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Good morning, Chairman Duffy, Ranking Member Cleaver and members of the Subcommittee. My name is Ted Tozer, and I appreciate the opportunity to testify today on behalf of the Milken Institute Center for Financial Markets, where I am a Senior Fellow in the Housing Finance Program. Most of you know me from my previous role as President of Ginnie Mae from 2010 through January of this year, overseeing Ginnie Mae's growth and development for most of the post-Financial Crisis period to date. Prior to Ginnie Mae, I spent nearly 25 years at National City Mortgage, where I ran Capital Markets as Senior Vice President. I have also served in a variety of capacities in industry organizations, including tenures on the Mortgage Bankers Association (MBA) Board of Governors and as chairman of the MBA Capital Markets Committee.

Our team within the Milken Institute's Housing Finance Program has a very broad and deep collective housing finance background. We have recently come together to focus on reform in several areas, including:

- A balanced deployment of government and private capital in support of a fairer and more efficient housing finance system;
- Policy, regulatory, and industry-based reforms to the housing finance system that are commercially practical, and that foster safety, soundness, and best practices;
- Enhancing broad access to affordable credit, and liquidity within both the single and multifamily housing sectors; and
- Evaluating and promoting technological innovations that improve the housing finance system.

Accordingly, I would like to present my thoughts today on several elements that are part of the timely conversation on getting bipartisan comprehensive housing finance reform legislation over the finish line.

Ending the GSE Duopoly

A safe and sound housing finance system should support the overall reduction of the public capital footprint as more private capital re-enters the system at different points in the primary and secondary mortgage markets. For most of the post-crisis period, the collective Fannie Mae and Freddie Mac (the Government Sponsored Enterprises, or GSEs) footprint has comprised half or more of the mortgage market, and it would undoubtedly be larger today if not for Ginnie Mae's growth during this period. Ginnie Mae's ability to inject liquidity into the mortgage market during this critical time fueled this growth; the U.S. full faith and credit guarantee that backs Ginnie Mae mortgage-backed securities

(MBS) enabled continued availability of FHA, VA, and RHS products to the four corners of the credit box that neither private capital nor the GSEs were able to provide.[1] This evidences Ginnie Mae's countercyclical ability to keep credit flowing when other sources of liquidity are constrained.[2]

Significant administrative and operational reforms within the GSE conservatorships – now in their ninth year – have enhanced the GSEs' continued outsized role in the mortgage market. Despite the constraints of conservatorship, both GSEs have been able to retain smart, talented management and support teams to pursue many successful initiatives that have reduced their operational, business, and market risks, and taxpayer exposure as they continue to provide market liquidity. They are also modernizing critical securitization infrastructure through the development of a Common Securitization Platform (CSP) and, if they adhere to the current schedule, will begin issuing a Single Agency Security through the CSP in early 2019.[3] These are all developments that should play an important role in a reformed secondary market system.[4]

As dominant and protected gateways to the secondary market for conventional mortgages, the GSEs have also been able to infuse within their respective proprietary underwriting systems and processes a wide range of new and innovative financial technology, or "FinTech" products, to improve their operational efficiency and customer service. And they are effectively using the Qualified Mortgage (QM) Patch to begin to extend their reach to more "harder to serve" consumers.[5] Arguably, however, with their protected, government-advantaged status and the powerful economic benefits that accompany it, the GSEs have achieved these gains at the cost of crowding out a potentially significant measure of market competition and additional innovation. As I will discuss, this is neither a sustainable nor advisable model over the longer term. Whatever other principles guide lawmakers' efforts as they pursue legislative reform, they should focus on the priorities of (i) ending the current GSE duopoly and creating a more competitive secondary market that would compete away economic rents (thereby reducing costs to all consumers), (ii) encourage innovation, and (iii) reward those who responsibly and sustainably provide credit to harder and more costly to serve populations and geographies.

