

Written Statement for the Record of Senator Sherrod Brown
Executive Session to Consider S. 1217
Senate Committee on Banking, Housing, and Urban Affairs
April 29th and May 15th, 2014

I thank the Chairman and Ranking Member, and their staffs, for months and months of hard work on this issue. I also thank Senator Corker and Senator Warner for starting this important conversation.

Most of us agree on the factors that caused the failures of Fannie Mae and Freddie Mac (the Enterprises). Their principle weaknesses were well-documented by the Financial Crisis Inquiry Commission (FCIC):

The Enterprises had a ***“deeply flawed business model as publicly traded corporations with the implicit backing of and subsidies from the federal government and with a public mission”***;

They were allowed to invest in toxic private-label mortgage-backed securities (PLS) with lax underwriting standards; and

They were leveraged 75 times their capital.

Any legislation to reform the Enterprises must address these three critical issues.

While the legislation before the Committee has improved substantially, I am concerned that it has not yet addressed these flawed incentives, and I am not ready to support it today.

I am concerned that the guarantors and aggregators in the new system will be motivated by the same combination of private profit and public guarantee as the Enterprises.

I am concerned that the “senior-subordinated” structure of the “capital markets execution” system will recreate the features of toxic structured securities that caused losses at the Enterprises, as well as some bailed out Wall Street banks.

And I am concerned that the definition of “capital” in the bill is too weak, that regulators can waive capital requirements during crisis, and that regulators can still bail out companies that are too important to the mortgage financing market.

As we move forward, we must not re-create a failed system.

The FCIC concluded that the Enterprises ***“contributed to the crisis, but were not a primary cause ... [They] participated in the expansion of subprime and other risky mortgages, but they followed rather than led Wall Street and other lenders in the rush for fool’s gold.”***

While I appreciate the Chairman’s efforts, my concerns ultimately arise from the underlying structure of the proposal.

This framework appears to be similar to ones that were outlined in a 2011 New York *Times* article titled “***Banks Want Pieces of Fannie-Freddie Pie***” – right down to replacing the Enterprises’ affordable housing goals and duty to serve with an incentive fee.

It concerns me that this legislation closely follows Wall Street’s 2011 proposals, which, according to the *Times*, “***resemble ideas that banks circulated in Washington several years before the financial crisis.***”

We should not turn over the Enterprises’ business to the same Wall Street banks that triggered the financial crisis and taxpayer bailouts

Recently, the credit rating agency Moody’s said that this legislation is “***credit positive for banks and in particular the large banks as it likely would continue to favor institutions with lower funding costs that have the ability to take advantage of economies of scale.***”

In addition to the funding advantage they already enjoy, Moody’s report says that Too Big to Fail banks’ ability to play multiple roles in this new system means they “***would have an advantage over institutions which elect not to or are unable to do so,***” and would benefit from “***greater visibility into credit and pricing and therefore a better capacity to correctly price risk, as well as their services.***”

We should not provide Wall Street banks with further advantages over community banks and credit unions.

I am also not convinced that it is time to do away with the Enterprises’ affordable housing goals and duty to serve.

The FCIC concluded that the affordable housing goals bore little, if any, responsibility for the Enterprises’ expansion into risky PLS deals.

Eliminating the goals and the duty appears to be based more in ideology than anything else, and the burden rests with those who want to replace them to show that the new system will serve all communities better – including rural and minority borrowers.

Throughout this process, we have heard that the goal of our efforts is bringing private capital back into the housing market, but it concerns me that the legislation is limited to the government-guaranteed market.

One way to put private capital behind the mortgage market is to revitalize a PLS market that was rife with fraud, conflicts of interest, and legal uncertainty.

I agreed with the Ranking Member’s comments last October when he expressed “***just how important a vibrant, well-functioning private mortgage-backed securities market is to our housing finance system,***” and that “***private capital is on the sidelines, and that the government needs to reduce its footprint.***”

Unfortunately, this legislation adopts none of the reforms to the PLS market suggested by the witnesses at our October hearing, namely creating a fiduciary duty for servicers and trustees to act in the best interest of PLS investors.

Private capital simply will not come off the sidelines without such protections, and our efforts will be incomplete without them.

Finally, simpler reform is better reform. I am concerned that the complexity of the legislation before us could: create opportunities for arbitrage; distort pricing; increase concentration; and exacerbate systemic risk.

This framework creates unrealistic expectations that regulators will be able to protect borrowers and taxpayers, and further distorts an already unlevel playing field for our community institutions.

It is clear that the current system cannot go on forever, and that we cannot go back to the old way of doing business.

Nonetheless, I have heard far too many concerns from Ohio's consumer groups and community institutions – from Lakewood to Coldwater – to support this bill.

Holding this markup is an important benchmark, but there is still more work to be done.

We received valuable input throughout this process from many stakeholders – from consumer groups to realtors to community institutions – that we should incorporate in any future reform efforts.

I again thank the Chairman and Ranking Member for their leadership, and I look forward to continuing this conversation.

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