

Testimony of

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Banking, Housing, and Urban Affairs

**“Principles of Housing Finance Reform”**

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Chairman Crapo, Ranking Member Brown, and members of the Committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA). My name is David H. Stevens, and I am President and CEO of MBA. From 2009 to 2011, I served as Assistant Secretary for Housing and Federal Housing Administration (FHA) Commissioner at the U.S. Department of Housing and Urban Development (HUD). I am a Certified Mortgage Banker (CMB), and I have over 35 years of experience in real estate finance, including nearly a decade as Senior Vice President for Single-Family Business at Freddie Mac, where I witnessed the strengths of the business model as well as the weaknesses that contributed to the financial crisis and led to the current state of our housing finance system.

MBA is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. The association works to ensure the continued strength of the nation's residential and commercial real estate markets, to expand homeownership, and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. MBA's membership of over 2,300 companies represents all elements of real estate finance, including firms serving both the single-family and commercial/multifamily markets. Our membership includes commercial banks, investors, brokers, conduits, and industry vendors, as well as nearly 650 independent mortgage bankers, community banks, and credit unions, which comprise almost 80 percent of our single-family membership.

We are now nearing nine years since Fannie Mae and Freddie Mac (the GSEs) first entered conservatorship, and yet their long-term status remains unresolved. The financial crisis exposed the structural conflicts and misaligned incentives in the GSE business model, as well as weaknesses in the regulatory framework that was in place at the time. The result—a breakdown of the secondary mortgage market, \$187 billion in taxpayer assistance, and continuing federal support of almost \$260 billion—underscores the importance of comprehensive reform.

Conservatorship of the GSEs has already persisted far longer than was ever intended. And while the Federal Housing Finance Agency (FHFA) has taken important administrative steps during this period, an extended conservatorship is economically and politically unsustainable. In the absence of comprehensive reform, borrowers forego the benefits made possible by a more vibrant secondary market, taxpayers remain exposed to elevated levels of credit risk, development of the private-label securities market remains stagnated, and lenders face increased uncertainty about the future. In short, the status quo is an unacceptable long-term outcome.

To address the need for change, MBA convened its Task Force for a Future Secondary Mortgage Market (Task Force) in early 2016. The Task Force was comprised of members covering a broad cross-section of the real estate finance industry, including bank and nonbank lenders serving the single-family and multifamily markets and spanning a wide range of sizes and business models, mortgage insurers, REITs, and title companies. The members of the Task Force spent over a year considering and debating many potential models before issuing final recommendations for a reformed and improved secondary mortgage market system. The result of this extensive work was a detailed proposal released in April 2017, titled *GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market*. I have submitted this proposal as an addendum to my written testimony.

It is important to note that our Task Force focused on balancing key public policy objectives with the realities of the marketplace. As industry practitioners, our members placed a premium on pragmatism. We are fully aware that there is no single perfect solution to GSE reform—all proposals involve various trade-offs. We believe that our plan addresses these trade-offs in a way that will benefit consumers, industry, and taxpayers, while also providing the long-term stability so essential to a healthy housing finance system.

The Task Force took particular interest in two areas that have tested past reform efforts—the appropriate transition to a new system and the role of the secondary market in advancing a national affordable-housing strategy. Distinct working groups within the Task Force studied these issues and developed carefully crafted recommendations that we believe can bridge the divides that currently exist.

With respect to the transition from the status quo to a new end state, the MBA proposal makes use of concepts that are well-established in finance and banking, as well as historical examples that have provided insights into the key elements of successful models. The Task Force specifically noted the importance of leveraging the assets, infrastructure, and regulatory framework of the current system wherever possible, while also emphasizing that any workable transition must utilize a clear road map and be multi-year in nature.

The Task Force also sought to develop an affordable-housing framework that appropriately targets the scope of the federally-supported secondary market within the full continuum of households, covering both renters and homeowners of varying income levels. To advance this objective, the MBA proposal features a framework that involves quantitative and qualitative metrics that focus on outcomes and that are transparent, well-defined, measurable, and enforceable. The GSEs' multifamily executions and their support for rental housing would be preserved. The proposal also recommends other potential improvements to better serve the full continuum of households, including

updating credit-scoring models, better capturing nontraditional income, and providing enhanced liquidity for small-balance loans.

Another critical objective of the Task Force—and one that has been the subject of intense debate during past reform efforts—was to ensure that secondary market reform fosters a competitive primary market that is served by lenders of all sizes and business models. In particular, the Task Force recognized the important role that smaller lenders play in strengthening the system for consumers by focusing on niche markets and leveraging unique knowledge of local needs (see *Exhibit A – Small Lender Access: Why It Matters*). The MBA proposal reflects this objective by ensuring equitable access to secondary market programs, prohibiting special pricing based on loan volume, preserving cash window and small pool execution options, and preventing vertical integration by the largest market participants.

After contemplating many different types of business structures and regulatory frameworks for the Guarantors that will issue eligible mortgage-backed securities (MBS), the Task Force determined that a model based on regulated utilities would be most effective. The core justification for utility-style regulation rests with the premise that privately-owned utilities derive much of their existence and powers from the state. Because the Guarantors will be granted the ability to distribute securities carrying a full faith and credit guarantee from the federal government, they must also accept the responsibility—and the regulatory oversight—to serve customers in an efficient and fair manner. The regulator would ensure that the premiums charged by the Guarantors are neither excessive nor inadequate, and that they remain nondiscriminatory in nature. Pricing would be transparent, with rates posted for public input. And in addition to the legal and economic rationale for utility-style regulation, this framework is also intended to address the problematic growth-company models and mindsets that existed at the GSEs prior to the financial crisis. Investor-owned utilities will aim to provide shareholders with a steady dividend over time rather than taking on excessive risks in a reach for market share. Companies with a dividend-focused culture will compete through more efficient operations, product and process improvements, and customer service.

### **GSE Reform: Core Principles**

The MBA proposal recognizes the need for any comprehensive GSE reform plan to balance three major priorities: 1) taxpayer protection; 2) investor returns; and 3) consumer cost and access to credit. Pushing too far in any one direction may lead to a mortgage market that does not adequately meet the needs of all participants. To achieve the appropriate equilibrium among these priorities, the Task Force developed the following core principles to guide its work:

Core Principles:

- Preserve the 30-year, fixed-rate, prepayable single-family mortgage, as well as long-term financing for multifamily mortgages;
- Maintain a deep, liquid to-be-announced (TBA) market for securities backed by conventional single-family loans;
- Attract global capital and preserve liquidity during times of economic stress through an explicit government guarantee for eligible MBS backed by single-family or multifamily mortgages;
- Limit the explicit government guarantee to the eligible MBS, while prohibiting the extension of the guarantee to the equity or debt of the Guarantors;
- Require the Guarantors to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities;
- Support a competitive and diverse primary market for lenders of all sizes and business models;
- Enable a robust, innovative, and purely private mortgage market to coexist alongside the government-backed market;
- Preserve existing multifamily financing executions and permit new options;
- Establish a strong, transparent regulatory framework that promotes liquidity while protecting the taxpayers;
- Ensure that private capital assumes most of the credit risk;
- Ensure liquidity in the event of a full-blown systemic crisis; and
- Minimize risks to the liquidity and stability of the mortgage markets during the transition to the end state.

**GSE Reform: Guardrails**

The MBA proposal also addresses the risks that are inherent in any plan to reform the secondary mortgage market. To mitigate these risks, the Task Force developed a set of “guardrails”—a statutory and regulatory framework designed to protect taxpayers, ensure liquidity, preserve what works in the current system, and align incentives across both the primary and secondary markets. These guardrails are comprised of structural requirements, prudential standards, and market conduct regulation:

Structural Requirements:

- The end state should allow for more than two approved Guarantors to issue government-guaranteed MBS;
- The regulator should be authorized to grant additional Guarantor charters;
- The government guarantee should be explicit, funded by appropriately priced insurance premiums, and limited only to the MBS issued by the Guarantors;

- Guarantors should disperse credit risk to private capital investors through a variety of credit risk transfer (CRT) mechanisms, including deeper first-loss CRTs that are transparent, scalable to all lenders, and capable of limiting taxpayer exposure to nothing more than catastrophic risk;
- Guarantors should be stand-alone companies and lenders should not be allowed to own controlling interests in Guarantors;
- Guarantors' rate of return should be regulated using a utility regulation framework;
- Guarantors should issue a single uniform type of security for single-family mortgages;
- The Common Securitization Platform (CSP) should be established as a self-funding, government-owned corporation and must be accessible to new Guarantors;
- The CSP should own all GSE historical single-family data, and new Guarantors and other market participants should be able to access and analyze this information for an administrative fee; and
- The regulator should have established mechanisms in place to respond to liquidity disruptions during severe market downturns or catastrophic events.

Prudential Standards:

- The regulator should have sufficient powers and discretion with respect to capital regulation and other aspects of prudential oversight;
- Single-family loans eligible for inclusion in the government-backed MBS should meet a Qualified Mortgage (QM) type standard;
- Multifamily mortgages of a type and quality similar to those financed by the GSEs today should be eligible for inclusion in the government-backed MBS;
- Guarantors may hold only limited mortgage portfolios to support cash window operations, delinquent loan repurchases, loss mitigation activities, and certain multifamily assets; and
- Guarantors that reach a given size may be designated and regulated in a manner similar to systemically important financial institutions (SIFIs).

Market Conduct Regulation:

- Guarantor charters should expressly maintain a bright line between the primary and secondary mortgage markets, with the Guarantors' allowable activities limited to the secondary market;
- The regulator should ensure that Guarantors provide equitable, transparent, and direct access for lenders of all sizes and types, and pricing and program participation should not be based on the loan volume or asset size of lenders;

- Guarantors should be required to maintain both cash window and MBS execution options; and
- Guarantors should be required to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities.

### **Why Congress Needs to Act**

In its role as conservator of the GSEs, FHFA has put in place a number of policies and procedures to improve access to the secondary mortgage market and reduce the risks to taxpayers. These changes include more appropriate guarantee fee (g-fee) pricing that is based on the riskiness, not the volume, of the loans delivered; the development of the CSP and the Single Security initiative; extensive use of credit risk transfers by the GSEs; substantial reductions in the GSE retained mortgage portfolios; and enhanced oversight of, and risk management at, the GSEs.

Despite these important steps, there is a critical need for legislative reform—both to bring about the remaining structural changes that are necessary to achieve the core principles listed above, as well as to “lock in” the recent improvements made by FHFA. It is only Congress that can:

- Alter the existing GSE charters to reconstitute the firms as Guarantors;
- Establish an explicit federal government guarantee on eligible MBS, as well as a Mortgage Insurance Fund (MIF) to stand ahead of taxpayers;
- Empower FHFA with a utility-style regulatory mandate to maintain a level playing field, as well as the authority to grant charters to new Guarantors in order to better enable competition in the secondary market; and
- Preserve the administrative reforms made by FHFA as conservator of the GSEs.

And perhaps most importantly, legislative reform is the only outcome that provides the legitimacy and public confidence necessary for long-term stability in both the primary and secondary mortgage markets.

It is therefore clear that calls to simply recapitalize the GSEs and allow them to operate without further structural changes are misguided. Under such plans, the post-crisis reforms already achieved could be reversed at the discretion of future FHFA directors. And recapitalization absent comprehensive legislation would likely embolden those who seek private profit at the expense of sound public policy, while mortgage market participants may lose confidence in the prospects of serious reform, creating further uncertainty around business planning.

Finally, any movement towards recapitalization without corresponding reforms would be unnecessary from a safety and soundness perspective given the large levels of federal

support currently available to the GSEs. Even worse, this type of recapitalization plan would likely be counterproductive to efforts to develop and implement much-needed reforms.

We cannot go back to a housing finance system that provides private gains when markets are strong yet relies on support from taxpayers when losses occur. Only by enacting comprehensive legislative reform can borrowers, lenders, and investors realize the full benefits of a diverse, competitive primary market and a vibrant, liquid secondary market. The hard work of reform should proceed without delay.

Once again, I appreciate the opportunity to present this testimony, and I will reiterate MBA's long-standing commitment to working with the Committee on all elements of GSE reform.



**Exhibit A**

***Small Lender Access: Why It Matters***

# Small Lender Access: Why It Matters

It is important to recognize and address in reform legislation the role that limited access to the GSEs played in driving the sharp consolidation that began in the late-1990s. Between 1998 and 2010, the market share of the 10 largest single-family originators rose from less than 40% to almost 80%.

The GSEs played a significant role in driving this concentration. Beginning in the late 1990s, the GSEs competed for business by negotiating market share agreements with the largest volume lenders, providing lower guarantee fees and underwriting exceptions that drove even more business to these institutions. Unable to compete against lower guarantee fees and aggressive underwriting variances, smaller lenders were forced to deliver their loans to the largest lenders. This “aggregation” model played a contributing role in the GSEs’ financial troubles by driving underpriced guarantee fees, spreading weak underwriting standards, and concentrating counterparty risk into a handful of aggregators.

In the wake of the crisis, the market share of home mortgage originations from the larger institutions declined sharply. By 2015, large depository institutions’ market share had fallen to 21 percent for purchases, and 27 percent for refinances.<sup>A</sup> Several factors — legacy issues with pre-crisis mortgage and servicing portfolios, Basel III rules, regulatory burden and reputational risk in the mortgage business — all played a role in the decision of larger banks to shift their capital into more promising lines of business.

Fortunately for consumers, the gap in funding was filled by independent mortgage bankers (IMBs), whose market share in both purchases and refinances increased from the low-20s in 2008 to nearly 48 percent in 2015. Most of these institutions are smaller companies, but several IMBs grew to become top 20 originators. Community banks and credit unions also picked up market share, despite a decline of more than 1,100 reporting institutions.

Importantly, FHFA helped facilitate the transition through key policy changes intended to strengthen access to the GSEs for smaller lenders, including requiring guarantee fees to be based on the underlying loan risk (not loan volume), and eliminating preferential underwriting standards for selected institutions. Direct access to the GSEs’ cash and MBS windows played a critical role in the recovery by ensuring these smaller lenders could provide the liquidity the market needed.

MBA believes that the mortgage market and consumers benefit from a large and diverse base of lenders. Smaller lenders, in particular, play a key role in strengthening the system for consumers by focusing on niche markets and leveraging unique knowledge of local consumer needs. Recent post-crisis research shows that highly concentrated mortgage markets through the 2000s reduced the sensitivity of mortgage rates to movements in the MBS market, and that more competitive local markets tended to narrow primary-secondary market rate spreads and deliver lower rates to consumers.<sup>B</sup>

- To that end, the Task Force’s recommendations embody several key small-lender principles:
- Ensure equitable, transparent and direct access to secondary market programs;
- Prohibit G-fee pricing based on loan volume or asset size of single-family lenders;
- Preserve cash window and small pool execution options for smaller lenders;
- Maintain the “bright line” to ensure that Guarantors do not compete with lenders;
- Prevent vertical integration by prohibiting lenders from owning or controlling a Guarantor.

A. *MBA Executive DataBook, 2015 Origination Trends*, © 2016.

B. *Concentration in Mortgage Lending, Refinancing Activity and Mortgage Rates*, NBER Working Paper Series; David S. Scharfstein, Adi Sunderam, Working Paper 19156; <http://www.nber.org/papers/w19156>.

**Exhibit B**

***GSE Reform: Creating a Sustainable,  
More Vibrant Secondary Mortgage Market***

ONE VOICE. ONE VISION. ONE RESOURCE.



# GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market

This paper explains MBA's recommended approach to GSE reform, the last piece of unfinished business from the 2008 financial crisis. It outlines the key principles and guardrails that should guide the reform effort and provides a detailed picture of a new secondary-market end state. It also attempts to shed light on two critical areas that have tested past reform efforts — the appropriate transition to the post-GSE system and the role of the secondary market in advancing an affordable-housing strategy. GSE reform holds the potential to help stabilize the housing market for decades to come. The time to take action is now.

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# Executive Summary

The Mortgage Bankers Association (MBA) is the national association representing the full depth and breadth of the real estate finance industry. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, commercial banks, community banks, credit unions, thrifts, REITs, securitization conduits, life insurance companies and others in the mortgage lending field.

This paper is the product of more than a year's worth of work by MBA's Task Force for a Future Secondary Mortgage Market. The task force was created in March 2016 and directed to develop a proposal that will address the future of the secondary mortgage market as it relates to Fannie Mae and Freddie Mac (the Government Sponsored Enterprises, or "GSEs"), and in particular, an end state model that can also fulfill an affordable-housing/duty-to-serve mission. The members of this task force are made up of individuals from MBA member companies those in the market every day, representing a broad cross-section of the residential and multifamily real estate finance sectors, including entities of varying sizes and business models.

The task force considered many potential models in developing its recommendations for a new secondary market system, ranging from the formation of a government-owned corporation to restoration of the GSEs to their pre-crisis form. In assessing the trade-offs among various approaches, several core principles emerged as critical to ensuring the long-term health of the secondary mortgage market.

## Principles

We believe that all GSE reform options should be evaluated and measured against these core principles. Working from these principles, MBA's proposal is for a new government-guaranteed secondary market "end state" that would advance the following critical policy objectives:

- Maintain the liquidity and stability of the primary and secondary mortgage markets through the establishment of a resilient and vibrant housing finance system, throughout the transition process to the end state.
- Replace the implied government guarantee of Fannie Mae and Freddie Mac with an explicit guarantee at the mortgage-backed security (MBS) level only, supported by a federal insurance fund with appropriately priced premiums.
- Protect taxpayers by putting more private capital at risk through expanded front- and back-end credit enhancements.
- Establish strong capital standards and enhanced regulatory powers to ensure a sound and stable secondary market system.
- Promote a strong, diverse primary market through a level playing field for lenders of all sizes and business models.
- Ensure that there is a bright line separating the primary and secondary mortgage markets.
- Heighten competition by allowing the regulator of the new system (either the Federal Housing Finance Agency [FHFA] or a successor agency) to charter new entities ("Guarantors") to provide for securitization of eligible single-family and multifamily MBS.
- Preserve where possible the existing infrastructure — for example, a rechartered Fannie Mae and Freddie Mac could be the first two Guarantors.
- Strengthen affordable-housing policy consistent with sound lending principles and a holistic national housing strategy.
- Ensure that a robust private mortgage market can exist parallel to the government-backed market, with each complementing and balancing the other through different economic cycles.