Improving on the GSE-based Model

There are elements of the GSEs' systems and processes that are critical to maintain and improve upon in any future housing finance system. In discussing this principle, I will use the terminology of "issuer" and "guarantor" interchangeably. I do so because issuers under the Ginnie Mae construct have the same legal responsibility to absorb delinquent

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[1] See, e.g., http://www.dsnews.com/daily-dose/06-26-2017/end-%E2%80%A8of-era-tozer-talks.
[2] During my tenure at Ginnie Mae, the total unpaid principal balance of Ginnie Mae MBS grew from $900 billion to over $1.8 trillion (surpassing outstanding Freddie Mac MBS volume in mid-2016). If Congress can accomplish legislative housing finance reform, the outsized FHA footprint would reduce over time into a more strategic role.
[3] The first such security through the CSP in 2019. See Federal Housing Finance Agency, *An Update on Implementation of the Single Security and the Common Securitization Platform (June 2017)*.
[4] Many commenters have discussed the potential application of the CSP in support of not only GSE, but also Ginnie Mae and private label securitizations. In this respect, the CSP can be an effective utility that can serve the entire mortgage market.
[5] See 12 C.F.R. § 1026.43(e)(4)(2)(A).

principal and interest payments and loan losses as do Fannie Mae and Freddie Mac acting as guarantors under the current GSE construct. In particular:

1. *The "To Be Announced" or "TBA" Market.* The TBA Market, which was developed in 1970 to support the explicitly guaranteed Ginnie Mae MBS, has grown into the most liquid and important secondary market for mortgage loans. It is second in daily volume only to the U.S. Treasury market, with trading of roughly $200 billion per day.[6] The TBA Market relies on the homogeneity of the underlying loans and the issued securities, and the government guarantee backing the securities. These features effectively eliminate credit risk and analytical complexities for investors, and TBA traded securities are one of the primary hedging instruments for managing interest rate risk. The TBA Market's elimination of credit risk is critical to the ability to offer American borrowers a pre-payable fixed rate 30-year mortgage, which remains the cornerstone of low- and moderate-income borrowers' ability to finance a home. Preservation of the TBA Market is one of the most important features to maintain in a future housing finance system, which evidences our support for an explicit full faith and credit government guarantee of TBA securities.

   While preserving the TBA Market is essential, some observers have noted that converting the federal government guarantee of the GSE's (or their successor entities') MBS from their current charter-based implicit guarantee to an explicit Ginnie Mae full faith and credit guarantee, could put pricing pressures on the market for existing Ginnie Mae securities – and therefore on the cost of the underlying FHA, VA, and RHS loans. This is because the conventional Ginnie wrapped MBS would be much more liquid and price competitive relative to current Ginnie Mae securities due to their volume advantage. Stakeholders and policymakers should explore this possibility and carefully consider the best way of mitigating any market dynamics that could raise the cost of FHA, VA, and RHS loans.

   The September 2016 Milken Institute Proposal (the Milken Institute Proposal) and the more recent MBA Proposal both agree on the need to preserve a robust TBA Market. However, one way in which the two proposals differ is that MBA recommends that the Ginnie Mae MBS Platform continue to support current government-guaranteed lending programs (FHA, VA, and RHS), while the GSEs' CSP should serve as the issuance platform for collateralized pools of conventional loans. In each case, the securities would enjoy a full faith and credit federal guarantee. At this time, however, the GSEs' CSP, which is jointly owned by the two enterprises, is still under construction and not fully operational. Its ultimate capabilities and timeline to full functionality, as well as its adaptability to non-GSE guarantors' systems, will become clearer over time. While Ginnie Mae would have to gain new capacity to oversee private counterparties providing credit enhancement to pools of non-government guaranteed mortgage pools, the existing Ginnie Mae platform could accommodate conventional pools without burdensome and costly alterations. Unlike the GSEs' CSP, which is currently designed to serve just two issuer/guarantors, the Ginnie Mae MBS Platform – which has been modernized using 21st century technology – is capable of accommodating multiple issuers delivering into single or multi-lender securities, and currently accommodates approximately 430 different issuers (with no single issuer dominating the program). As such, the Ginnie Mae MBS Platform can play a

[6] SIFMA, *TBA Market Fact Sheet (2015)*.

valuable role in a reformed housing finance system. While there are pros and cons of maintaining the use of parallel securitization platforms – one for current government-program (i.e., FHA/VA/RHS) Ginnie Mae wrapped MBS and another for conventional Ginnie Mae wrapped MBS – policymakers should strongly consider the option of using the Ginnie Mae MBS Platform for issuing both government and conventional mortgage backed securities. This would preserve a single TBA Market and avoid any potential pricing differentials that could arise in the case of parallel platforms featuring the same Ginnie Mae wrap, but with differential volumes and liquidity attributes.

