role for government.

These and related points of bipartisan agreement represent real progress that we have banked and demonstrate that the Johnson-Crapo majority did not forge its consensus by merely picking off low-hanging fruit.

Resolving many of the above issues required principled compromise and the maintenance of good will and open lines of communication among members on both sides of the aisle. But there is obviously more work to be done to broaden the bipartisan coalition, and that work is ongoing.

As discussion around this legislation continues, and notwithstanding Director Watt's publicly stated position that FHFA will not participate in the legislative debate about the future of the GSEs, several of the conservator's pending actions will not only affect the pricing of GSE mortgage credit and their risk profile and footprint, but they may also influence the contours of the future housing finance system.

And, while by no means determinative of the final outcome of the legislative process, last week's report by the Congressional Budget Office notes that adoption of Johnson-Crapo would save American taxpayers tens of billions of dollars over ten years compared to the present GSE-centric system.

In conservatorship, FHFA has been moving the GSEs along a course that intersects with housing finance reform and elements of the Johnson-Crapo consensus.

Three such actions include expanded efforts to transfer GSE mortgage credit risk to the private sector through credit risk-sharing transactions; continued progress on the development of the Common Securitization Platform; and, most recently, a decision to transition the Enterprises towards the issuance of a single security.

As these initiatives are implemented through non-legislative means, their positive influence on market practices will ease the transition toward achieving lasting legislated housing finance reform. As importantly, other near-term decisions by FHFA will also help inform future legislative discussions.

These include decisions on how guarantee fees and loan-level price adjustments related to borrower credit quality will be evaluated going forward and capital standards that FHFA will require of private mortgage insurance companies that do business with Fannie Mae and Freddie Mac.

Among the critical issues FHFA will address in re-setting g-fees and mortgage insurance standards are the level and composition of capital to allocate against expected and unexpected losses; the extent to which the loss-absorbing capacity of MIs should include some portion of contractual, but unearned, future premiums; and, the amount by which the strengthening of counterparties' financial position reduces GSEs' residual risk positions, thereby meriting a reduction in the overall g-fee structure.

In setting these policies for the GSEs, FHFA must make the same kinds of tradeoffs between adequate risk management and taxpayer protection, maintaining broad access to credit, while putting private capital in front of the government guarantee, as policy makers and legislators must do in setting capital requirements for guarantors in the future housing finance system.

By making their analytics and decision-making processes around these critical issues transparent and public, FHFA's actions should provide invaluable insights in the continuing discussions around legislative reforms.

And, it is not just in its conservator role that FHFA affects housing finance; it does so also as prudential regulator of the Federal Home Loan Banks. Because the vast majority of North Carolina's community and regional banks are members of the Atlanta Federal Home Loan Bank, the North Carolina Bankers Association and its members have good reason to stay abreast of FHLB initiatives and FHFA's proposed regulatory changes to the system.

The Administration's vision for housing finance reform recognizes the importance of ensuring that community lenders have the same access to the secondary market as big banks.

And Johnson-Crapo would help fulfill this need by allowing FHLBs to serve as loan aggregators either at a bank level or through a separate subsidiary.

FHFA has recently approved a pilot program that allows the Federal Home Loan Bank of Chicago to become a Ginnie Mae issuer—enabling it to purchase and securitize pools of FHA, VA, or USDA loans from its member banks and sell these securities to investors.

This pilot represents the first time that a Federal Home Loan Bank will serve as an aggregator rather than merely as a conduit, and if successful, could be expanded to the rest of the System, thereby increasing small lender access to the secondary market, as envisioned in Johnson-Crapo.

A similarly ambitious program recently approved by FHFA is the Chicago Home Loan Bank's partnership with Redwood Trust, a mortgage real estate investment trust, or REIT.

Through Redwood's captive insurance subsidiary, a new member of the Chicago FHLB, this Mortgage Partnership Finance program (or MPF) would allow member banks to sell their jumbo mortgage loans to Redwood without having to go through a competitor large bank.

If successful, this partnership may create a new source of liquidity and access to the secondary market for the roughly 1,500 community banks, thrifts, and credit unions that participate in the MPF program.

I raise the Redwood Trust initiative because it is likely to be affected by FHFA's recently proposed rule that would phase out FHLB membership of existing captive insurers and prevent new captive insurers from future membership.

While not directly aimed at REITs, the outcome of this rulemaking will affect the economics of taking mortgage credit risk for REITs, an important consideration in the context of the future housing finance system.

It is true that funding REITs through their captive insurance subsidiaries poses potential incremental risks to the FHLB System that are not associated with lending to its traditional depository membership base.

For example, REITs are not subject to the same stringent prudential regulatory oversight; do not have access to stable funding sources like deposits or emergency funding tools such as the discount window that member depositories do; and differ with respect to resolution and accounting standards.

However, many of the activities that REITs engage in appear to be aligned with the FHLB System's core mission, and represent an important source of private capital that should be at the core of the U.S. housing finance system.

While Treasury has not taken a position on the captive insurance issue, it is important that the North Carolina Bankers Association join the conversation with FHFA as it strives to strike a balance between ensuring safety and soundness of the FHLB system and supporting residential lending and community investment by member banks.

Conclusion

To conclude, private capital is expected to take an increasingly greater first loss position in front of a government guarantee with respect to the GSEs in conservatorship; in the activities of the Federal Home Loan Banks; and, in a future system as envisioned in proposed housing finance reform legislation.

The willingness of owners of that capital to play this role in ways that will ensure broad access and affordability, while reducing taxpayer exposure and enhancing financial stability will depend upon near-term regulatory decisions and legislative actions that will define the contours of a future system.

To paraphrase Finley Peter Dunne's aphorism that "politics ain't beanbag;" well, housing finance reform ain't beanbag either. This is a tough, challenging, area of public policy to be involved in. But the stakes are just too high for any of us to sit back and be satisfied with an inadequate and ineffective status quo.

Resolving outstanding differences will be difficult and hard-fought, but the results consequential. All of us must weigh in, and the North Carolina Bankers Association and its members need to be part of the mix.

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