## Recommendations

To achieve these policy objectives, the Task Force makes the following recommendations for a new end state for the government-guaranteed secondary mortgage market:

- The system would be a multiple Guarantor model, with at least two entities and preferably more.
  - + Rechartered successors to Fannie Mae and Freddie Mac would likely be the first two Guarantors.
  - + The regulator would be permitted to charter additional Guarantors, encouraging competition (or at least the threat of it). New firms would be able to apply for a Guarantor charter that authorizes them to serve either the single-family or multifamily market or both markets.
- Guarantors would compete primarily on operations/systems development, customer service, product parameters and innovation (within guidelines set by the regulator and the CSP for single-family mortgages), and pricing/execution.
- Additional private capital would come from rigorous capital requirements for Guarantors that could be satisfied through a combination of their own capital and proven means of credit risk transfer (CRT). Guarantors would be encouraged to disperse risk through credit risk transfers:
  - + Lenders would maintain their current role of obtaining primary market credit enhancement (e.g., deeper private mortgage insurance, recourse, and existing multifamily risk-share mechanisms).

**MBA believes that the transition to a new secondary-market end state remains among the most critical and challenging components of comprehensive reform.**

- Guarantors would be monoline, regulated utilities owned by private shareholders. Guarantor activities would include:
  - + Acquisition of single-family loans through both cash-window and MBS executions.
  - + Acquisition of multifamily loans through existing multifamily financing and other executions.
  - + Issuance of a single MBS for single-family mortgages through the Common Securitization Platform (CSP), which would be established and operate as a self-funded government corporation.
  - + Holding a limited mortgage portfolio intended only for aggregation prior to MBS issuance from cash-window operations, for delinquent loan buyouts and loss mitigation, and for limited multifamily purposes.
- Guarantors would also engage in secondary market risk sharing through reinsurance, structured notes and other instruments for institutional credit investors and existing multifamily risk-transfer executions.
- The regulator could reduce risk-sharing levels during periods of market duress.
- MBS issued by the Guarantors would be backed by the federal government's full faith and credit guarantee supported by a federal mortgage insurance fund (MIF).
  - + The MIF would be built up over time through appropriately priced insurance premiums paid by the Guarantors.
  - + The MIF would cover catastrophic risk, kicking in only in the event of a Guarantor failure after all layers of private capital had been exhausted.



- + The taxpayers would be at risk only after all layers of private capital and the MIF are exhausted.
- + In the event of a taxpayer bailout, future Guarantors would be tapped with higher insurance premiums going forward to reimburse taxpayers and rebuild the MIF reserves to their required reserve ratio.
- The entire system would be regulated by the FHFA (or a successor agency) with expanded authorities. This regulator would:
  - + Provide prudential supervision over the Guarantors, including requiring higher capital levels than in the pre-crisis system.
  - + Monitor and regulate target rates of return for the Guarantors, designed to attract investors seeking low-volatility, safe and consistent equity investments.
  - + Ensure fair and equitable access to the secondary market for lenders of all sizes (e.g., no preferential single-family pricing based on volume).
  - + Ensure that Guarantor activities comply with rules establishing a bright line separating the primary and secondary markets.

## Transition

MBA believes that the transition to a new secondary market end state remains among the most critical and challenging components of comprehensive reform. The path toward reform outlined in this paper seeks to minimize disruptions to the housing finance system during this transition, while bringing the new system up to speed in a reasonable time period and ensuring that genuine, sustainable reform occurs to increase the stability of the system. As a result, the Task Force's transition recommendations in this regard include elements that would mitigate the disruptive impact of the change:

- Preserving the existing human capital and operational processes at both GSEs and reasonably supporting their emergence as viable Guarantors.
- Transitioning to the new system over a multiyear period, with implementation occurring gradually to avoid market disruption and to build required capital.
- Reducing barriers to entry and allowing new entrants to become Guarantors as soon as possible in order to encourage competition.
- Utilizing FHFA and its existing legal authorities as the starting point, modified as necessary to accomplish the objectives of secondary market reform.



# The Essential Role of Congress: Why Congress Needs to Act

To create this new secondary mortgage market system, only Congress can:

- Change the existing charters for Fannie Mae and Freddie Mac;
- Create the Mortgage Insurance Fund (MIF) to guarantee eligible mortgage-backed securities;
- Establish a new, explicit government guarantee that stands behind the MIF;
- Empower FHFA or a successor regulator to grant charters to the new Guarantors;
- Provide the legitimacy and public confidence necessary for a long-term solution to housing finance reform.

- Encouraging the improvement of technology platforms supporting secondary mortgage market activities as part of the transition process.
- Providing the regulator sufficient flexibility to adjust the timing and execution of the transition based on market conditions or other critical factors to mitigate potential disruption.

- Improve liquidity for segments of the market that are currently underserved.

To achieve these missions, MBA recommends that the regulator periodically develop a comprehensive affordable-housing plan against which it would hold the Guarantors accountable. The key parts of the plan would be:

- The establishment of both quantitative and qualitative affordable-housing goals.
- The annual assessment of an affordable-housing fee (set within a permissible cost range defined by statute) on new business purchases of the Guarantors.

Because affordable-housing policy should be responsive to feedback from existing programs and seek new paths forward when necessary, the regulator would have flexibility to adjust the appropriate mix of goals and the fee to maximize the policy's effectiveness.

## Affordable Housing

Finally, MBA believes that America's housing finance system should meet the housing needs of the full continuum of households, from families residing in the most directly subsidized, affordable rental homes to those served by the prime jumbo single-family lending market. As part of this effort, the Guarantors operating in the government-guaranteed secondary market must serve three critical affordable-housing missions:

- Provide responsible, sustainable access to credit for prospective homeowners.
- Provide liquidity for the development and preservation of affordable rental housing.

# GSE Reform: Quick View

	GSEs PRE-Conservatorship	GSEs IN Conservatorship	Guarantors (MBA Model)
<b>Investor purpose</b>	Growth stock returns/risks	Conserve assets	Utility-level returns/risks
<b>Government backing of MBS</b>	Implicit government guarantee	Explicit government guarantee	Mortgage Insurance Fund (MIF) funded by premiums paid, backed by explicit government guarantee
<b>Government backing of corporate debt</b>	Implicit guarantee	Explicit guarantee	No guarantee
<b>Regulatory limitations on pricing</b>	No	Yes	Yes
<b>Retained investment portfolio</b>	Large	Reduced	Minimal
<b>Capital standards</b>	Low capital levels on both retained/guaranteed risk	Reduce capital cushion to zero by 2018	Enhanced Guarantor capital standards
<b>SF risk transfers to private market</b>	Front-end only (MI and lender recourse)	Testing back-end structures in addition to front-end	Deeper front-end and back-end
<b>MF risk transfers to private market</b>	Lender Risk Share	Lender and Capital Markets Risk Share/Transfer	Lender and Capital Markets Risk Share/Transfer
<b>Number of entities</b>	Two	Two	Two or more
<b>New Guarantor entrants permitted</b>	No	No	Yes
<b>SF lender access</b>	Preferential pricing and underwriting by loan volume	Guarantee fee and underwriting variances restricted	Prohibit guarantee fee and underwriting variances based on volume
<b>Support for single-family TBA market</b>	Yes	Yes	Yes
<b>Support for multifamily finance</b>	Yes	Yes	Yes
<b>Preserve operational infrastructure and processes</b>	Yes	Yes	Yes
<b>Affordable housing mission</b>	Yes	Yes	Yes



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MAIN ST

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# Introduction

Resolving the status of Fannie Mae and Freddie Mac (the GSEs), now nearing their ninth year of government conservatorship, remains the final piece of unfinished business from the 2008 financial crisis. The financial crisis plainly exposed the structural conflicts, misaligned incentives, and other weaknesses in the GSE business model and its regulatory framework. The result was a catastrophic failure of the secondary mortgage market that required more than \$187 billion in direct taxpayer support and a continuing federal commitment of more than \$250 billion.

Administrative reforms undertaken by the Federal Housing Finance Agency (FHFA), as both regulator and conservator of the GSEs, have resulted in significant progress in stabilizing the companies while paving the way for future reform. Indeed, the GSEs today, operating in conservatorship and subject to strict regulation, are in a state that is already closer to our recommended utility-model end state, relative to the pre-crisis GSE system that required dramatic federal intervention in 2008.

Meanwhile, legislative reform proposals introduced in both the U.S. House of Representatives and the U.S. Senate have yielded productive discussions but no concrete outcomes. Both chambers passed comprehensive GSE reform legislation in committee during the 113th Congress, but these efforts stalled for various reasons, including concerns about complexity, cost to consumers, fears of exacerbating the impact of credit and economic cycles, and the legislation's perceived lack of a sufficient affordable-housing strategy.

As the GSEs move closer to having no retained capital, the possibility of another draw from the U.S. Treasury — even if the GSEs incur just a modest loss — is very real. While the GSEs have an ample financial backstop remaining at Treasury, the current government-dominated system, in which the GSEs are in a state of conservatorship, is unsustainable over the long term. Looking ahead, establishing a strong, vibrant secondary mortgage market will be essential to help power economic growth and secure a more prosperous future. The stakes are high: GSE reform must be a top and immediate policy priority for the new administration and Congress.

To address the need for change, MBA formed a member task force last year to jump-start the reform conversation and develop a plan for a revitalized secondary market that could be implemented by Congress working with the next administration. The Task Force, representing a cross-section of both single- and multifamily lenders of varying sizes and business models, was charged with two overarching goals:

- Re-evaluate MBA's prior policy proposals for GSE reform and develop a durable end-state model that could facilitate access to mortgage credit through all economic cycles while protecting taxpayers;
- Evaluate a broad range of reform options, considering the trade-offs between different approaches as measured against a guiding set of principles; and
- Develop a vision for an affordable-housing strategy that could serve citizens along a continuum of economic circumstances.

To make the results of those efforts actionable, the Task Force was further charged with developing a road map that would ensure an orderly transition to the new secondary market system that will minimize disruptive impacts.

Our recommendations are outlined in detail below, along with a description of principles and guardrails critical to ensuring a healthy, stable and vibrant market for single-family and multifamily mortgages. We explain the recommended end-

state model and provide a transition road map designed to minimize disruption to the system and the broader economy. Finally, we outline our vision for supporting America's affordable-housing needs through the role of the Guarantors.

## Balancing Competing Priorities

In evaluating any proposal for GSE reform, three major objectives must be balanced: protecting taxpayers, attracting capital to Guarantors, and ensuring consumers and borrowers have access to affordable financing. Pushing too far in any direction may result in some of the objectives being missed.

- 1. Taxpayer Protection:** The system should greatly reduce the likelihood that it would require taxpayer support in all but truly catastrophic, systemic events. In order to accomplish this objective, the system should have significant private capital in place to absorb potential losses, a clearly defined government backstop, strict regulation and supervision, a well-defined credit box and carefully targeted efforts to make housing more affordable.
- 2. Investor Returns:** To generate the large amount of private capital required to fund such a system, the Guarantor business model and expected returns through the cycle need to be attractive. That is, private investors in the Guarantors would have a reasonable expectation of a market rate of return on a risk-adjusted basis. To achieve this objective, investors would want to ensure that capital requirements are not too high, regulation and supervision is not too expensive, credit standards are sound and efforts to make housing more affordable do not impinge significantly on returns. Being able to issue MBS with a government backstop, even if the backstop is paid for through insurance premiums, is a business benefit because the backstop ensures the market will stay open during financial market disruptions.
- 3. Consumer Cost and Access to Credit:** Homebuyers and borrowers are concerned with the all-in cost of obtaining financing. Higher capital requirements, more costly regulation and affordable-housing fees all add to consumer costs. Higher consumer costs, however, would likely be offset by a move to an explicit government guarantee of eligible MBS, as evidenced by the spread between prices on Ginnie Mae and GSE securities. Of course, not being able to get a loan — either because of tight credit criteria, increased costs or market disruption — has a negative impact as well. Roughly one-third of existing-home sales today go to first-time homebuyers, down from a historical average closer to 40 percent. One of the primary causes for this drop-off is the higher costs and tighter credit environment in today's mortgage market. For first-time buyers and others on the margin, a tighter credit box can mean being shut out of the market altogether. Efforts to extend affordability and access to underserved borrowers are one of the items that FHFA or its successor would closely monitor in the system we envision.

# Principles and Guardrails

## Principles

The Task Force developed the following core principles. Applying these principles is critical to ensuring that the end state provides the broadest possible liquidity through all economic cycles while protecting taxpayers.

- Preserve the 30-year, fixed-rate, prepayable single-family mortgage and long-term financing for multifamily mortgages.
- Maintain a deep, liquid to-be-announced (TBA) market for securities backed by conventional single-family loans.
- Attract global capital and preserve liquidity during times of economic stress through an explicit government guarantee for eligible MBS.
- Limit the explicit government guarantee to the eligible MBS, while prohibiting the extension of the guarantee to the equity or debt of the Guarantors.
- Require the Guarantors, as a condition of their charter, to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities.
- Support a competitive and diverse primary market for lenders of all sizes and business models.
- Enable a robust, innovative and purely private mortgage market to coexist alongside the government-backed market.
- Preserve existing multifamily financing executions and permit new options.
- Establish a strong, transparent regulatory framework that promotes liquidity while protecting the taxpayers.
- Ensure that private capital (including single-family loan-level credit enhancement such as mortgage insurance, lender recourse and other available forms of credit risk transfer) assumes most of the credit risk. For the multifamily finance market, the Guarantors would utilize current risk sharing and risk transfer structures used as part of Fannie Mae's Delegated Underwriter Servicing (DUS) program and Freddie Mac's K Deals, and other securitization structures to be developed.
- Ensure liquidity in the event of a full-blown systemic crisis.
- Minimize risks to the liquidity and stability of the mortgage markets during the transition to the end state, giving special attention to potential operational disruptions.







## Guardrails

MBA recognizes that reforming the secondary market presents certain risks — to taxpayers, consumers, and the stability of the housing finance system itself. To mitigate these risks, we have also developed the following guardrails — a statutory and regulatory framework designed to protect taxpayers, ensure liquidity, preserve what works today, and align incentives across both the primary and secondary markets.

### Structural Requirements

- The end state should allow for more than two approved Guarantors to issue government-guaranteed MBS. The new regulator, FHFA or its successor, should be authorized to grant charters subject to statutory requirements and regulatory guidelines, and the charters should not be limited in number.
- New entrants should be able to apply for a Guarantor charter to serve the single-family or multifamily market or both markets.
- The government guarantee should be explicit, funded by appropriately priced insurance premiums and limited only to the MBS issued by the Guarantors, and should not extend to the Guarantors or their corporate debt and equity.
- Guarantors should disperse credit risk to private-capital investors through a variety of CRT mechanisms in addition to the loan-level credit enhancement provided by the primary market.
- Guarantors should be stand-alone companies and should not be subject to undue influence by any individual shareholder. For example, individual lenders or bank holding companies should be limited to a maximum 10 percent ownership interest in any Guarantor.
- Guarantors' rate of return should be regulated using a utility regulation framework, with posted and transparent guarantee fee pricing designed to produce a reasonable rate of return for investors. The expectation is that the Guarantors will be low-volatility companies that would pay steady dividends over time, not growth companies that aggressively seek to expand market share or generate above-market returns.
- Guarantors should issue a single uniform type of security for securitizing single-family mortgages.
- The CSP should be established as a self-funding, government-owned corporation and must be accessible to new Guarantors once chartered.

- To reduce barriers to entry for future Guarantors, the CSP should own all GSE historical single-family data. New Guarantors and other market participants should be able to access and analyze this information for an administrative fee.
- The end state should have established mechanisms in place to respond to liquidity disruptions during severe market downturns or catastrophic events. These mechanisms should aim to stabilize the overall housing finance system and not necessarily the Guarantors.

## Prudential Regulation

- The end state regulator should have sufficient powers and discretion with respect to capital regulation and other aspects of prudential oversight.
- Single-family loans eligible for inclusion in the government-backed MBS should meet a Qualified Mortgage (QM) type standard and be subject to conforming loan limits established by Congress and adjusted over time based upon home-price appreciation in a manner determined by the regulator. Guarantor credit parameters within the QM-eligibility framework, pricing engines and customer interfaces would be subject to prudential oversight, but should remain proprietary to each Guarantor. Multifamily mortgages of a type and quality similar to those financed by the GSEs today would also be eligible for inclusion in the government-backed MBS.
- Guarantors may not hold mortgage portfolios for investment purposes. However, they may hold a short-term liquidity book to aggregate loans from cash-window operations, a contingency portfolio for loss-mitigation purposes and a limited multifamily portfolio.
- Guarantors that reach a given size should be designated and regulated in a manner similar to systemically important financial institutions (SIFIs).

## Market Conduct Regulation

- Charters should expressly maintain a bright line between the primary and secondary mortgage markets, with the Guarantors' allowable activities being limited to the secondary market, to guard against systemic risk concentration and to facilitate competition.
- The regulator should ensure that Guarantors provide equitable, transparent and direct access for lenders of all sizes and types — pricing and program participation should not be based on the loan volume or asset size of participating lenders.
- Guarantors should be required to maintain both cash-window and MBS execution options in order to support large and small lenders alike.
- Guarantors, as a condition of their charter, should be required to support an effective national affordable-housing strategy that helps meet the needs of low-income and underserved households and communities. This strategy should incorporate both single- and multifamily approaches to support homeowners and renters.