2. *Affordable housing.* Affordable housing goals and charter-based requirements to serve low- and moderate-income households have not been fully satisfied in post-crisis practice, as broad segments of affected borrowers and markets continue to be underserved by the market and by the GSEs in conservatorship. A reformed housing finance system should provide broad access to affordable mortgage credit to all qualified consumers and geographies. Toward that end, both the Milken Institute and MBA Proposals support a modest affordable housing strip of about 10 basis points on the outstanding balance of guaranteed MBS to support the production and preservation of rental and homeowner housing for low- and moderate-income consumers.

   The Milken Institute Proposal would continue Ginnie Mae's policy of allowing any entity that has the requisite financial resources and operational capacity to become an approved issuer of government-guaranteed securities, and compete to find economic success in the marketplace without the imposition of affordable housing mandates beyond the aforementioned strip. This approach stands in contrast to the MBA Proposal, which would impose firm-level affordable housing and duty to serve requirements on the two or more private guarantor/issuers. Using Ginnie Mae as contemplated under the Milken Institute Proposal allows for innovation and specialization to develop among its large issuer base. For example, the average FHA credit score fell from around 720 in 2010 when four issuers dominated the Ginnie Mae market, to 675 presently, when no issuer has more than a 7% Ginnie Mae issuance share. This drop in credit score did not result from regulatory mandates but from compliant credit box expansion by lenders deriving from their respective competitive strengths – for example, having strong ties to minority communities, or expertise in dealing fairly and effectively with distressed borrowers.

   Furthermore, in comparison to the MBA approach, which imposes affordable housing requirements at the guarantor/issuer level, the Milken Institute Proposal relies more upon statutory and regulatory affordable lending requirements imposed upon originators in the primary market. To the extent that such requirements are found wanting, I would support finding ways through regulatory and/or legislative approaches to improving and strengthening requirements to help close primary market lending gaps. Another potential way to close the lending gap is by conferring upon Ginnie Mae the statutory power to increase and decrease (within stated bounds) the affordable housing strip paid by individual issuers, encourage existing issuers to expand lending to low-and moderate-income and underserved borrowers, and incentivize new issuers to focus on ways to serve those markets responsibly and sustainably. Ginnie Mae would thus be mandated by statute and provided economic tools to ensure that the system as a whole creates an environment which will allow affordable credit and homeownership for every American who has the ability and desire to become a successful homeowner.

Whichever model reform efforts pursue, the future housing finance system must serve the needs of underserved borrowers who are ready for and able to succeed at homeownership, but who cannot access to affordable credit in the present system. At the same time, we must remain vigilant against not only discriminatory practices against protected classes, but also overly restrictive or lax lending practices. We must also remain aware of, and be ready to address, market-driven forces that cause any such dynamic. For example:

- The GSEs currently charge loan level pricing adjustments (LLPAs) for lower credit score and lower down payment loans. These LLPAs operate to increase the cost of the loan to the consumer. Because of the low down payments, these loans must have a Mortgage Insurance (MI) product that stands in first loss position attached to them. However, based on the GSEs' analysis of the MI companies' claims-paying abilities, the GSEs do not give full economic credit to the MI first-loss protection in setting the related LLPAs – despite the fact that MI companies are now subject to much more stringent post-crisis capital and financial standards imposed by the Federal Housing Finance Agency. Thus, the consumer ultimately bears not only the cost of the MI product, but an additional economic charge that derives from the economic inefficiency created by the GSEs' LLPAs with respect to MI products.

- Additionally, the GSEs determine which MI products are eligible for purchase. By reducing the MI products that are eligible for purchase, the GSEs reduce the ability of borrowers to access credit (for example, a borrower may be able to obtain an MI product at a potentially higher – but still affordable – MI premium, but the GSEs may have declared such product ineligible for purchase).