In the recommended end state, the Guarantors would be focused exclusively on providing sustainable credit availability to the single-family and multifamily markets in all geographies and through all economic cycles.

# Small Lender Access: Why It Matters

It is important to recognize and address in reform legislation the role that limited access to the GSEs played in driving the sharp consolidation that began in the late-1990s. Between 1998 and 2010, the market share of the 10 largest single-family originators rose from less than 40% to almost 80%.

The GSEs played a significant role in driving this concentration. Beginning in the late 1990s, the GSEs competed for business by negotiating market share agreements with the largest volume lenders, providing lower guarantee fees and underwriting exceptions that drove even more business to these institutions. Unable to compete against lower guarantee fees and aggressive underwriting variances, smaller lenders were forced to deliver their loans to the largest lenders. This “aggregation” model played a contributing role in the GSEs’ financial troubles by driving underpriced guarantee fees, spreading weak underwriting standards, and concentrating counterparty risk into a handful of aggregators.

In the wake of the crisis, the market share of home mortgage originations from the larger institutions declined sharply. By 2015, large depository institutions’ market share had fallen to 21 percent for purchases, and 27 percent for refinances.<sup>A</sup> Several factors — legacy issues with pre-crisis mortgage and servicing portfolios, Basel III rules, regulatory burden and reputational risk in the mortgage business — all played a role in the decision of larger banks to shift their capital into more promising lines of business.

Fortunately for consumers, the gap in funding was filled by independent mortgage bankers (IMBs), whose market share in both purchases and refinances increased from the low-20s in 2008 to nearly 48 percent in 2015. Most of these institutions are smaller companies, but several IMBs grew to become top 20 originators. Community banks and credit unions also picked up market share, despite a decline of more than 1,100 reporting institutions.

Importantly, FHFA helped facilitate the transition through key policy changes intended to strengthen access to the GSEs for smaller lenders, including requiring guarantee fees to be based on the underlying loan risk (not loan volume), and eliminating preferential underwriting standards for selected institutions. Direct access to the GSEs’ cash and MBS windows played a critical role in the recovery by ensuring these smaller lenders could provide the liquidity the market needed.

MBA believes that the mortgage market and consumers benefit from a large and diverse base of lenders. Smaller lenders, in particular, play a key role in strengthening the system for consumers by focusing on niche markets and leveraging unique knowledge of local consumer needs. Recent post-crisis research shows that highly concentrated mortgage markets through the 2000s reduced the sensitivity of mortgage rates to movements in the MBS market, and that more competitive local markets tended to narrow primary-secondary market rate spreads and deliver lower rates to consumers.<sup>B</sup>

- To that end, the Task Force’s recommendations embody several key small-lender principles:
- Ensure equitable, transparent and direct access to secondary market programs;
- Prohibit G-fee pricing based on loan volume or asset size of single-family lenders;
- Preserve cash window and small pool execution options for smaller lenders;
- Maintain the “bright line” to ensure that Guarantors do not compete with lenders;
- Prevent vertical integration by prohibiting lenders from owning or controlling a Guarantor.

A. *MBA Executive DataBook, 2015 Origination Trends*, © 2016.

B. *Concentration in Mortgage Lending, Refinancing Activity and Mortgage Rates*, NBER Working Paper Series; David S. Scharfstein, Adi Sunderam, Working Paper 19156; <http://www.nber.org/papers/w19156>.





In the recommended end state, the Guarantors would be focused exclusively on providing sustainable credit availability to the single-family and multifamily markets in all geographies and through all economic cycles.







# The End State

In many respects, MBA's proposal is intended to preserve what works in the current system — it supports a highly competitive primary mortgage market composed of lenders of a variety of sizes and business models. Primary market lenders place loan-level credit enhancements; including private mortgage insurance, lender recourse and multifamily risk-share structures. All of these primary market activities take place on one side of the bright line, the dividing line between primary and secondary market activities.

Lenders would sell conventional conforming loans into the secondary market by working with Guarantors. Lenders would also continue to originate and securitize loans utilizing other forms of guaranteed and non-guaranteed options, including Federal Housing Administration (FHA), U.S. Department of Veterans Affairs (VA), U.S. Department of Agriculture (USDA), Ginnie Mae and conventional loans held on bank balance sheets or securitized through private-label securities (PLS).

From a lender's perspective, the process of selling conventional conforming loans should be similar to the current process. Lenders could sell through a cash window or pool loans into securities. The Guarantors, including rechartered Fannie Mae and Freddie Mac and any new entrants, would manage the credit risk on these pools, and would be the issuers of the MBS. Single-family securitizations would utilize the CSP, at which time the explicit guarantee is placed on the MBS for the benefit of investors, ensuring timely payment of principal and interest. A portion of the guarantee fee would be used by the Guarantors to cover the MIF premium.

Each of the Guarantors would issue into a single security. Most likely, the single security would be structured the same as the forthcoming Uniform MBS (UMBS), but will also have an explicit guarantee. Investors will trade single-family MBS through a TBA market similar to today.

Multifamily loans sold to the Guarantors would be securitized in the same manner as today, utilizing current executions such as Fannie Mae's DUS program, Freddie Mac's K Deals, and perhaps other securitization and risk-sharing/transfer structures to be developed by Guarantors and approved by the regulator.

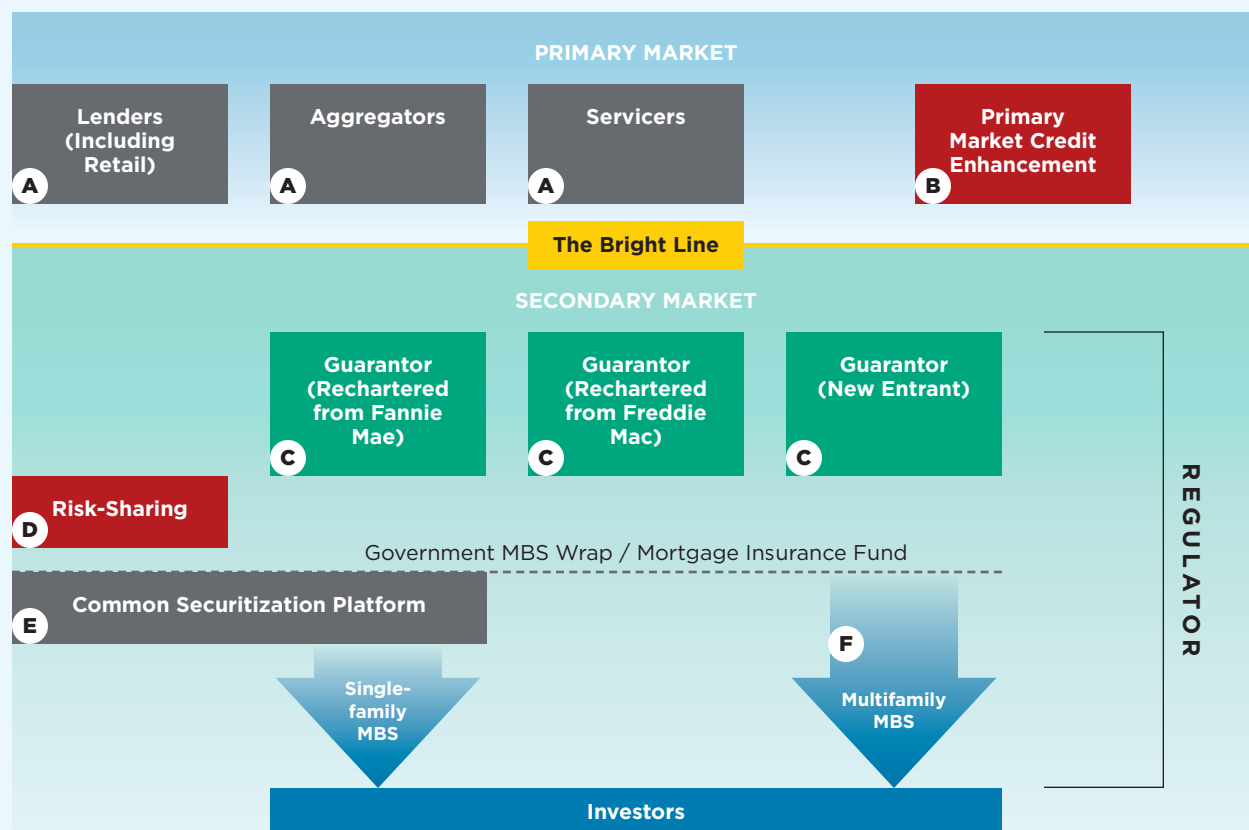
The Guarantors would manage the credit risk on these mortgages through underwriting, retained capital and through front-end and other risk sharing. In addition, Guarantor pricing would be tightly regulated by the regulator just as GSE pricing is tightly regulated by FHFA as conservator.

## Number of Guarantors

MBA believes there should be multiple (i.e., more than two) Guarantors that are authorized to acquire eligible loans from lenders and issue government-guaranteed single-family and/or multifamily MBS. Legislation should authorize a process to allow other entities to apply for and receive a charter, similar to the current process for applying for a national bank charter. A new charter could be specific to the single-family market, multifamily market or both markets.

As a utility-style regulator, one of the key factors the FHFA would be required to consider would be the impact of new competitors on both existing Guarantors, on the relevant market and on consumers. Maintaining the balance in the regulatory compact would be an important factor in evaluating new charters. FHFA would determine whether the applicants meet the standards for a Guarantor charter.

# End State Model



## Primary Market

- A. **Single-family lenders (including correspondent aggregators) and servicers.** Would be explicitly afforded "level playing field" in delivery/credit enhancement and pricing terms, regardless of volume. **MF Lenders** would operate in the same fashion as today.
- B. **Primary market credit enhancement.** To ensure that private capital assumes most of the credit risk, and that the risk is dispersed rather than overly concentrated, the regulator may require certain levels of single-family loan-level credit enhancement (such as mortgage insurance, lender recourse, loss sharing) and other forms of secondary market risk-sharing (see box "D"). Current MF executions and risk sharing would remain and retain existing platforms, and not be part of the single security.

## Secondary Market

- C. **Chartered Guarantors.** Monoline, regulated rate of return utilities owned by private shareholders; rechartered Fannie and Freddie could be the first two. Corporate debt NOT backed by government. Acquires loans in order to issue MBS (including SF single security) and credit risk transfer (CRT) instruments; performs master servicer functions. Subject to prudential supervision by FHFA or its successor, including strong regulatory oversight of operations, and supplemental regulation similar to SIFs. Mortgage portfolios allowed ONLY for liquidity/contingency purposes (esp. for delinquent loan (DQ) buyouts/loss mitigation) and short-term cash window

and limited multifamily investment. Would compete on operations/systems development, customer service, certain product innovation (w/in CSP and regulator guidelines) and pricing/execution. Primary regulator would enforce duty to serve requirements. Would remit commitment fee to government for federal wrap on MBS; could also include an affordable-housing contribution fee.

- D. **Secondary market risk-sharing.** Reinsurance, structured note and other forms of distributing Guarantor portfolio risk to institutional credit investors. Secondary market risk-sharing, as well as various forms of loan-level credit enhancement (see box "B"), would be used to protect taxpayers and would be actively monitored by the regulator to ensure safety and soundness. Per regulatory determination, risk-sharing requirements could be reduced during a stress environment as part of a countercyclical role.
- E. **CSP.** Issuance platform for government-backed single-family MBS. Validates collateral, processes disclosures/issuances. Owns existing GSE historical data/compensating factors analysis and QM compliance engine. Owned independent of Guarantors as a government corporation, and able to facilitate PLS as separate business.
- F. **Multifamily.** Existing DUS and K-deal programs are preserved. Could be subject to separate charter to facilitate multifamily-only guarantor.

A credible threat of additional entrants would encourage dynamism and spur the Guarantors to provide better service to their seller/servicers and ultimately to consumers. In addition, the prospect of new Guarantors would ensure that the existing Guarantors have an incentive to compete against each other in areas such as:

- Offering technology solutions and systems for interfacing with seller/servicers;
- Structuring and executing risk-sharing transactions;
- Product innovation;
- Pricing and execution; and
- Customer service.

## Operating Structure

From the perspective of a lender or investor, Guarantors would operate in a way similar to how the GSEs operate today to perform critical secondary mortgage market functions. As an example, we strongly urge the continuation of both GSEs' multifamily operations in their current form. The Guarantors' single-family operations would also be similar to today's market, with their activities focused on purchasing eligible mortgages and issuing mortgage-backed securities wrapped by the full faith and credit of the federal government, and dispersing credit risk to private investors.

The Uniform MBS, scheduled to launch in 2019, should be the basis for the single-family MBS issued by the Guarantors in order to maximize liquidity. Guarantors would be provided incentives to distribute credit risk to private market investors rather than retaining all of the risk. Single-family risk transfer would consist of both (1) front-end, lender-arranged primary market credit enhancement like mortgage insurance and lender recourse,

## What Is the Bright Line?

CONCEPT  
IN DEPTH

**MBA has historically held that the proper role of Fannie Mae and Freddie Mac is confined to the secondary mortgage market, consistent with their respective charters. We believe that the separation of the primary and the secondary markets has been an important element of what has made the secondary market effective in providing liquidity and making mortgage credit available nationwide. The division between the primary and secondary markets has become known as the “bright line.”**

The separation of primary and secondary mortgage market activities is embedded in the GSEs' statutory charters. Both GSEs' charters expressly prohibit the use of their lending authority “to originate mortgage loans” — the defining primary market activity.

More broadly, the public purposes set forth in their respective charters, which are substantively similar in this regard, specify a secondary mortgage market role that is responsive to private capital: “To provide stability in the secondary market for residential mortgages; to respond

appropriately to the private capital market; to provide ongoing assistance to the secondary market for residential mortgages... by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.”

Given the critical role that this separation has played in the nation's mortgage markets, MBA underscores the importance of maintaining the bright line, both as it governs current GSE activities and in our recommended end state.



# How Will the Guarantors Compete and Why Will This Competition Benefit Consumers?

The secondary mortgage market benefits from alignment and standardization in many areas. Outside of these areas, however, Guarantors (new entrants and rechartered GSEs) should compete with each other on price, product, and service.

## Price

Some question the feasibility of price competition because Guarantors would be restricted by the same capital standards and qualified mortgage (QM) limitations. But think of a close parallel: thousands of banking institutions are subject to similar capital standards and regulation, and yet a variety of business models flourish. Even though all face similar capital standards, they engage in price competition along a number of dimensions.

Others have argued that price competition would be impossible because any competitor with the lowest price for the safest business would skim the cream off of the market, leaving others unable to earn a market return. Adverse selection is always a concern but pricing for risk is rarely one-dimensional and market participants are always dealing with uncertainty regarding potential outcomes, not just risk.

## Product

Within the umbrella of Qualified Mortgage status for eligible single-family mortgages, there would be no ability for Guarantors to offer high-risk products such as NINJA (no-income, no-job, no-asset) loans or other non-QM products. But there would be room for product development and product differentiation within the QM rubric.

For instance, new adjustable-rate mortgage (ARM) products that are viable under QM have been developed recently as portfolio products. We are currently in a predominantly fixed-rate market, but if rates do rise as expected, it is likely that the ARM share of the market will increase. Future Guarantors would also compete on product development to meet a range of housing needs (e.g., condos) just as the GSEs do now.

## Service

Beyond pricing and product strategy, as any lender knows, service matters, too. The GSEs both have experienced, knowledgeable sales forces with deep understanding of lenders operating in the primary market. With this knowledge, they have been able to provide differentiated offerings of services, along with product and service bundles, which fit large and small, bank and nonbank, publicly held and privately owned customers.

Superior service can win customer loyalty even if the product and pricing strategy is not always the “best.” Just like any other business, there are aspects that are difficult to quantify but are nonetheless extremely important.

Of course, poor service can also have an impact. In the post-crisis environment, many lenders were unhappy with the GSEs’ approach to repurchase demands and “rep and warrant” enforcement. In a more competitive market, this behavior could have led lenders to move away from the GSEs. In the absence of such competition, lenders had little negotiating leverage.

Even the potential for additional competition can have an impact. Economist William Baumol coined the term “contestable markets” to recognize the fact that if new competitors could potentially enter a market, even that threat of entry can help to ensure that incumbents will provide good service and will keep their pencils sharpened with respect to pricing and product strategy.

# What is a “Qualified Mortgage” (QM)?

CONCEPT  
IN DEPTH

The Dodd-Frank Act’s ability-to-repay/Qualified Mortgage (QM) rule requires single-family lenders to determine that a borrower has a reasonable ability to repay a mortgage before the loan is consummated. The rule provides a compliance safe harbor for mortgage loans that are originated as QMs. In order for a loan to qualify as a QM, it may not contain certain “risky” features, such as interest-only or negative-amortization terms, and it must meet specified underwriting standards.

These standards also include a debt-to-income ratio cap of no more than 43 percent, or in the alternative, eligibility for the programs of Fannie Mae and Freddie Mac (“the patch”), the Federal Housing Administration (FHA) or other government agencies. The safe harbor is also limited to loans that are of “prime” quality based on a pricing benchmark. Considering the significant potential liability and litigation expenses for a violation of the rule, many lenders have limited themselves to making only QM “safe harbor” loans.

As a result, some categories of borrowers who should qualify for a QM are having trouble gaining access to safe, sustainable and affordable mortgage credit. MBA is continuing to work with policymakers, including the CFPB, to improve the rule in order to responsibly widen the credit box.

As the QM patch will expire in 2021, legislation and/or regulatory action is necessary to formulate this QM standard going forward.

and (2) back-end structures such as reinsurance and capital markets transactions developed by the Guarantors for the credit-investor market.

MBS eligible for the government guarantee would consist of single-family mortgages that meet current or future QM standards. However, Guarantors would be able to define their own credit criteria within the government’s eligibility parameters. Making Guarantor credit decisions open to competition is one of the most important reasons for having multiple competing Guarantors. We believe this approach is superior to a structure in which a single, monopolistic entity provides the government guarantee.