- In contrast, Ginnie Mae allows FHA lenders to decide which FHA programs (which include FHA insurance premiums) they wish to offer and allows such lenders to include these loans in their own pools.[7] Removing the veto power of the GSEs on MI offerings will create an environment that fosters healthy MI company competition and encourages fairly priced products that meet the needs of the market.

3. *Equal access to the secondary market for lenders of all sizes*. Prior to the financial crisis, the GSEs extended preferential volume-based guarantee fee pricing to larger lenders, effectively raising the cost of lending to – and therefore hurting the ability to compete by – smaller and mid-sized lenders. Smaller and mid-sized lenders were limited in their options because the system required all conventional loans to go through the GSE "door" to access the capital markets. The system did

[7] For example, the four large bank issuers that dominated Ginnie Mae MBS issuance early in my tenure at Ginnie Mae included credit overlays in their origination programs that disallowed FHA originations at the lower end of the credit spectrum. Other Ginnie Mae issuers recognized the opportunity in this lending space and, under the Ginnie Mae construct, were able to originate such loans and include them in their own Ginnie Mae MBS issuance.

not allow for any disruptors to provide an alternative pathway to the capital markets. Guarantee fees are now uniform across the board, and any future housing finance system must preserve this feature in the interest of fairness and equal access to the government-backed secondary market through regulation and dynamic competition.

Key Elements of any Path Forward

It is important to focus on some of the key elements embedded in a number of the thoughtful plans that have been proposed in the government/industry housing finance reform dialogue. Most importantly, a future housing finance system must:

- Put an end to the GSEs' pre-conservatorship business models that allowed profits to be privatized and losses socialized and paid for by taxpayers;
- Oppose any efforts to recapitalize and release the GSEs from conservatorship with their flawed and conflicted business models intact, along with their implicit government guarantee and protected market positions; and
- Foster a more competitive secondary market system where no entity is too big to fail, and one in which sufficient private capital stands in front of an explicit and paid-for government guarantee of qualified mortgage-backed securities.

And, in considering future possibilities, lawmakers must:

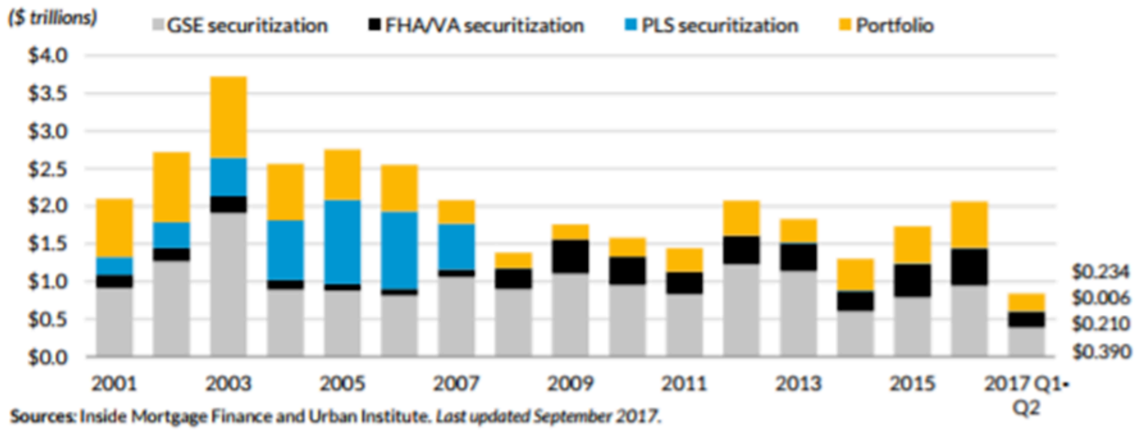
- Decide how to incorporate the considerable tangible and intangible assets of the GSEs into a modern and sustainable housing finance system;
- Decide whether the GSEs should continue as shareholder-owned companies, regulated as public utilities, or become government-owned entities;
- Utilize existing infrastructure to the greatest extent possible, even if that means shifting some tools, functions, units, personnel, or information (including GSE historical data) from one entity to another, or from one platform to another; and
- No matter what the future state of the housing finance system, remain dedicated to the goals of creating a safe, sound, and resilient U.S. housing finance system that serves the needs of all consumers.

Encourage the Return of a Safe Private Label Securities Market as a Meaningful Source of Private Capital

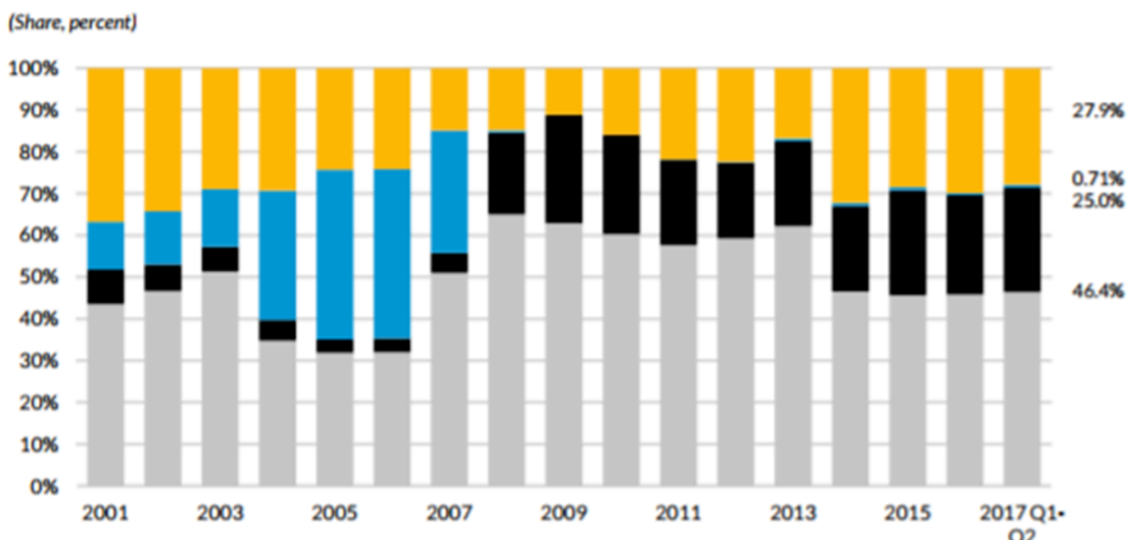
Private capital is the other side of the coin from a government guarantee. Private capital comes in the form of down payments, private mortgage insurance, portfolio lending, secondary market purchases, credit risk transfer structures, issuer/guarantor capital, financial institutions' balance sheets, and also private label securitization (PLS). The PLS market has been virtually non-existent in the post-crisis world not only because economics have favored GSE or Ginnie Mae execution and bank balance sheet portfolio activity, but also because of the role PLS played in the Financial Crisis. For example, the following charts illustrate the relative sizes of the different market shares by dollar volumes and by percentages:[8]

First Lien Origination Volume

After a record high origination year in 2016 ($2.1 trillion), the first lien originations totaled $840 billion in the first half of 2017, down 6 percent from the same period last year, mostly due to the elevated interest rates. The share of portfolio originations was 28 percent, down slightly from 30 percent in 2016, despite an increase in Q2 2017. The GSE share stayed at about 46 percent. The FHA/VA share was slightly up: 25 percent for the first half of 2017 versus 24 percent in 2016. Origination of private-label securities was well under 1 percent in both periods.



Sources: Inside Mortgage Finance and Urban Institute. *Last updated September 2017.*



Sources: Inside Mortgage Finance and Urban Institute. *Last updated September 2017.*

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[8] Urban Institute, *Housing Finance at a Glance: A Monthly Chartbook (October 2017)*, p. 8.

Many have cited deficiencies and weaknesses in PLS contracts, governance, structures, and collateral as a leading cause of many billions of dollars of "misallocated losses." By misallocated losses, I mean losses that were supposed to be borne by one party in a PLS deal (typically – but not exclusively – the seller, issuer, or servicer) but were instead borne by another party (typically the investor) because the architecture of the trusts lacked sufficient means or mechanisms to detect, pursue, and enforce contractual breaches and violations. These misallocated losses spurred a crisis of confidence and resultant "trust gap" on the part of the institutional investors who bore them, and who are necessary parties to the re-emergence of PLS as a meaningful part of a future housing finance landscape.