## Common Securitization Platform

The Common Securitization Platform is expected to play a significant role in the future single-family market, though repurposed in critical ways. The CSP would be required to facilitate issuance of MBS backed by eligible loans/pools presented by any Guarantor, reducing barriers to entry for future entrants. In connection with its core functions, the CSP would also collect the insurance premiums from the Guarantors and remit them to the Mortgage Insurance Fund (MIF), as described below.

The CSP would also house all GSE historical single-family data. In exchange for an administrative fee, prospective Guarantors and other market participants would be able to access this data. Transferring historical data to the CSP and making it available will provide more opportunities for standardization and transparency, while removing a critical barrier to entry for future Guarantors.

Because the CSP’s functions are those of a natural monopoly — the sole entity that can review and certify conventional single-family MBS as eligible for issuance with a government guarantee — the CSP should be established as a government corporation under the direction of the FHFA. As a government corporation, it would not rely on federal appropriations and would fund its operations exclusively through the fees it collects as part of the issuance and guarantee process.

# The Common Securitization Platform (CSP): What is it? How is it Funded and Regulated?

**What is the CSP?** As described by Freddie Mac, the “CSP is a technology and operational platform that is being developed by Common Securitization Solutions, LLC, a joint venture of Fannie Mae and Freddie Mac. CSP will perform many of the core back-office operations for the Single Security, as well as most of the Enterprises’ current securitization functions for single-family mortgages, on behalf of the Enterprises. The CSP is necessary for the implementation of the Single Security.”

**Why is the CSP important?** The CSP provides many potential benefits. First, it has significantly upgraded the core infrastructure at the heart of the agency MBS market. Second, by updating it jointly for Fannie Mae and Freddie Mac, it has fostered the alignment necessary to support the Single Security.

Beyond the benefits to the market while the GSEs are in conservatorship, the CSP also paves the way for new entrant Guarantors under the recommended end state. To make a transportation analogy, without a CSP, a new entrant would need to lay the tracks for a new railroad along with buying the locomotive and train cars. With the CSP, it will still be a major effort to launch a new Guarantor, but the infrastructure will be in place and available, dramatically lowering the barriers to entry, particularly as the new Guarantor would also be able to issue into the Single Security.

**How will it work in the MBA model?** Currently the CSP is a joint venture of Fannie Mae and Freddie Mac. The CSP should be carried forward in the new end state, with new entrants given the opportunity to directly connect once they have received their Guarantor charter from the regulator. However, MBA believes that a better long-term structure for the CSP would be as a government corporation overseen by FHFA. Fannie Mae and Freddie Mac would be compensated for their shares of the CSP as part of the transfer to a government corporation.

The CSP would be run by its own executive with the authority to hire staff and budget to keep the platform operating efficiently. FHFA would manage the MIF, but the operational task of issuing MBS with the explicit guarantee would fall to the CSP. The CSP would be funded through administrative fees on the issuance of MBS and not through federal appropriations. Given its status as a government corporation, it would target a modest rate of return to ensure adequate staffing and necessary technology upgrades over time.

**Why government ownership?** As the foundation of the secondary market’s critical infrastructure, the CSP in economic terms is a “natural monopoly,” with economies of scale such that it makes sense to only have a single operator. Moreover, in this role, the CSP truly cannot fail, for if it did, the market would shut down. The two choices available in this type of situation are for the government to form a corporation to operate the entity or for the government to bless and then tightly regulate a financial market utility that may be cooperatively owned. MBA believes that a government corporation makes more sense, as it eliminates the concerns with respect to a private entity being too big to fail. However, as the debate develops, the choice between the relative merits of a government corporation versus a financial market utility should continue to be considered.

**What are some examples of Government Corporations?** Several representative government corporation models illustrate the wide variety of structures of federal government corporations, including Ginnie Mae, the Federal Deposit Insurance Corporation (“FDIC”) and the Pension Benefit Guaranty Corporation (“PBGC”). These examples warrant further study as possible models for the CSP.

## Privately Owned Utility Model

MBA believes that the Guarantors should be owned by private shareholders and regulated as utilities. Private ownership would better encourage ongoing investment in the Guarantors, allowing them to keep pace with market demands and technological developments.

Prior to the crisis, Fannie Mae and Freddie Mac operated as “growth” companies, aggressively pursuing market share, leveraging their capital and implied guarantees, and promising investors growth-stock returns on equity. MBA believes that, given their unique ability to distribute the government guarantee, chartered Guarantors should be required to focus on long-term, steady returns that support a stable housing finance delivery system similar to the way public utilities must support power, water or other critical infrastructure.

Management of the Guarantors should be focused on providing a steady, although not risk-free, stream of dividends over time. The lower-risk, lower-volatility equity investment in the Guarantors should be attractive to investors seeking a competitive, risk-adjusted rate of return while receiving higher dividend yields than are available from fixed-income instruments.



As regulated rate-of-return utilities, the Guarantors would have the following characteristics:

- Operated as monoline businesses;
- Directed by charter and regulation to serve the defined public purposes of ensuring mortgage liquidity and broad access to credit;
- Subject to tight regulation of their activities and strong corporate governance;
- Owned by patient-capital investors;
- Held to explicit capital requirements by their regulator; and
- Incentivized by profit motive to innovate and compete.

Although our proposal would not require the Guarantors to be mutually or cooperatively owned and managed by lenders, we believe the new regulatory system should permit the chartering of lender-owned mutuals, provided ownership was broadly distributed. For example, no single lender or bank holding company should be permitted to hold more than a 10 percent ownership interest,<sup>1</sup>

## What Is the Single MBS?

CONCEPT  
IN DEPTH

One of the strategic goals of the Federal Housing Finance Agency is to develop a single mortgage-backed security in the single-family market that could be issued and guaranteed by Fannie Mae or Freddie Mac. Currently, the securities issued by each of the GSEs are not interchangeable with one another. A single MBS would enhance access to the TBA market, improve overall liquidity, reduce costs to taxpayers, lower barriers for prospective new entrants, and lay the groundwork for a more competitive and efficient secondary market. MBA strongly supports this effort.

<sup>1</sup> A 10 percent ownership limitation to prevent undue influence would be comparable to a provision in Federal Reserve regulations that establishes a rebuttable presumption of control when a person, or persons acting in concert, acquire a 10 percent interest in a state member bank or bank holding company. See 12 CFR 225.419(c).



to prevent it from having undue influence over the Guarantor. A mutual or cooperative structure could prove to be an attractive option for either of the successors to the GSEs or a new Guarantor entrant.

In addition, reform should establish mechanisms to address liquidity disruptions during severe market downturns that would aim to stabilize the overall housing finance system and not necessarily the Guarantors.

## Capital

To ensure that additional private capital is placed at risk ahead of the MIF, the federal government and taxpayers, MBA's proposal would give the regulator authority to set specific capital levels, both risk-based and overall leverage limits/ratios. In making that recommendation, we recognize that setting capital requirements is a complex exercise and that setting them correctly is vital, particularly since the GSEs were insufficiently capitalized to survive the financial crisis.

Establishing the appropriate level (and types) of capital depends upon the credit quality of the underlying loans, on an understanding of stressful environments, their likelihoods and their impacts on credit losses. Moreover, capital requirements cannot be set in isolation. Capital standards should require

similar capital for similar risks, regardless of the charter or business model of the entity holding the risk. When that is not the case, there will be regulatory capital arbitrage, with loans flowing to whichever entity has the lower capital requirement for each type of loan, rather than the entity that is best equipped to hold and manage the risk. Fannie Mae and Freddie Mac were insufficiently capitalized to survive the crisis. MBA's proposal requires that Guarantors have sufficient capital to cover all but catastrophic risk.

Congress should have the regulator develop a stress loss capital standard rigorous enough that Guarantors meeting that standard could have withstood the Great Recession. These capital requirements for the Guarantors, including the types of instruments that count as capital, should be consistent with the capital requirements for single-family and multifamily mortgages set for banks and other competing investors in mortgages such as insurance companies, in order to ensure that similar risks require similar capital, regardless of where those risks are held. The capital base for the requirement should primarily be composed of Tier 1 capital, i.e., common and preferred equity, but should also provide capital relief to the Guarantors for distributing rather than retaining credit risk, so long as this is done on an economically sensible, equity equivalent basis.

Background on the regimes governing banks, insurance companies, SIFIs and the impact of credit risk transfer mechanisms should be looked to as guides for the development of Guarantor capital requirements.

## Bank Capital Requirements and Supervision

The objective of bank capital regulation is to reduce the probability of a bank failure, which could put the taxpayer at risk as the government insures deposits. Bank capital regulation has evolved considerably over the past 30 years. In 1988, Basel I, developed by the Basel Committee on Banking Supervision, introduced the notion of risk-based capital requirements, with different risk weights applied to different types of assets. For example, Treasury securities carried a zero percent weight, agency MBS a 20 percent risk weight and residential mortgages a 50 percent risk weight. Banks were required to have total capital, composed of both common and preferred equity, subordinated debt and other components, of at least 8 percent of risk-weighted assets. Thus, for mortgages, banks were effectively holding 50 percent risk-weighted capital (half of 8 percent = 4 percent), almost 10



# Regulated Utility Model: How Does it Work?

**MBA has proposed that the Guarantors be regulated similar to investor-owned utilities. The core justification for utility style regulation rests with the premise that the privately-owned utility derives much of its existence and its powers from the state.**

The key tenet of regulating privately-owned utilities is the “regulatory compact:” private firms that are granted an exclusive or limited number of franchises accept the responsibility (and the regulatory oversight) to serve customers in an efficient and nondiscriminatory manner. This compact requires a balancing of interests by the regulator:

“Investors will only provide capital for provision of utility services if they anticipate obtaining a return that is consistent with returns they might expect from employing their capital in an alternative use with similar risk; customers will only accept utility rates if they perceive that the rates fairly compensate the utility for its costs, but are not excessive as a result of the utility taking advantage of its privileged position.”<sup>A</sup>

In addition to the legal and economic rationale for utility-style regulation of the Guarantors, this framework is also intended to directly address the problematic growth-company models and mindsets that existed at the GSEs prior to the financial crisis. The compulsion to grow led to excessive risk taking in a reach for market share, an unhealthy focus on the portfolio businesses and encroachment on the bright line, as the GSEs leveraged their duopoly power to grab an ever-larger share of industry profitability.

By contrast, investor-owned utilities — and their regulators — aim to provide shareholders with a steady dividend over time. Utilities are encouraged to deploy large capital outlays in relatively low risk, regulated business models to achieve stable outcomes for investors and consumers. Companies with this mindset

and culture in competitive markets compete through more efficient operations, product and process improvements, and customer service.

Investor-owned utility regulation is based on “cost of service regulation.” The regulatory compact requires a two-fold focus:

“(1) establish prices based on the actual prudent costs (i.e., avoid monopoly pricing); and

(2) provide incentives to maintain a reasonable level of efficiency in serving the customers. Rates are set with reference to the Total Revenue Requirement (TRR)...”<sup>B</sup>

Regulators can directly monitor and control rate of return or pricing. For monopolies, regulators may set rates based upon observed costs and an agreed-upon level of return. In markets with multiple utilities operating, those with significant market power may be held to regulated, cost-based rates, while new entrants may be allowed greater flexibility to charge market-based rates.

Typically price regulation in these markets requires nondiscriminatory pricing across the customer base, i.e., there is a level playing field. Pricing also tends to be transparent, with rates and the rate calculation posted for public input.

Clearly many aspects of this style of regulation and business model are good fits for the role of Guarantors in a future market. Moreover, FHFA in its role as conservator has moved regulation of pricing in this direction already, with more level and more transparent pricing than was the case pre-crisis.

A. *Cost of Service Regulation In the Investor-Owned Electric Utility Industry: A History of Adaptation*; Dr. Karl McDermott, Edison Electric Institute. 2012.

B. Ibid.

times the GSE requirement. Additionally, banks were held to a leverage limit, which required that capital made up at least 4 percent of their total assets.

By the mid-2000s, bank regulators were concerned that the simple risk-based capital weights were causing distortions in the financial markets because these weights did not align with the underlying risk — and in fact in many cases led to regulatory capital arbitrage — where banks were holding riskier assets that had relatively low risk weights while selling safer assets that had higher risk weights. Within the mortgage market, an example was the ability of a bank to sell a low-risk mortgage with a 4 percent capital requirement in exchange for an MBS with a 1.6 percent capital requirement, but that might hold a higher-risk mortgage that could be a profitable investment at the 4 percent capital level. This led to a large incentive for banks to securitize conforming mortgages with the GSEs and hold the MBS. Given that the GSEs were only required to hold 0.45 percent against the off-balance-sheet MBS, the financial system as a whole held less capital against the mortgages than would have been the case if the loans had remained on bank books.

Basel II was an attempt to provide a more flexible risk-based approach, but the effort in fact may have led to too little capital in the banking system.

Following the crisis, Basel III was an effort to enhance the quantity and quality of capital backing the banking system. Regulators and accounting treatment brought more assets onto the balance sheet. There was also a move to both higher minimum capital ratios and a greater reliance upon common equity as the primary form of loss-absorbing capital. The risk weights for holdings of residential mortgages were left unchanged. However, the risk-based capital treatment of mortgage servicing rights (MSRs) was much more severe, with an effective cap of 10 percent of equity capital and a higher risk weight.

Another change post-crisis has been much greater regulatory action around stress testing. The Comprehensive Capital Analysis and Review (CCAR) program is a horizontal review of large banking organizations. The Federal Reserve provides a set of adverse economic scenarios the large banks use to simulate how their organizations would fare with respect to having sufficient capital. The Fed then uses the results of these stress tests as an input into its approval of bank dividend and stock buyback programs. Regulators are viewing stress tests as a more dynamic approach to measuring a financial

institution's strength. (FHFA requires that Fannie Mae and Freddie Mac conduct a similar exercise using the stress scenarios posited by the Fed.)

## Insurance Capital Requirements

In the United States, insurance is regulated at the state level, with some consultation among the different state regulators. Insurers are also regulated against capital standards, but these are often expressed relative to risk-in-force rather than total or risk-weighted assets. Insurance regulation is also more likely to see a stream of future premiums as a source of loss-absorbing capacity, and hence looks to be sure that pricing is sufficient to cover losses under all but the most catastrophic scenarios.

In MBA's proposal, with the Guarantors having only a minimal investment portfolio holding assets of short duration, insurance regulatory concepts may become more applicable than bank regulatory concepts.

## SIFI Requirements

Dodd-Frank gave the Financial Stability Oversight Council (FSOC) the authority to designate financial firms systemically important financial institutions (SIFIs) if they "could pose a threat to the financial stability of the United States." SIFIs are subject to oversight from the Federal Reserve and stricter capital requirements. At present, bank holding companies with more than \$50 billion in assets are subject to SIFI regulation. Four non-bank SIFIs have been designated. SIFIs are subject to tougher regulatory oversight than their smaller and less complex competitors.

Should they meet that threshold, Guarantors should be held to SIFI-consistent capital requirements and regulatory supervision to eliminate the potential for regulatory capital arbitrage. Capital requirements should be set in consultation with the Federal Reserve, FSOC and Treasury. Guarantors should also be subject to regular stress tests comparable to, if not part of, the CCAR process.

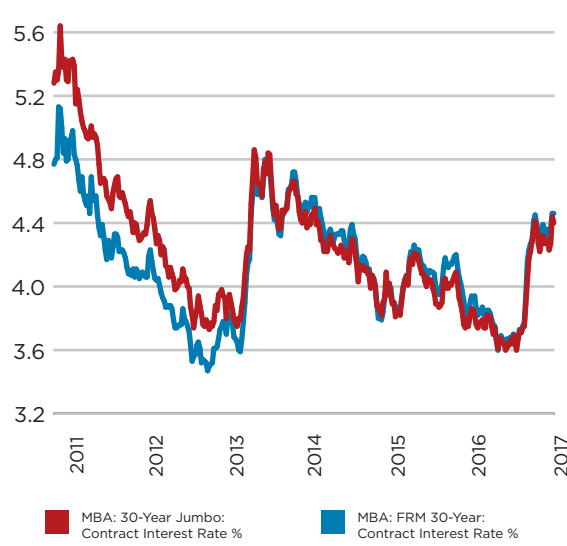
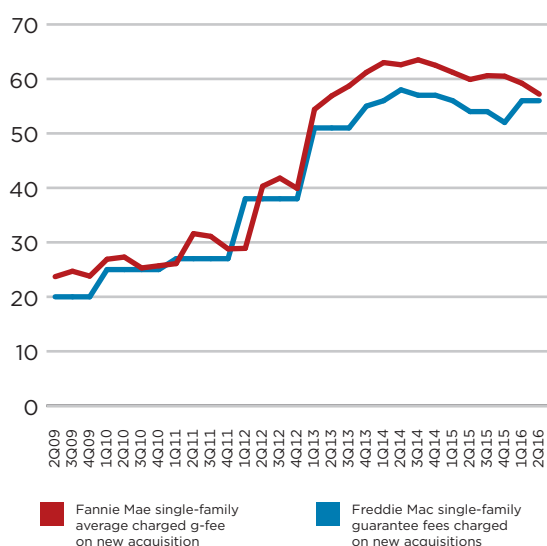
Institutions that exceed the SIFI threshold are not "too big to fail." However, they may be too big to resolve quickly. As a result, they are required to adhere to stricter regulation to ensure that they have sufficient resources to be sustained through a crisis and longer resolution period.

# GSE Capital Requirements Pre-Crisis and through HERA

In the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, Congress precisely defined the contours of an economic scenario that would form the basis for Fannie and Freddie's risk-based capital requirements, and also defined minimum capital levels, which would limit the GSEs' leverage.

For loans or securities kept on balance sheet, the minimum capital requirement was 2.5 percent, while for MBS that were guaranteed but sold to other investors, the minimum requirement was 0.45 percent. These capital levels were found to be inadequate through the crisis as default rates exceeded 12 percent for certain mortgage vintages, with loss rates above 4 percent.

requirements for the GSEs. These authorities were not really utilized as the GSEs were subsequently placed into conservatorship. Note that guarantee fees charged by Fannie Mae and Freddie Mac have roughly tripled through the conservatorship period, a symptom of the implied capital standards for the GSEs being increased substantially. As shown in the chart below, another indication of



In the wake of the crisis, accounting rules and bank regulatory standards changed in a manner to bring assets and liabilities that were previously considered "off balance sheet" onto the balance sheet through consolidation.

The Housing and Economic Recovery Act, passed in the summer of 2008, provided the FHFA director broader authority and more discretion with respect to both risk-based and minimum capital

this implicit increase in capital is that rates on 30-year fixed jumbo mortgages, which previously had been 25-50 basis points higher than those for conforming loans, crossed over in 2013 and since have regularly been lower than conforming rates. This suggests that current implied capital levels for the GSEs are similar to those embedded in bank pricing models for jumbo mortgages.





### Capital Relief for Distributing Rather than Retaining Credit Risk

GSE reform legislation should have the regulator set a “system level” of capital that ensures that all but catastrophic risk is borne by private capital. However, the regulator should also be required to develop a framework for the Guarantors to distribute rather than hold risk when it is economically sensible to do so. Thus, the capital requirements should count Guarantor capital, but also provide relief to the extent that Guarantors lay off the risk in a bona fide manner through front-end and back-end risk sharing, i.e., distribute the risk to be borne by mortgage insurance (MI) capital, lender capital and fully funded capital market structures.

The regulator should grant such CRT capital relief for approved structures and counter parties that have proven capability to absorb losses over the market cycle. Capital relief from CRT, either front-end or back-end, should be evaluated on an equity equivalent basis, i.e., the economic benefit of the transfer should be measured relative to another dollar of equity capital. Credit should be given only when risk-share capital is truly committed and targeted to cover losses ahead of the Guarantors.

### What Is the Capital Requirement Measured Against?

The capital requirements set forth in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 differed for balance-sheet assets versus off-balance-sheet obligations. Given the accounting and regulatory changes to bring more assets and liabilities explicitly on balance sheet, that distinction likely should not be maintained.

However, the nature of the risks is different. Assets on the cash balance sheet need to be financed, and given the nature of the assets, the interest-rate risk is quite large and demands its own capital. Guarantees on MBS held by others result in credit risk exposure. Note that on Fannie Mae’s and Freddie Mac’s balance sheets, assets financed by Fannie Mae with debt are tracked separately from loans held in trusts for MBS investors.

MBA believes that Guarantor investment portfolios should not only be limited in terms of size, but also have strict parameters with respect to allowable investments. For example, loans held for purposes of aggregation should only be held for a limited period of time as determined by the regulator. Delinquent loans purchased out of pools should be sold as nonperforming loans (NPLs) or reperforming loans (RPLs) within a defined time period, barring a systemic risk event, at which point the regulator may grant a reasonable extension.

In sum, the risk-based capital standard for Guarantors should be set with respect to the entire credit book and potential losses in a stress environment. The regulator should establish Guarantor capital standards that are aligned with the Guarantors' risks, including the impacts of credit risk transfer, and they should be consistent with other capital regimes (such as the banking and insurance industries) for comparable risk exposures. These requirements would be more stringent for entities subject to SIFI-like regulation. The regulator's judgment as to capital adequacy should also be informed by the results of stress testing, such as the CCAR process or a similar adverse-scenario exercise.

## Multifamily Considerations

Multifamily rental housing is a critical part of the U.S. housing market and our communities. More than 18 million households live in multifamily rental housing — a development with five or more units — and this includes workforce rental housing, seniors housing, student housing, rental properties that primarily serve low- and moderate-income families, and market-rate rental housing. While the GSEs' multifamily businesses are not as large as their single-family counterparts, their role is vitally important in supporting a necessary element of the housing continuum.

MBA's end state recommendations encompass both the single-family and multifamily roles of the GSEs. At the same time, we recognize that certain recommendations apply to specific market segments. For example, the single security concept, the continuation of the TBA market, the CSP and others are relevant to the single-family mortgage market. Likewise, the unique elements of the multifamily finance business should inform the application and implementation of policy changes to the multifamily lending sector and the GSEs' role therein.

In particular, the strengths of the existing multifamily finance system and infrastructure should be carried over into the newly chartered Guarantors. As noted below, both GSEs' multifamily businesses have experienced very low default rates, even during the financial crisis, and their predominant multifamily business executions have incorporated significant private capital through risk-sharing and risk-transfer mechanisms. In addition, given that the GSEs do not play the same dominant role in multifamily finance as in single-family finance, there is strong competition among a range of capital sources in apartment lending — with banks, life insurance companies, commercial mortgage-backed securities and other market participants competing actively in this sector.

Because of the nature of multifamily lending, the underlying real estate asset and the competitive environment in multifamily housing finance, the application of our recommendations and any action by policymakers should take into account the unique attributes of the GSEs' core activities in this market. Whether in crafting the specifics of regulations to implement the end state framework, the treatment of multifamily loans under regulatory capital standards or the details of the transition process such as the possibility of stand-alone multifamily Guarantors — we recommend that the characteristics of the underlying business line define the application of policy changes governing the GSEs.

## Taxpayer Protection

In our recommended end state, taxpayers would be protected by a clear set of market conduct rules, prudential requirements and the MIF.

First, eligibility standards, established by FHFA, would restrict the mortgages the Guarantors can acquire to safe, stable Qualified Mortgages and well-underwritten multifamily mortgages, mitigating the potential credit risk. In addition, competition based on underwriting concessions or pricing benefits — especially when such benefits are based on delivery volume — would be prohibited.

Second, Guarantors would be engaged in both front-end risk sharing (such as private mortgage insurance and recourse) as well as laying off risk through back-end structures such as reinsurance or structured risk transfers for credit investors. Existing multifamily risk share (with lenders) and risk transfer (with investors) would be utilized in the multifamily sector. The regulator would assess the depth of such risk transfers to ensure they would be sufficient to absorb losses in all but the most catastrophic scenarios.

Third, Guarantor capital requirements would be significantly higher than under the old system for Fannie Mae and Freddie Mac.<sup>2</sup> Capital standards similar to those established for mortgage assets held by banks would likely have allowed the GSEs to survive the 2008 crisis.<sup>3</sup> FHFA would set such standards and apply corrective-action supervisory measures to ensure Guarantor capital is maintained.

2 The GSEs' capital ratios were well below 2 percent in the years immediately preceding the financial crisis. Congressional Budget Office, *The Effects of Increasing Fannie Mae's and Freddie Mac's Capital* (October 2016), <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/52089-gse-report.pdf>.

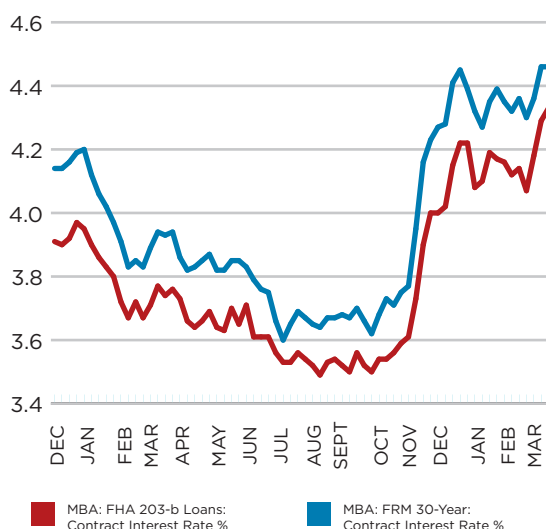
3 12 U.S.C. § 1821(n).

## Proposal's Impact on the Cost of Mortgage Credit

Under our proposed model, higher capital standards for the Guarantors and increased levels of private capital at risk would produce somewhat higher consumer and borrower costs. Guarantee fees are likely to be modestly higher than today given the increase in private capital required at the Guarantor level.

However, moving to an explicit federal guarantee should increase the value of MBS, offsetting some of the higher costs to consumers. The chart shows a comparison between FHA and conforming conventional mortgage rates over the past few years. A primary reason for the higher price on the Ginnie Mae securities is the full faith and credit guarantee behind those MBS. Fannie Mae and Freddie Mac MBS are backed by the Treasury through the PSPAs, but even the relatively small distinction in the current environment leads to a marked difference in price. At a consumer level, note the spread (chart below) between mortgage rates on conventional vs. FHA loans.

Ultimately the system will be more stable over time and hence the mortgage market will be available to consumers, even during severe downturns — a benefit that is worth the trade-off of modestly higher costs.





Finally, the MIF would add an additional layer of taxpayer protection in the case of a catastrophic or systemic market disruption. In exchange for the explicit guarantee, Guarantors would pay an insurance premium on each MBS issued. This fee would be deposited into the MIF managed by the FHFA. After a transition period, the MIF would be required to maintain a minimum level of reserves as insurance on outstanding MBS.

The MIF would be called upon to make timely payment of principal and interest to MBS investors in the event of a failure of a Guarantor. Only if the MIF were fully exhausted would there be a cost to taxpayers. Under these circumstances, the remaining Guarantors would be charged higher insurance premiums going forward to pay back taxpayers and rebuild the MIF reserves to their required reserve ratio, similar to the FDIC's practices with the Deposit Insurance Fund (DIF).







# Transition: From Status Quo to End State

Although the GSEs' transition out of conservatorship remains among the most critically important components of comprehensive GSE reform, this subject has not received the significant analytical treatment it deserves. This section seeks to describe the objectives of the transition process and to provide some concrete detail as to what would be involved in its successful implementation.

The overall goal of transition is to execute the steps necessary to move to a more sustainable, vibrant secondary mortgage market, while preventing and mitigating any potential adverse impacts to liquidity and the availability of mortgage credit. Upon enactment of GSE reform legislation, the transition from the GSEs to two newly chartered Guarantors operating under a suitable regulatory framework would occur over a multiyear period. The transition would encompass both operational and ownership elements. It would involve the transformation of the government-controlled GSEs into privately owned Guarantors with new charters, subject to new regulatory requirements. The transition should also open the door for new entrants seeking a Guarantor charter and attract greater levels of risk-bearing private capital to the housing finance system.

To convert the GSEs to Guarantors, and to allow for the chartering of new Guarantors, GSE reform must provide a mechanism to relieve the GSEs of their existing statutory charters, recharter them under the new regulator-conferred charter and create a process for new entrants to obtain such a charter. The transition examples discussed below are possible options that demonstrate that this can be done while keeping operations functioning. Other options may also be viable, subject to the guiding principles below that focus on market liquidity and operational stability throughout the transition process.

Notably, certain key decisions will affect the transition, including decisions as to the corporate structures used for the transition, the extent to which FHFA transfers GSE assets and liabilities to new entities, the treatment of untransferred assets and liabilities, and statutorily directed modifications to the Preferred Stock Purchase Agreements (PSPAs). GSE reform legislation may specify the outcomes of such decisions or delegate decision-making authority to FHFA.

## Transition Principles

The overarching objective for any transition process must be to minimize risks to liquidity and stability of the mortgage markets. As a result, the following principles should guide the transition process:

- **Clear Road Map and End State.** To promote market understanding of the transition, GSE reform legislation should outline the transition road map in sufficient detail, including steps that must be completed prior to chartering the Guarantors. The legislation should also clearly identify the target end state.
- **Continuity of Business Operations and Government Backstop.** To foster continued liquidity and market stability in the single-family and multifamily markets, and to support the preservation of the TBA market, the business operations performed by the GSE should continue throughout transition. In addition, it is critical that the government backstop now provided through the PSPAs remain in place at least until the new end state is fully functioning, capitalized and replaced by an explicit government guarantee at the MBS level.
- **Preserve and Leverage Existing Assets and Infrastructure.** To reduce operational risks, the transition should leverage existing human capital and operational processes at both GSEs and build on reforms that FHFA and the GSEs have already put into place during conservatorship. Where legacy technology can be upgraded during this process, those opportunities could be explored.



- **Utilize Existing Regulatory Framework Where Appropriate.** To reduce implementation risks, GSE reform legislation should leverage FHFA and its existing legal authorities and the existing regulatory framework as the starting point, modified as necessary to accomplish the objectives of GSE reform, as well as actions it has taken as conservator for the GSEs.
- **Regulatory Flexibility.** To allow FHFA to react promptly to changing conditions in the mortgage market and for the Treasury Department to divest its ownership stake in the GSEs in prudent fashion, the transition should provide the regulator with adequate flexibility.
- **Guarantors as Viable Businesses.** To enable the Guarantors to emerge from transition as privately owned entities that can sustainably support a secondary mortgage market, the transition process and regulatory requirements should enable the rechartered GSEs and any newly chartered Guarantors to be viable businesses with sufficient (but not guaranteed) prospects of long-term value to attract private capital.
- **Multiyear Transition Period.** To give FHFA sufficient time to put the necessary infrastructure into place, enable the Guarantors to meet regulatory capital standards and reduce the risk of market disruption, the transition should occur over a multiyear period.

## The Three-Phase Transition

Upon the enactment of GSE reform legislation, the transition would consist of three phases, as illustrated below:

1. Preparation,
2. Implementation; and
3. Divestiture by the federal government.

While the steps within each phase may occur concurrently or in an order different from how they are listed, the transition should complete each phase before moving on to the next one.

### Phase 1: Preparation

The Preparation phase establishes the regulatory foundation and creates the infrastructure necessary to carry out the Implementation phase.

#### Comprehensive Transition Plan

Congress should direct FHFA to develop a Comprehensive Transition Plan. This plan should describe in detail the activities that will occur during the Preparation phase, including steps to mitigate the risk of disruption. It should also outline the key decisions that must be made as well as the mechanics for carrying out those decisions. The plan should also address the need for FHFA resources, personnel and infrastructure to establish, administer and set premiums for the MIF; supplement the existing regulatory framework with new regulatory authorities; and otherwise administer the transition. The plan must also include a communications component aimed at enhancing transparency and providing critical information to market participants.

#### Regulatory Framework

To regulate the Guarantors from the time they are granted their charters, FHFA would need to have a new regulatory framework substantially in place prior to the start of the Implementation phase. Because the charters and functions of the Guarantors will be different from those of the GSEs, FHFA will need to review its regulations and implement any necessary amendments or issue new regulations. FHFA would similarly need to review and revise other regulatory issuances, such as policy and examination guidance or examination procedures. While existing FHFA regulations should be leveraged, the development of the regulatory framework could require some time to complete.

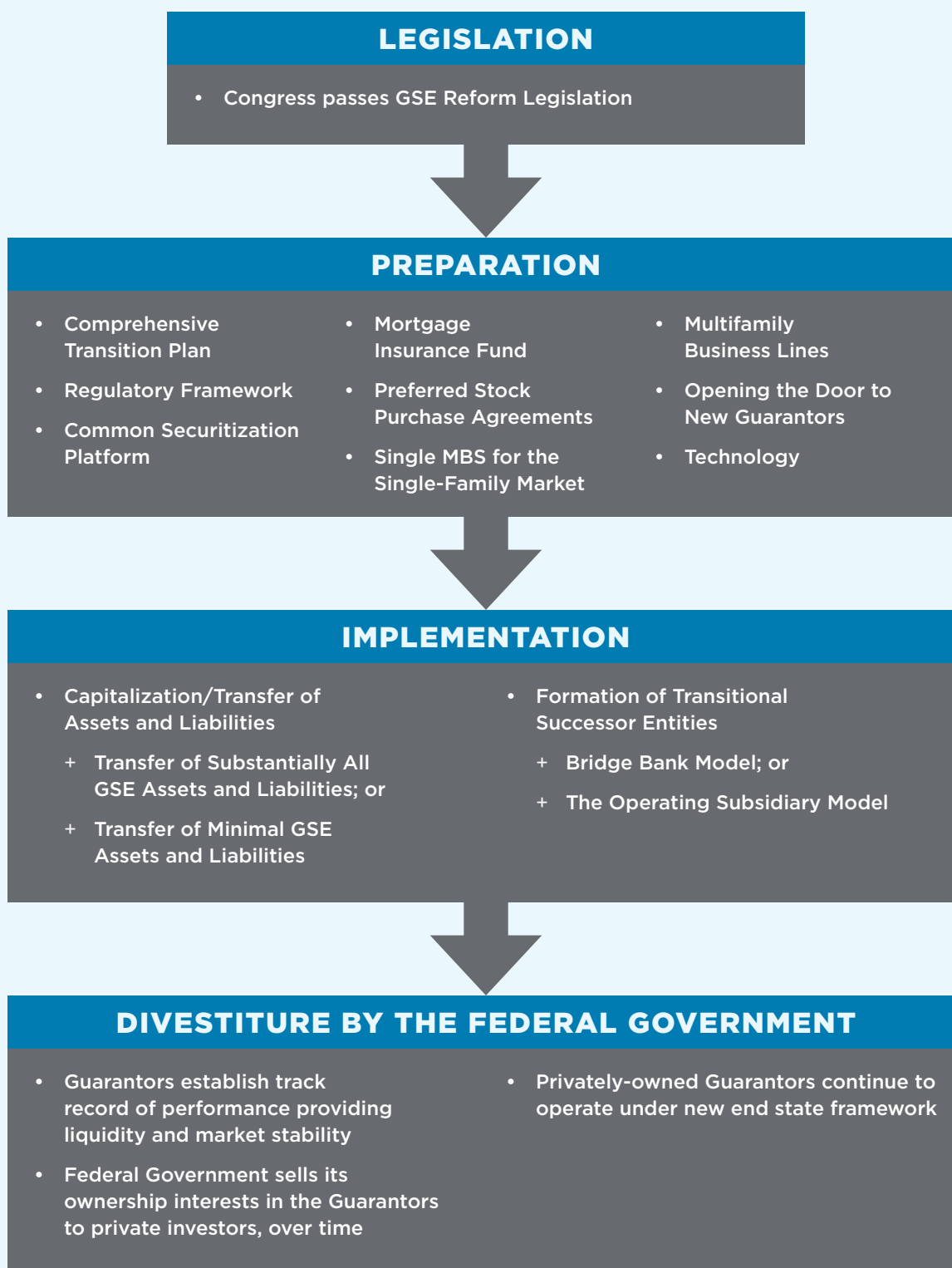
#### Common Securitization Platform

Today the two GSEs jointly own the Common Securitization Platform (CSP). Our proposed end state includes a transfer of ownership of the CSP and its conversion to a government corporation. Congress or FHFA might also consider other ownership/governance models that would advance the principles and guardrails we have identified.