Industry efforts – in particular, the Structured Finance Industry Group task force "RMBS 3.0", which one of my Milken Institute colleagues chairs – are working to address and solve for the issues that plagued the PLS market in the few years running up to the Financial Crisis. This effort will also include an analysis of GSE credit risk transfer (CRT) deals, which, by directly exposing investors to credit risk of the underlying loans, are essentially no different than PLS transactions. In that light, the contractual standards and disclosures in CRT deals should mirror those in PLS, notwithstanding certain differences in existing laws and regulations relating to PLS and GSE issuances. At present, some of the post-crisis rules and practices relating to PLS issuance represent vast improvements over their pre-crisis counterparts, while other post-crisis rules and practices that were intended to represent improvements have or will have little to no impact. Additionally, in some cases new practices are emerging that actually weaken investor protections vis-à-vis pre-crisis transactions – not through contractual weakness or deficiencies, but through relatively transparent provisions that ring-fence issuer liability at the expense of investor protections or limit the investor's ability to take action against an issuer. Some investors are comfortable buying securities from these latter transactions, while others deliberately steer clear of them. It remains to be seen how much traction these deals will generate, and whether they or the deals with stronger investor protections become the longer-term PLS template.

As a gating matter, however, the economics and potential market size of PLS are the critical governors to its resurgence. The large institutional investors necessary to support such a market will likely not participate in it if the economics and market share do not support a large and liquid investment opportunity relative to other potential investments. Because of this, it is imperative that conforming loan limits be reduced over time no matter which housing finance reform plan is enacted. The post-crisis political and economic conditions that drove the rise in limits to help ensure liquid markets and access to credit have greatly subsided, and there should be – preferably through administrative action rather than by legislation – a systematic ratcheting down of first the super-conforming loan limits, and then the conforming loan limits as the PLS market develops. In addition, policymakers, regulators, and industry should review whether the government should continue backstopping certain types of products, such as vacation homes, investment properties, and high combined loan-to-value cash-out refinances where the cash-out proceeds are not used to pay for designated expenses such as home improvement, medical expenses, school tuition, and similar purposes.

This is why the work on PLS (and for that matter, GSE) reform efforts must be accomplished before or concurrently with a resurgence in the PLS market; safer PLS architecture must accompany attractive economics if the PLS market is to help create new, competitive lending channels without the weaknesses and deficiencies embedded in many pre-crisis deals. The PLS market must be ready to handle the potential volume that would follow a decrease in conforming loan limits in order to ensure a PLS price execution that would support compliant, competitively priced lending to many Americans who might otherwise find it difficult to access mortgage credit.[9]

Ultimately, securitization is a tool that, when transacted properly with well-underwritten loans and accurately disclosed information, can provide a meaningfully sized, scalable, and liquid pathway for private capital to stand in front of a catastrophic government guarantee. It is therefore imperative that, as an industry, we work together with policymakers, regulators, and other industry participants on this effort.

Conclusion

The U.S. housing market has rebounded in significant and positive ways since the Financial Crisis, and I commend policymakers, regulators and industry for working together in the face of tremendous adversity to navigate perhaps the most challenging socioeconomic event since the Great Depression. However, we have much yet to do to cement the foundations of a reformed housing finance system that will serve the needs of the market and of the American people now and in the future. On behalf of the Milken Institute Housing Finance Program within the Center for Financial Markets, I urge the Committee and all of Congress to seize this opportunity and collaborate in crafting legislation that would accomplish this critical mission. We stand ready, willing and able to assist the Committee and all other policymakers, regulators and industry in this undertaking.

Thank you.

[9] Also, we believe that the promulgation of clearer lending regulations – as opposed to "rulemaking by enforcement" – would also greatly benefit the healthy resurgence of the PLS market. Rulemaking by enforcement imparts ambiguity into the primary and secondary markets and poses potentially significant damages for industry participants, which chills the proper functioning of markets and, ultimately, hurts the consumer by restricting access to credit or driving up the price of that credit.