#### Mortgage Insurance Fund

Legislation would direct FHFA to establish the MIF and implement regulations and processes for setting premiums, processing claims and otherwise operating the MIF.

# Transition Phases





### **Preferred Stock Purchase Agreements**

While the GSEs together have drawn approximately \$187.5 billion from the PSPAs, approximately \$258 billion remains collectively available to the GSEs under the PSPAs' current terms. To foster liquidity and market stability, Congress should direct Treasury and FHFA to amend the PSPAs to ensure that they provide an appropriate MBS-level backstop for the GSEs' existing MBS. As discussed below, GSE reform legislation could direct that the PSPAs be amended to permit the Guarantors to build capital by retaining earnings after they begin operations and before Treasury sells its equity interest in them.

If preserving the PSPA backstop is not an option, Congress could grant an explicit guarantee to the existing MBS and other legacy GSE obligations; or the GSEs, rechartered as Guarantors, could establish a voluntary exchange mechanism for investors to obtain an explicit guarantee on existing MBS. Accounting and tax considerations may lead investors to desire to retain their existing securities. The actual risk borne by taxpayers as to GSE obligations would diminish as the existing book ages.

### **Single MBS for the Single-Family Market**

One of the most important steps of the transition will be to determine how best to move from an implicit to an explicit guarantee on the MBS without harming the liquidity of the outstanding \$5 trillion MBS market. The GSEs have developed a liquid forward market for mortgage-backed securities for the single-family market, which is generally referred to

as the TBA market. The TBA market enables lenders to hedge risk, attracts private capital to mortgage markets and reduces the cost of mortgage lending.

On this issue, the drive to develop a single and fungible GSE security for the single-family market is particularly instructive. In 2019, both Fannie Mae and Freddie Mac are expected to issue the UMBS with the same payment-delay and investor-disclosure features. Freddie Mac will also offer an exchange for investors, providing UMBS in exchange for its outstanding Participation Certificates or a cash payment. The UMBS is an important step toward a true single security.

In the new system, the Guarantors, including new entrants, should issue only a single security for the single-family market. The key features of a single security — including an exchange mechanism between the old and new securities — are essential in order to reap the consumer benefits of the TBA market.

Although making securities from different Guarantors fungible and able to be commingled in a second-level securitization will be beneficial in terms of leveling the playing field between Fannie Mae and Freddie Mac, the move to a true single security will enable new entrants to successfully compete in the secondary market. As an analogy, consider the recent changes in the Ginnie Mae market. Previously most issuance was in the Ginnie I security, where each of the hundreds of issuers pooled loans into their own issuances. Investors could track the performance of individual issuers, and may have expressed preferences for particular lenders given

their propensity to have faster or slower prepaying collateral. Recently, for many reasons but also to benefit smaller issuers, Ginnie Mae has encouraged more volume into the Ginnie II security, which is a large pool composed of loans from many different issuers. This approach of pooling loans from different Guarantors into a single issue, a true single security, may be beneficial for market liquidity and may also help new Guarantors gain a foothold in the market.

### **Multifamily Business Lines**

The multifamily businesses of the GSEs differ substantially from their single-family credit guarantee businesses. The recommended end state would largely preserve the operations, infrastructure and market executions of the current multifamily businesses, and would allow them to remain with their respective single-family credit guarantee businesses. Alternatively, it might be appropriate for one or both GSE multifamily lines of business to carry forward into separate new Guarantors. We believe that the transition process should allow for this option. Regardless, the Preparation phase, and the overall transition process as it impacts the multifamily business lines, should allow for appropriate differential treatment of multifamily in light of differences in the underlying business models.

### **Opening the Door to New Guarantors**

Legislation should open the door for new entrants as early in the transition process as possible. New entrants then can apply for a Guarantor charter under the standards and procedures established in the legislation and implementing regulations. A new charter could be specific to the single-family market, multifamily market or both markets. As a utility-style regulator, one of the key factors the FHFA would be required to consider would be the impact of new competitors on both existing Guarantors, on the relevant market, and on consumers and borrowers. Maintaining the balance in the regulatory compact would be an important factor in evaluating new charters.

FHFA would determine whether the applicants meet the standards for a Guarantor charter. Because of the time that may be required to complete the process of applying for and receiving a charter, it may be appropriate for FHFA to begin accepting and processing applications during the Preparation phase, providing a way for new entrants to begin competing with GSEs now rechartered as Guarantors. The OCC process for chartering new national banks or federal savings associations may provide a useful model.

### **Technology**

The transition to Guarantors issuing MBS under a new regulatory and guarantee framework may provide a unique opportunity to upgrade the technology that Guarantors could use to support their secondary market activities. As a result, the Comprehensive Transition Plan should include consideration of leveraging the opportunity to explore and implement new technology solutions.

## **Phase 2: Implementation**

The Implementation phase would include (1) completing the steps necessary to transform the GSEs into Guarantors in the new system and (2) granting Guarantor charters to new entrants under the procedures and standards established during the Preparation phase.

### **Capitalization/Transfer of Assets and Liabilities**

GSE reform legislation should direct FHFA and Treasury to explore a wide range of efficient and cost-effective ways to raise capital for the GSEs as they are rechartered as Guarantors. The most appropriate capitalization approach and process will depend on a combination of factors, including:

- The regulatory capital requirements that the legislation and FHFA apply to the Guarantors;
- The extent to which FHFA reorganizes the GSEs and winds down noncore businesses and the GSEs' retained portfolios;
- The extent to which the GSEs are permitted to retain earnings;
- The capital levels of the GSEs at the time of transfer;
- The extent to which FHFA transfers legacy GSE assets and liabilities to the new entities;
- The nature of PSPA or other support for legacy GSE obligations, and the use of the PSPA backstop going forward;
- The extent to which Guarantors receive a management fee for the administration of legacy GSE MBS under a management contract, if applicable;



- When and how the government would seek to divest its equity interests in the Guarantors; and
- Market views of risk and expected returns on new capital for equity investors in the Guarantors.

While there are many variations on possible recapitalization approaches, they fall into two general categories: (1) transfer of all or substantially all GSE assets and liabilities to the new Guarantors, and (2) transfer of only a minimal level of assets and liabilities to the new Guarantors.

Under both approaches, the Guarantors could become capitalized through combinations of selective transfer of GSE assets and liabilities, potential management contract income, accumulation of retained earnings or Treasury capital draws under the PSPAs. Treasury also may ultimately exercise its warrant for common equity and sell its common and senior preferred equity interests in the GSEs to private investors, choosing the time and manner to the benefit of taxpayers and the future stability of the housing finance system. The following are the major differences between the two approaches that Congress will need to consider:

#### **Transfer of Substantially All GSE Assets and Liabilities**

This approach may be the most straightforward one to recapitalization, as it would effectively keep the core operations and books of business of the GSEs largely intact and would reduce the risk of market distress or confusion. It would also be consistent with the FDIC's bridge bank model, the limited life regulated entity (LLRE) approach under the Housing and Economic Recovery Act of 2008 (HERA) and the federal government's general approach with the restructuring of AIG — all familiar to the market. The transfer could also be for certain types of assets such as single-family mortgage assets, multifamily mortgage assets or a certain combination thereof.

On the other hand, the fact that the new Guarantors would bring forward their existing GSE books of business would require that they raise substantially more capital. In addition, the resulting size of the Guarantors under this approach could act as a barrier to entry or make it more difficult for new entrant Guarantors to compete. The transfer of substantially all of the legacy GSEs' books of business might also confuse investors as to the change in the nature of the government backstop resulting from the reform. Specifically, investors may find it challenging to understand that, post-reform, the government no longer backs the Guarantors themselves, but only

the MBS. The PSPA backstop placed on legacy GSE obligations during conservatorship could also result in confusion regarding which assets are backed by the PSPA, which are backed by the MIF and which assets are not federally backed at all.

#### **Transfer of Minimal GSE Assets and Liabilities**

This approach might include the transfer of staffing, buildings, systems and operations to the new Guarantors and holding back the prior books of business. It would likely require the continued existence of two entities for each GSE — one to become the new Guarantor and the other to hold the legacy assets and liabilities. For continuity, the entities holding the old books of business would likely contract with their respective Guarantor to administer legacy GSE assets and liabilities in exchange for a management fee.

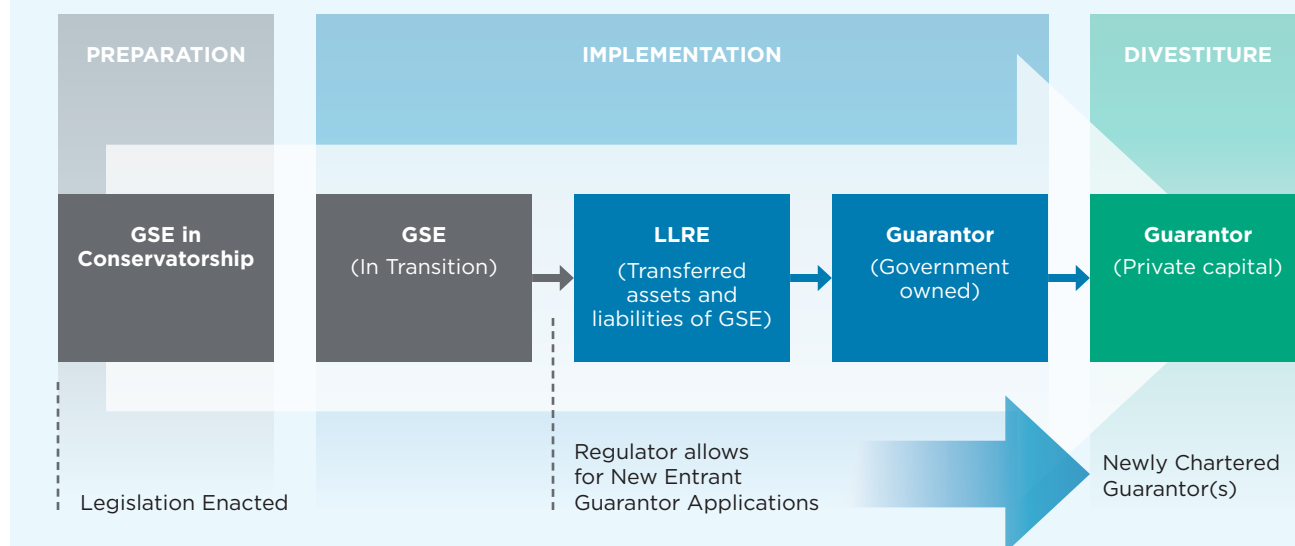
Key benefits of this approach are that the new Guarantors would be smaller and require less capital, which might enable them to raise adequate capital as well as provide new entrants a better opportunity to compete against them. On the other hand, this approach would include more moving parts and so might be more complicated to execute. The fact that the government would retain the legacy GSE securities could also extend the time necessary for the government to fully divest. In addition, a pure stand-alone Guarantor — without its prior credit guarantee or retained portfolio book — is an untested business model and so may be less attractive to new private capital.

#### **Formation of Transitional Successor Entities**

There are several models that could be utilized to complete the transition of the GSEs to Guarantors. Two possible paths are the **bridge bank model** and the **operating subsidiary model** — each of which has its own set of trade-offs. The former would be more amenable to transferring substantially all assets and liabilities to the Guarantors; the latter would be more amenable to transferring only minimal assets and liabilities. Both would result in newly chartered Guarantor entities emerging from the GSEs, and allowing for new Guarantor entrants as well.

Congress could legislatively authorize either or both alternatives, or another path that meets our transition principles. Alternatively, it could authorize and provide discretion to the regulator to pursue a path that meets several statutorily defined objectives, including minimizing disruption in the investment and mortgage markets, so long as it moves the GSEs toward the recommended end state.

# Overview of Bridge Bank/LLRE Model



## Bridge Bank Model

One transition approach that would allow the GSEs to effectively be rechartered as Guarantors is the bridge bank model. As discussed below, Congress modeled the approach already in the HERA statute after the bridge bank model the FDIC has long applied to resolve banks that have become insolvent.

Bank resolution models like bridge banks are designed to protect depositors and the federal DIF. By law, the FDIC must choose the bank resolution method that is the least costly to the DIF.

The “bridge depository” provisions of section 11(n) of the Federal Deposit Insurance Act<sup>4</sup> allow the FDIC to restructure insured depository institutions during conservatorship after passing the insolvent institution through a receivership to reduce certain liabilities. The remaining assets and liabilities of the institution are then salable to private parties through stock offerings.

One resolution method employed by the FDIC is a purchase and assumption transaction (P&A) utilizing a bridge bank in which a third-party institution buys some or all of the assets and some of the liabilities of the institution. A bridge bank P&A may be a useful model for transitioning to Guarantors and addressing the legacy MBS assets and liabilities of the GSEs. In a bridge bank P&A, the FDIC temporarily acts as the acquiring institution

and a new bank is chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. The new bank bridges the gap in time, enabling the FDIC to evaluate and market the bank to third parties, and enabling prospective purchasers to evaluate the bank in order to submit an offer.

An advantage of a bridge bank is that it provides time to arrange a permanent resolution, giving purchasers and investors the opportunity to evaluate the bank and submit bids. During the time the FDIC is operating the bridge bank, the FDIC prepares to sell the bank by soliciting interest and arranging for due diligence by potential acquirers, and by receiving and evaluating bids.

Significantly, a bridge bank preserves franchise value, ensures continuity of services, and gives the FDIC and purchasers time to consider pricing. These features of a bridge bank could be advantageous in resolving and reforming the GSEs.

FHFA authority under current law provides for something very much like an FDIC bridge bank in a receivership situation. Under HERA, FHFA can establish a bridge bank — known as an LLRE — that can operate for two years, with three one-year extensions before it must be sold or resolved.

4 12 U.S.C. § 1821(n).



Upon its creation, an LLRE may purchase such assets and assume such liabilities of the pre-receivership GSE, as FHFA, in its discretion, determines to be appropriate except that the amount of liabilities assumed by the LLRE cannot exceed the amount of assets purchased or transferred from the pre-receivership estate. The purpose of this requirement is to ensure that an LLRE has a sound balance sheet. The receiver can also selectively transfer assets and liabilities to the LLRE to create an institution that satisfies regulatory capital requirements.

### **Application to Transition**

This approach would have the advantage of leveraging existing legal authorities as opposed to creating a new framework. However, Congress would need to modify the current receivership approach under HERA to make it an appropriate vehicle for the transition. Under HERA, the LLRE must succeed to the charter of the original GSE. By contrast, GSE reform legislation would need to authorize the regulator to grant each LLRE the new Guarantor charter, consistent with our end state recommendations. Because of the need for an extended and flexible transition period, it also may be necessary to extend the statutory time limits for LLRE operations. Alternatively, legislation could specify a new, analogous process, modeled on elements of the FDIC bridge bank and HERA receivership process, tailored to the needs of this unique situation and our recommended end state.

To reduce the risk of market disruption from the use of a wind down and transition process, GSE reform legislation and FHFA must explicitly delineate the key features of the end state. In addition, because the term “receivership” could invoke market uncertainty or confusion, notwithstanding the fact that the process would be a path to the recommended end state, the legislation should describe the process with alternative language, such as the Regulatory Transformation Process, Transition Conservatorship Process, or functionally similar language.

Regardless of nomenclature, the market must understand the end state and the transition process. Precise legislative language and the use of established bridge bank procedures could help ensure that this message comes through. Clear communication that the PSPAs and the MIF remain in place throughout the Implementation phase can also reduce the risk of the market misunderstanding the impact of the transition process.

### **The Operating Subsidiary Model**

An alternative transition approach would be to direct each GSE to form wholly owned subsidiaries (or affiliates) to operate in a parallel manner with the parent entities during the transition. The subsidiaries could be paid a fee for managing the legacy assets of their parent companies and would be prohibited from paying dividends to them. This management fee could begin to capitalize the entities that would become the two initial Guarantors. Such an approach could leverage FHFA’s and the GSEs’ experience establishing the CSP as a jointly owned subsidiary of the Enterprises. This approach would be more attractive if the legacy (pre-GSE reform legislative enactment) books of business were to be separated from the operating entities going forward.

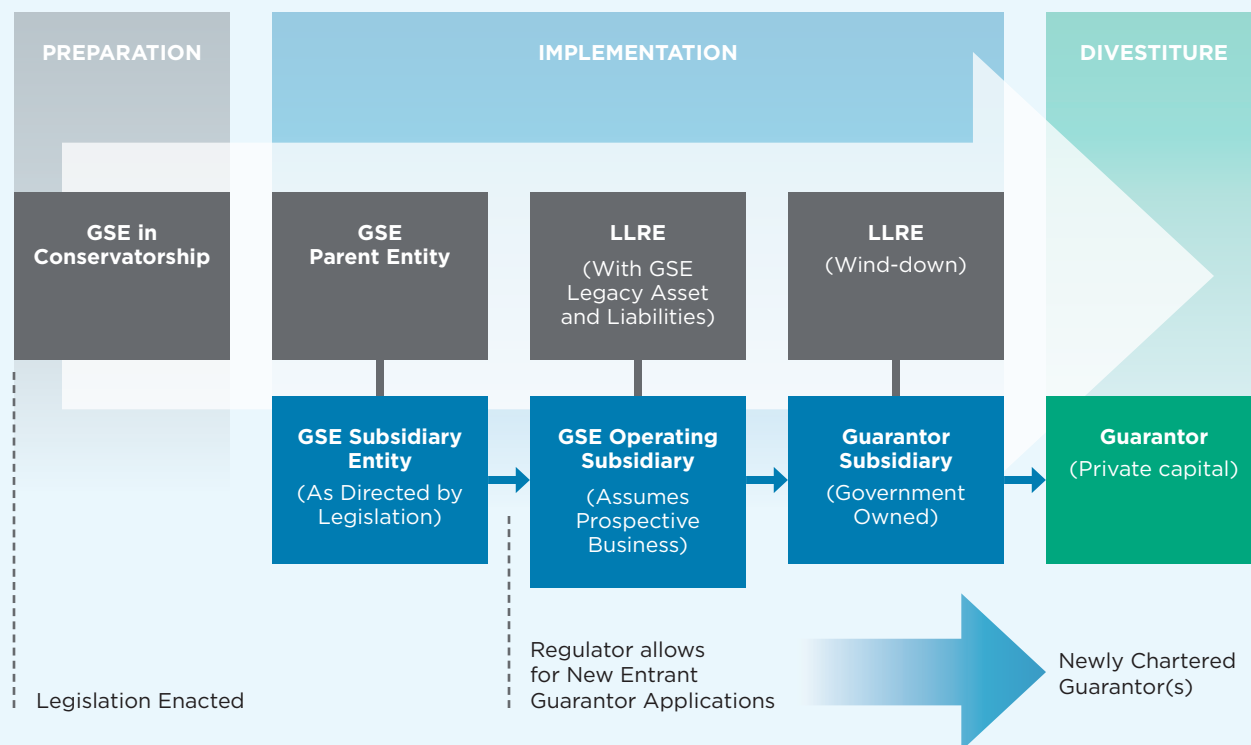
Establishing the subsidiaries could require a modification of the PSPAs to facilitate this structure. Also, because the GSEs have typically operated under a single legal structure and are currently limited from setting up subsidiaries, GSE reform legislation could direct the GSEs to establish them, and the GSEs would need to absorb the cost of setting up new systems to be able to track operations across additional legal entities.

At the appropriate point, the GSEs could spin off their subsidiaries by selling all of their equity interest in them. The subsidiaries would emerge as the newly chartered Guarantors, authorized to issue new MBS backed by the Mortgage Insurance Fund and subject to the principles and guardrails specified in our end-state recommendations.

### **Application to Transition**

The value of this approach is that the entities that would become the newly chartered Guarantors would also develop a track record, and markets would gain familiarity with them prior to the date on which they become stand-alone entities. It also may create a structure that is adaptable to a decision to transfer minimal assets and liabilities to the Guarantors, and for the subsidiaries to enter into management contracts with the parent companies to administer the GSEs’ untransferred books of business.

# Overview of Operating Subsidiary Model



## Phase 3: Divestiture by the Federal Government

The final phase of the transition, divestiture, replaces government ownership and control with private capital. That occurs when Treasury sells its equity interests in the GSEs to private-sector investors. This approach is similar to the one taken with respect to AIG.

As part of the Comprehensive Transition Plan, FHFA and Treasury should develop a high-level plan that sets out the objectives and strategies for divestiture. Importantly, the regulators must possess sufficient flexibility to account for market conditions during the divestiture process. The outcome will be favorable only if the transition process and regulatory requirements result in Guarantors with sufficient potential for long-term value to attract private capital. Moreover, many investors will be interested in purchasing equity in the Guarantors only after they have established a track record of performance (for example, a period of three or more years).

During such time, the Guarantors should be permitted to build their capital bases by retaining earnings. We envision legislation directing such amendments to the PSPAs in the context of comprehensive reform. We underscore that the legislation should provide substantial flexibility to regulators to calibrate and sequence the divestiture process in a smooth manner that both strengthens the transition process and protects taxpayer interests.

## AIG Recapitalization as Example

The process the government employed to recapitalize and sell its common and preferred stock interests in AIG provides a possible model for restructuring the GSEs. The substantial amount the federal government invested in AIG (\$182.3 billion) was one of the government's largest investments in a private sector company.

Both Treasury and the Federal Reserve assisted AIG with numerous restructuring and reform efforts, and those efforts ultimately enabled both agencies to recover substantially greater repayment amounts than they invested to stabilize AIG. Other aspects of the restructuring may be instructive as models for restructuring the Enterprises in ways that protect taxpayer interests.

A salient aspect of the AIG restructuring is that AIG's operations were streamlined. AIG retained its core insurance operations while selling non-core assets and reducing its MBS and derivatives exposure, thereby decreasing the size of the company. Over a period of 19 months, the Treasury conducted six different public offerings of AIG common stock.

Treasury's steps resulted in a positive return on taxpayers' investment and Treasury continues to hold warrants to purchase shares of AIG common stock, which could increase the return when exercised. Treasury also allowed AIG's board of directors to declare a dividend to AIG's common stockholders in the form of warrants to purchase shares of AIG's common stock, with a condition that each party to the recapitalization plan would agree to close the deal on a certain date.

GSE reform legislation, therefore, should grant FHFA and Treasury substantial discretion to divest the government's equity interests over time.

# Affordable Housing: A Seamless Continuum of Housing

America's housing finance system should meet the needs of the full continuum of households, from families requiring the most directly subsidized, affordable rental homes to those served by the completely private prime jumbo single-family lending market.

Looking ahead, these housing needs must continue to be met through a broad variety of approaches that include single-family and multifamily housing capitalized by private, nonprofit, government or a combination of sources. But, with affordable-housing needs so great, the secondary market must also play a supporting role.

MBA research shows that in the United States there will be demand from 1.4 million to 1.6 million additional household units each year for the next 10 years.<sup>5</sup> Demand for housing will come from households that are increasingly diverse across dimensions of age, race, ethnicity and geography. In addition to these differences, Americans are increasingly divided by income and wealth. While some families are prospering, others feel they are falling further behind as they struggle to pay bills, secure an affordable home or send their children to college.

The growing economic divide has real-life consequences for the housing market: In 2015, the typical college-educated worker earned nearly twice as much as someone with a high school degree.<sup>6</sup> This divergence means that better-educated households often outbid others for limited housing resources, placing upward pressure on rents and prices — especially in desirable neighborhoods with decent housing, low crime and good schools. Falling homeownership rates among those without a college degree also contribute to growing wealth inequality. Affordable-housing policy is an essential part of the solution to these serious socioeconomic challenges.

The government-backed secondary mortgage market must provide liquidity to facilitate the development, preservation and purchase of all types of housing. Where it cannot achieve this goal alone, it should act in tandem with other resources to facilitate access to safe and reasonable-quality housing. Moreover, government policy in general should reflect a unified, holistic approach that responds to the full scope of housing needs. An effective affordable-housing policy must also be flexible and innovative, responding to feedback from existing programs and seeking new paths forward.

The continuum framework provides a single context for integrating the roles of single-family, multifamily and other programs in serving the housing market. The framework identifies five broad housing market segments that policymakers should consider in crafting a holistic housing strategy.

The continuum roughly categorizes households as:

- Low- and very-low-income renters occupying affordable rental units,
- Renters occupying market-rate housing,
- Credit-ready prospective homeowners,
- Homeowners currently served by the GSE single-family and condominium business, and
- Homeowners served by the prime jumbo market (who should not benefit from a government guarantee).

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5 *Housing Demand: Demographics and the Numbers Behind the Coming Multi-Million Increase in Households*. Fisher and Woodwell (July 2015).

6 MBA Economic and Mortgage Finance Outlook, MBA Annual Convention, October 2016.

The framework also identifies some of the federal programs that directly or indirectly impact consumers within the various segments along the continuum. A core objective of affordable-housing policy should be to promote opportunities for economic mobility along this continuum. This objective undergirds our recommendations in this section.

## A Viable Plan for Addressing Affordable-Housing Needs Is a Political Requirement for Bipartisan GSE Reform

Consideration of GSE reform offers a once-in-a-generation opportunity to reimagine federal housing policy. It provides the chance to assess how best to meet housing needs along the full continuum of households. Only by identifying who will — and will not — be served by the government-guaranteed secondary market in the new system can we be clear about the role of the Guarantors and the need for other initiatives to help those not adequately served.

## The Continuum

**Affordable Rental (with and without subsidies):** Households that are significantly below the area median income and may be eligible for policy-directed subsidies.

**Moderate Income and Market-Rate Rental:** Households that earn in the range of area average income. Depending on market circumstances, rents may be moderately burdensome.

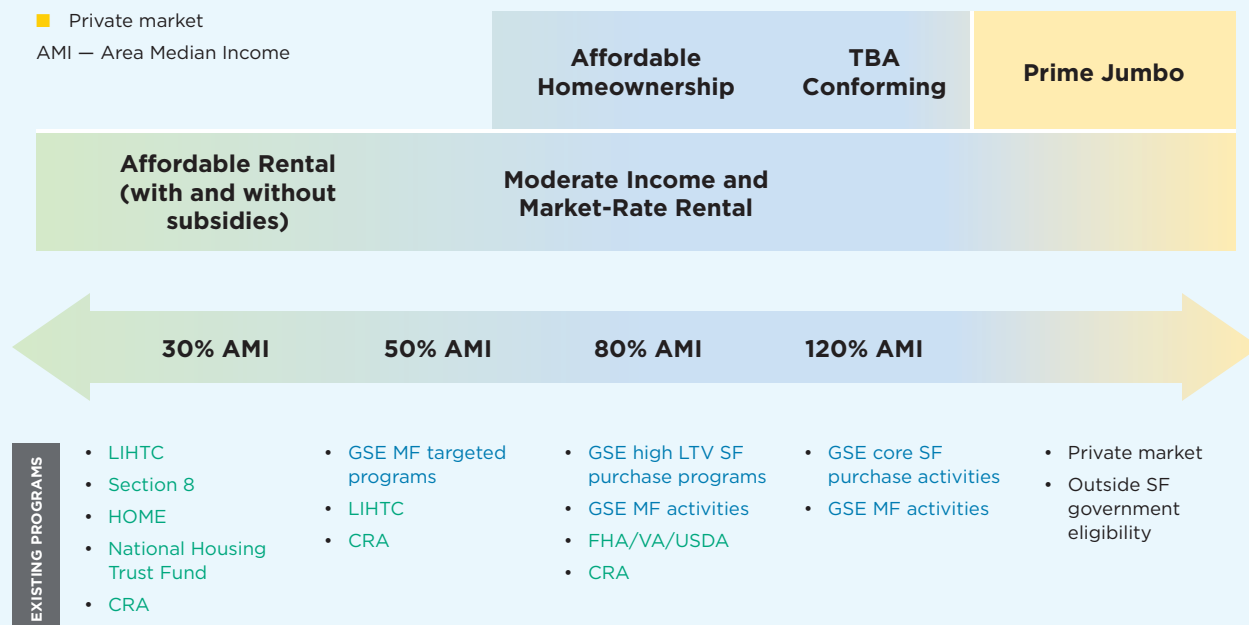
- Core GSE purchase activities
- GSE can partner as debt buyer; other direct funding required
- Private market

AMI — Area Median Income

**Affordable Homeownership:** Qualified prospective borrowers who may lack savings or family wealth necessary for traditional down-payment.

**TBA Conforming:** Core of conforming GSE single-family market. Benefit from government guarantee is primarily lower mortgage rates created by the additional liquidity.

**Prime Jumbo:** Loans above the conforming loan limit. Not intended beneficiary of government guarantee.



The housing system is made stronger by helping aspiring homeowners purchase their first home in a sustainable manner so that they can begin building wealth through equity appreciation. Further, a stable, vibrant housing system is one in which the secondary market provides ample liquidity for affordable multifamily rental housing.

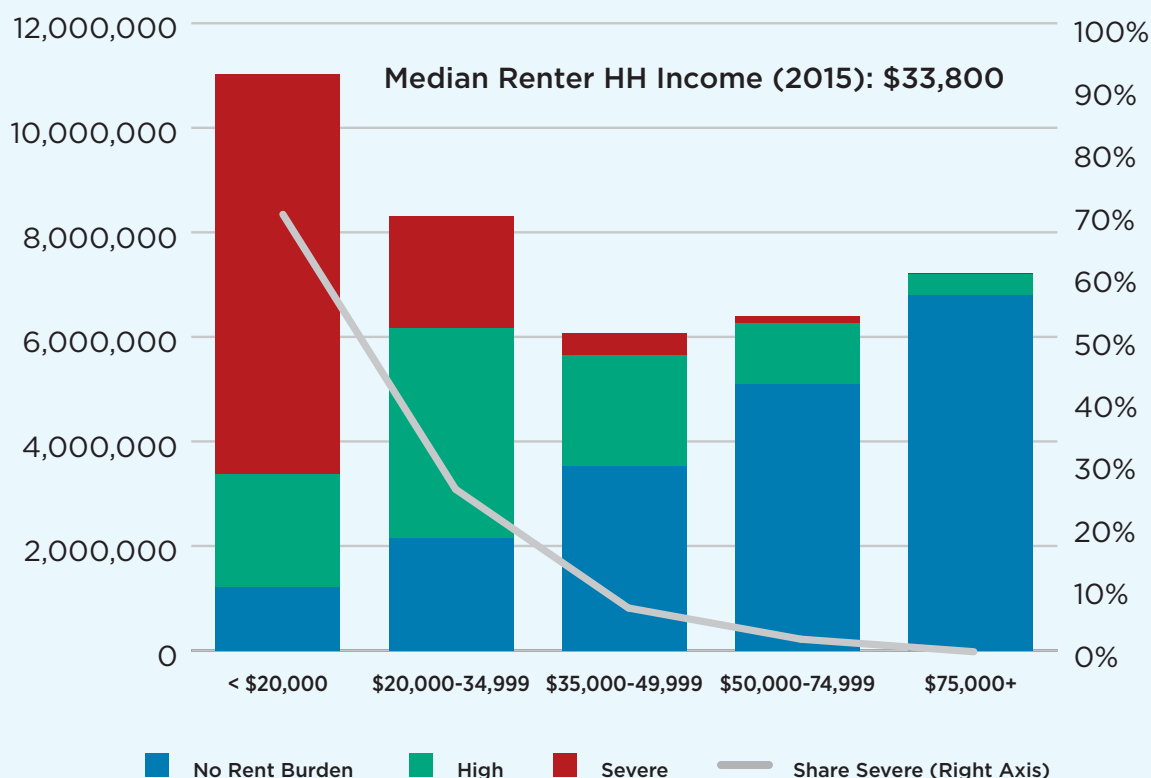
The following sections outline an affordable-housing plan for GSE reform. This plan sets out three critical affordable-housing missions and then charges the future regulator with assessing market conditions and developing a plan to meet these missions. The plan would be implemented with measurable goals that are enforceable against the Guarantors. An affordable-housing fee, charged against the new business purchases of the Guarantors, would play an important supplemental role.

## Three Critical Affordable-Housing Missions

A government-guaranteed secondary mortgage market must serve three critical missions:

1. **Guarantors should actively seek to provide responsible, sustainable access to credit for prospective homeowners.** The government-backed secondary market should promote opportunities for sustainable homeownership by facilitating access to affordable mortgage credit for first-time homebuyers. This objective is especially important for low- and moderate-income borrowers, as homeownership remains the primary means by which these groups build wealth. Progress on this front will require a range of responsible underwriting, documentation, product and outreach strategies, including ways to deal with the economic challenges of originating and servicing small balance mortgage loans and reaching nontraditional households. Innovation and responsible risk taking must be part of a comprehensive strategy to reach more creditworthy borrowers.

## Renter Households: Rent Burdens





# The Three Affordable-Housing Missions

**Expanding Access  
to Affordable  
Mortgage Credit**

**Preserving  
and Developing  
Affordable Rental  
Housing**

**Improving  
Liquidity for  
Underserved  
Segments of the  
Mortgage Market**

2. **Guarantors must work to provide liquidity for the development and preservation of affordable rental housing.** Widespread access to affordable rental housing of decent quality is essential to enhancing social mobility and promoting economic growth. Unfortunately, the gap between household incomes and the cost of building and maintaining rental housing (including moderate-income working households and those with special housing needs continues to grow. The figure above shows that the share of households with moderate rent burdens (paying more than 30 percent of income toward housing) and with severe rent burdens (paying more than 50 percent) is high. The housing system must place a renewed focus on facilitating the renovation and preservation of the existing housing stock serving low- and very-low-income households, as well as the development of new affordable rental homes.
3. **Guarantors must improve liquidity for segments of the market that are currently underserved.** Access to both mortgage credit and affordable rental housing remains a challenge for many segments of the market. These market segments include minority households as well as traditionally underserved parts of urban, suburban and rural communities. Credit also remains constrained in the market for lower-cost manufactured housing. Without an adequate policy response, these challenges will likely grow even more acute in light of powerful demographic trends now underway, including the increasing diversity of the U.S. population. The secondary market must therefore seek new ways to evaluate and underwrite borrowers and develop innovative products, partnerships and programs to respond to changing demographics and reach underserved groups and communities.

While these missions are critical, the government-guaranteed secondary mortgage market cannot, and should not, serve the entire continuum of households by itself. The government-guaranteed market can help facilitate financing for the development and preservation of good-quality, affordable rental housing, but the role of equity investment will be critical as well. In some cases, the secondary market will require partnership with other programs, such as Low Income Housing Tax Credits (LIHTCs), Section 8 Housing Choice Vouchers and the National Housing Trust Fund, to serve those with the most acute affordable-housing needs. Programs such as these should be appropriately funded to meet the needs of households on the low-income end of the continuum.

On the other end of the continuum, in the prime jumbo segment and luxury multifamily, the highest income and credit-quality borrowers should be served by the private mortgage market and do not require the support of a government guarantee.

The housing needs of historically underserved racial and ethnic groups and communities warrant special attention. Some of these needs can be met through existing regulatory frameworks like the Community Reinvestment Act (CRA). Others may require collaboration and information sharing between primary and secondary market participants, including mission-oriented and nonprofit organizations. Still others are best addressed through broader policies to reduce income inequality, create jobs and spur economic growth.

### **Preserve What Works, Enhance Other Parts of Existing System**

Many aspects of the existing secondary mortgage market benefit households in a manner that should be preserved in any new system. At the same time, other elements require improvement. In this section, we highlight what currently works in the multifamily and single-family segments of the market and then provide some guidance on areas where improvements are necessary.

The current GSE multifamily businesses are major success stories. Both GSEs' multifamily businesses have experienced very low default rates, even during the financial crisis, and their predominant business executions have incorporated significant private capital.<sup>7</sup> In addition, because the GSEs do not play the same dominant role in multifamily finance as in single-family finance, there is strong competition among private capital sources in apartment finance — with banks, life insurance companies, commercial mortgage-backed securities and other market participants competing actively in this sector. A particular affordable-housing success for the GSE multifamily businesses is the provision of liquidity for mortgage debt that is paired with equity raised by the LIHTC program, one of the most effective public/private financing programs for the production and preservation of affordable rental housing.

The future system of housing finance should ensure there is sufficient liquidity in the multifamily housing market broadly, with a particular focus on moderate-income and affordable rental housing. The vast majority of the two GSEs' multifamily businesses currently serve households with incomes at or below the area median. The Guarantors should assume this same role in the new system, supporting moderate-income and affordable rental housing while providing liquidity during periods of market disruption.<sup>8</sup>

### **Any affordability goals imposed in the context of GSE reform should align with and promote this focus.**

The single-family Guarantors should serve a market segment similar to that of the GSEs today. In the single-family market, the GSEs are, and have historically been, the dominant liquidity providers, particularly for longer-term, fixed-rate mortgages for middle-income homeowners. Borrowers benefit as a result of two key features of the current system: First, the GSEs are perceived as being backstopped by the federal government; and second, the majority of GSE single-family mortgage-backed securities are traded through the TBA market.

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7 Mortgage Bankers Association, *Affordable Rental Housing and Public Policy: Toward Greater Housing Security and Stability*. (December (2015).

8 For the calendar year 2015, 64 percent of the rental units in multifamily buildings with mortgages purchased by Fannie Mae had rents that were affordable to households at or below 80 percent of area median income, and 82 percent of the units were affordable to those at or below median income. At Freddie Mac, the shares were 75 percent and 89 percent, respectively. (See Fannie Mae *2015 Annual Housing Activities Report and Annual Mortgage Report*; and *2015 Annual Housing Activities Report Federal Home Loan Mortgage Corporation*.)



Together, these features allow a broad segment of borrowers who obtain financing through conforming loans to receive lower interest rates, while ensuring that financing for the nation's home purchase needs are met even through economic downturns. An explicit government guarantee of eligible MBS, paid for by the privately owned Guarantors, would continue to provide these benefits and, if properly managed, further reduce the risk of market disruption during a regional or national downturn. While there is much to recommend and preserve in the existing GSE multifamily business, there is greater room for improvement within the single-family business.

The current conforming loan limits should be preserved, with similar adjustments for high-cost areas, because they provide a well-understood threshold and relative ease of execution as compared with other metrics that rely on local area house prices or household incomes.

The Guarantors should have the flexibility to underwrite and price credit risk to ensure a reasonable cross-subsidy that can result in some savings for qualified borrowers while maximizing access to credit. Pricing and underwriting across various programs and markets should be as transparent as possible to ensure that eligibility, qualification and pricing information is clearly communicated to the market and balanced by sound risk-management practices.

Other elements of the existing housing finance system can be improved in ways that expand access to affordable mortgage credit.

**Potential improvements include:**

- **Updating credit-scoring models to leverage changes in technology, data and analytics that assess the creditworthiness of a larger segment of the population.** Credit-scoring models should continue to adapt to changing demographics and labor markets. Augmenting the type of data used to assess the creditworthiness of prospective buyers, including those with “thin” credit files, holds the potential to responsibly expand the pool of potential first-time homebuyers. A considerable amount of work has already been undertaken on this subject.
- **Updating documentation and derivation of income requirements to better capture self-employed or nontraditional household income that may help to identify creditworthy borrowers.** Nearly 15 million Americans are self-employed. Many face significant obstacles in meeting mortgage underwriting requirements, including income documentation.

- **Increasing the transparency of well-calibrated guarantee/credit enhancement pricing and underwriting eligibility.** The impact of loan-level price adjustments and other credit enhancements must be evaluated as part of any affordable-housing strategy. Lenders in the primary market are better able to serve borrowers to the full extent of the credit box when the parameters of eligibility requirements are well understood and consistent.
- **Providing enhanced liquidity for small-balance single-family and multifamily loans.** Small-balance loans in the residential market present unique economic challenges for lenders to originate and service. Reliable secondary market funding for these loans is important for serving lower-income borrowers and communities. In the multifamily market, incentives should be targeted toward improving liquidity for small-balance loans on projects providing affordable rental housing.
- **Partnering with lenders and other third parties to facilitate outreach and/or counseling programs for emerging demographics.** As the United States becomes increasingly diverse over the coming decades, serving these emerging borrowers will require different tools and approaches.
- **Improving access to credit for manufactured housing purchases.** Manufactured homes remain an important part of the affordable-housing stock in the United States, especially in rural areas, but there is a lack of uniformity in underwriting standards for assessing the collateral and credit risk associated with financing this product.

## Harmonize Federal Housing Policy

The at times overlapping missions of FHA, the U.S. Department of Veterans Affairs, the U.S. Department of Agriculture, the Rural Housing Service, Ginnie Mae and the GSEs should be made complementary. One approach would be to empower a single body or special advisor to harmonize and manage the various roles and targeted missions of these entities. A Special Advisor for Housing Policy Coordination could be created as part of the president's National Economic Council to help manage and rationalize housing policy and regulation. Integrating our fragmented housing policy into a single, unified strategy would allow for greater coordination and more dynamic program development, as well as clearer communication with market participants, stakeholders and regulators. Moreover, it would help reduce the risk

of discrete segments of consumers falling through the cracks as specific policies are developed and executed. Housing policy should also facilitate the movement of households along the continuum, enhancing — and not discouraging — geographic and economic mobility for those who seek it.

## Setting the Stage: The Affordable-Housing Plan

To achieve the three overarching affordable-housing missions, the end state regulator would be charged with developing a comprehensive plan. The Guarantors would then be held accountable for executing against this plan. A key part of the plan would be the achievement of affordable-housing goals established annually by the regulator. The regulator would determine whether each guarantor is meeting these goals, hold the Guarantors accountable for any failure to meet them, and recalibrate the goals as needed. In addition, the regulator would assess an affordable-housing fee on new business purchases of the Guarantors to help finance affordable-housing activities. The regulator would have flexibility in identifying and adjusting the appropriate mix of goals and fees.

Getting the mechanics right for both the Guarantors and the regulator is critical. We believe a successful approach will include the following key components:

- The end state regulator must create an affordable-housing plan that furthers the three affordable-housing missions. The regulator must periodically develop an affordable-housing plan that furthers each of our missions — namely expanding access to credit, preserving and developing affordable rental housing and improving liquidity for underserved markets.

The plan must be supported by research conducted by the regulator and with input from industry stakeholders, public interest groups and others, and aspire to achieve meaningful change within the broader framework of regulatory requirements, market trends, and safety and soundness.



- The regulator should implement the plan through a combination of affordable-housing goals for the Guarantors and a fee assessed against their new business purchases. The regulator should try to identify the best mix of goals and the fee (assessed within a permissible cost range defined by statute) to achieve the overarching plan.

This flexibility is important for several reasons. First, we do not yet know exactly how investors, Guarantors and other mortgage market actors will respond to a new end state system. For example, the exact shape of future credit risk transfers to private investors is unknown. This uncertainty will surely affect the ability of the secondary market to bear and price risk, a function that will likely mature over time. In addition, the needs of households themselves may change over time.

## A More Dynamic, Market-Based Approach to the Affordable-Housing Goals that Focuses on Outcomes

The GSEs have historically fulfilled their public mission through Affordable-Housing Goal regulations that mandated a particular ratio of loans purchased by the GSEs to be made to very-low-, low- and moderate-income borrowers and borrowers in low-income areas, or to multifamily property owners serving these communities.

In addition, “duty to serve” legislation required that the GSEs serve underserved markets in rural areas, affordable rental housing and manufactured housing. While recent duty-to-serve rules are relatively untested, the goals approach only evaluated performance based on whether or not the GSEs purchased qualifying loans. This blunt instrument sometimes led to suboptimal outcomes, particularly when the regulatory goal-setting process became disconnected from market signals.

## The regulator should assess the performance of the Guarantors in each of the relevant mission areas, including consideration of actual mortgage purchases, outreach activities, and related research and development efforts.

Because of this uncertainty, the regulator should be empowered to choose a combination of goals and a fee, within limits set to ensure the continuity of business strategies, to best achieve its affordable-housing missions. Flexibility will be especially important in the early stages of GSE reform, but the concept of dynamic housing goals, with appropriate governors, should be a core part of the new system.

- The plan and its implementation should be updated according to a periodic timeline that is defined in statute. The timeline should include adequate opportunity for the regulator to evaluate market conditions, establish a set of proposed goals and recalibrate them after receiving public input. It should also allow the Guarantors a reasonable implementation period. The regulator would then report to Congress on an annual basis on its progress in meeting the objectives of the affordable-housing plan.

The following discussion outlines a new approach to affordable-housing goals that addresses these and related concerns. Under this approach, some of the goals would include specific, quantifiable outcomes based on loans made to distinct borrower/market segments. Others would focus on qualitative efforts, such as outreach, research and targeted initiatives. Both are intended to work in tandem with and complement each other, and not be substituted for the other.

The regulator should assess the performance of the Guarantors in each of the relevant mission areas, including consideration of actual mortgage purchases, outreach activities, and related research and development efforts. A combination of quantitative, market-based targets and qualitative, activity-based targets should be used. The regulator must define goals in a manner that is appropriate for single-family and multifamily Guarantors, provided that goals for similar business lines are the same.



**Affordable-Housing Goals, whether quantitative or qualitative, should be:**

1. **Transparent and well defined.** Quantitative targets should be specified as a number, percentage or range within a demographic, geographic or income-based cohort. Qualitative targets should be assessed or graded according to established criteria that consider activities in combination with desired outcomes.
2. **Assessed in terms of market impact.** Success is ultimately based on concrete evidence about performance in certain markets, not merely on the level of resources committed or activities conducted. FHFA should focus on results that actually make a difference. At the same time, any goals should be based on market needs and circumstances, with realistic benchmarks.
3. **Measurable.** Clear metrics should allow for FHFA to evaluate performance against the affordable-housing objectives. These assessments should be made available in public, annual reports to Congress.
4. **Enforceable.** Failure to meet established goals should carry appropriate consequences, with financial penalties for more egregious failures. All significant failures should require remediation plans submitted by the guarantor to the FHFA for review and approval.
5. **Recalibrated periodically.** The FHFA should provide for formal, periodic opportunities for public input on potential refinements and adjustments to the goals. The timing of such input should be consistent with a schedule that allows the regulator to consider it fully before taking action. Any refinements and adjustments to the goals should be supported by independent research and data analysis by the regulator.
6. **Reviewed to avoid market distortions.** FHFA, in seeking to set or adjust the goals, should attempt to ensure that all goals are realistic, aligned with market circumstances, and do not inadvertently distort behavior or incentives for entities serving the affordable portion of the housing continuum. Consistent with sound risk-management practices, the Guarantors should have the flexibility to price credit risk in a way that provides a reasonable cross-subsidy to support segments of the mortgage market that are currently underserved.
7. **Balanced by safety and soundness.** FHFA should ensure that the affordable-housing obligations of the Guarantors are balanced by prudent risk-management practices.

## Completing the Missions with An Affordable-Housing Fee

To complement the affordable-housing goals of the Guarantors, we believe that an affordable-housing fee should be assessed on new business purchases of the Guarantors. The fee should be used to help support efforts along the continuum, including for market segments not traditionally served by the GSEs. By allocating resources in this way, particularly to assist lower-income renters, the Guarantors will be promoting stability and mobility along the continuum — keys to a healthy housing market.

## The Affordable-Housing Fee Should Supplement Secondary Market Activity

Fulfilling the three affordable-housing missions cannot be achieved exclusively through the government-guaranteed secondary mortgage market. As a supplement to secondary market activity, an affordable-housing fee should be dedicated to support certain affordable-housing funds, such as the National Housing Trust Fund and the Capital Magnet Fund. This fee should supplement the use of goals to support the three critical affordable-housing missions: providing access to credit for prospective homeowners, developing and preserving affordable rental housing, and improving liquidity for underserved markets.

### Certain core principles should guide the size and use of an affordable-housing fee. The fee should:

- Work in a manner similar to the current (4.2 bps) fee assessed on new business that the GSEs pay to the National Housing Trust Fund and the Capital Magnet Fund under HERA. The current fee is charged on each dollar of the outstanding principal balance of total “new” single-family and multifamily business purchases each year. Thus, it is a one-time annual assessment on each year’s acquisitions.
- Be established by FHFA through a public notice and comment rulemaking, subject to a range or band established by Congress in statute.
- Be set at a level that generates meaningful contributions to a range of important affordable-housing efforts without unduly raising the cost of mortgage credit for consumers. The impact on pricing to borrowers should be transparent.

- Be consistently applied for reasonable time periods to ensure continuity and maximize compliance. The schedule for setting and changing the fee should be transparent.
- Support mission-related activities undertaken by funds such as:
  - + **National Housing Trust Fund:** A fund currently administered by The U.S. Department of Housing and Urban Development (HUD) with monies allocated to states via a formula. The National Housing Trust Fund focuses primarily on housing support for “extremely” low-income (up to 30 percent of area median income [AMI]) and “very” low-income (up to 50 percent of AMI) renters.
  - + **Capital Magnet Fund:** A fund currently administered by Treasury with competitive grants provided to qualified affordable-housing organizations, such as Community Development Financial Institutions. The fund is used to leverage private capital and support investment in housing primarily for low-, very-low- and extremely-low-income households, as well as for certain community development activities.
  - + **Market Access Fund:** A new fund that would be administered by the regulator to support research, development and innovations in consumer education, product design, new market segments (such as single-family rentals), underwriting and servicing, as well as credit support for certain mortgage loans or pools and the development of affordable housing for rent and for sale. (A similar fund was proposed in the Johnson-Crapo GSE reform legislation in 2014.)

Once the fee is established, the regulator should report annually to Congress regarding the use of the funds generated by the fee, providing appropriate metrics to gauge performance and outcomes. In making these reports, the regulator should coordinate with the federal agencies charged with administering the funds described above.



## Moving Forward

Today far too many households suffer from housing cost burdens that are consuming excessive amounts of their income. The supply of rental homes affordable to the lowest-income families on the housing continuum is inadequate to meet demand. At the same time, the national homeownership rate has declined significantly since the financial crisis, with many minority and low-wealth communities falling even further behind. For many Americans, access to credit and the ability to obtain a mortgage to become a first-time homebuyer have been denied. Left unaddressed, these problems will likely intensify in the coming decade as our country undergoes a profound demographic transformation.

GSE reform offers the opportunity to develop an inclusive approach to affordable housing — one that serves the full spectrum of households, addresses shortcomings in today's system, provides greater protection for taxpayers, and attempts to anticipate future issues and obstacles. It is imperative that we seize this opportunity.

When Congress last considered GSE reform legislation in 2014, affordable housing was at the center of the debate. And it remains there today. This framework is designed to help outline a viable path forward.







# Conclusion: A Call to Action

As we approach the ninth anniversary of the decision to place Fannie Mae and Freddie Mac under government conservatorship, it is nearly universally acknowledged that maintaining the status quo of the housing finance system is not a viable solution.

The GSEs continue to move closer to a point where they will have no retained capital. The threat of a draw on their line of credit with the U.S. Treasury looms as a very real possibility. At the same time, the housing needs of millions of lower- and moderate-income families today remain unmet. Access to mortgage credit is unnecessarily tight, while rental cost burdens continue to weigh heavily on family budgets.

This paper is designed to provide the spark for a renewed focus on GSE reform. It outlines the key principles and guardrails that should guide this effort and provides a snapshot of what the new secondary-market end state should look like. It also attempts to shed light on two critical areas that have tested past reform efforts — the appropriate transition to the post-GSE system and the role of the secondary market in advancing an affordable-housing strategy.

While achieving GSE reform will not be easy, the potential upside is great. Our recommended approach to reform will:

- Inject much higher levels of risk-bearing private capital into the mortgage system, while dramatically reducing the system's reliance on government support.
- Protect taxpayers and consumers with a clear set of market conduct rules, prudential requirements, and a new Mortgage Insurance Fund financed with appropriately priced insurance premiums.

- Enhance the stability of the mortgage system with multiple Guarantors replacing the GSEs and operating as privately-owned utilities that are not too big to fail.
- Improve service and performance in the secondary market with multiple Guarantors competing on operations and systems development, customer service, product parameters and innovation, and pricing and execution.
- Ensure that mortgage lenders of all sizes and business models have equal access to the secondary market.
- Minimize disruption during the transition to the new system by preserving what works in the current system and utilizing the existing regulatory framework where appropriate.

Ultimately, GSE reform holds promise to create a more vibrant and sustainable housing finance system that can enhance the lives of millions of Americans and help stabilize the housing market for decades to come. The hard work of reform should proceed without delay.







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