Reforming the U.S. Housing Finance System

An Evaluation of the Prospects for Reforming Fannie Mae and Freddie Mac

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Introduction

Reforming Fannie Mae and Freddie Mac is a significant element of the administration's broader reform efforts to reengineer the U.S. housing finance system, which comprises more than 15% of the country's gross domestic product. The administration's reform proposals will likely touch on a broad number of participants in the housing system, ranging from Fannie Mae, Freddie Mac, the Federal Housing Administration (FHA), Ginnie Mae, the Federal Home Loan Bank (FHLB) System, the Rural Housing System (RHS), and Community Development Financial Institutions (CDFIs), to the housing processes and systems, which drive the mortgage origination, underwriting, securitization and after-market support of mortgages.

Background

The Housing System Landscape

Fannie Mae and Freddie Mac

Together, Fannie Mae and Freddie Mac have lost $224.7 billion since the onset of the financial crisis, which has triggered the injection of more than $150.3 billion of taxpayer funds to preserve the enterprises' solvency. The Congressional Budget Office projects that the taxpayers' losses on the GSEs will ultimately exceed $380 billion, making this the largest federal bailout ever. Other analysts suggest the losses on Fannie Mae and Freddie Mac could approach $1 trillion, if default and foreclosure rates remain high and property values continue to fall. These estimates vary largely because of the three different kinds of losses generated by the enterprises, including those (i) linked to the GSEs' $5 trillion of mortgage-backed securities (MBS) and loan guarantees; (ii) resulting from regular, ongoing operations in a declining housing market; and (iii) related to the GSEs' operating as de facto government agencies, subsidizing foreclosure-prevention efforts.

The GSEs' losses are destined to increase, as the enterprises dispose of growing levels of real estate owned. Fannie Mae's and Freddie Mac's losses on real estate owned (REO) are exacerbated by their geographic concentration in the hardest hit markets in the economic downturn—specifically Arizona, California, Florida, and Nevada. More than 42% of Freddie Mac's REO portfolio consists of properties in these four states, with a heavy concentration in California (20%). Similarly, Fannie Mae's REO portfolio is heavily concentrated in these four states (32.4%), with 12.9% of their portfolio located in California.

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	Fannie Mae	Freddie Mac
Non-performing Assets on 06/30/10	$217.2 billion	$118.7 billion
% Total mortgage loans	7.29%	6.30%
Serious Delinquencies on 6/30/10		
Single-Family Mortgages	4.99%	3.96%
Multi-Family Mortgages	0.80%	0.28%
Real Estate Owned on 06/30/10		
Number of properties	129,310	62,190
Carrying value of REO	$13.0 billion	$11.3 billion
Disposal severity ratio	34.3%	38.0%
Fair Market Value on 6/30/10	($138.0 billion)	($46.3 billion)

Sources: Fannie Mae 2010 Second Quarter Credit Supplement, 08/06/10;
Freddie Mac 2010 Second Quarter Financial Results Supplement, 08/09/10

Federal government agencies—Fannie Mae, Freddie Mac, and HUD—own in aggregate more than 46% of the nation's REO inventory, totaling 478,000 units, according to a June analysis by Radar Logic, prior to the release of second quarter results. In an analysis of mortgage delinquencies, Radar Logic projects the government's REO holdings may ultimately exceed 3.0 million units, as serious mortgage delinquencies (5 million homeowners) and 30 to 90 day delinquencies (2.3 million homeowners) move through the resolution process (and assuming a 35% cure rate). Zillow estimates that the federal government's losses on the foreclosure pipeline could exceed $300 billion, which would be borne by Fannie Mae, Freddie Mac, and FHA, unless commercial banks are compelled to take the losses through forced loan buybacks.

The U.S. Government's Potential REO Inventory	
30-90 Days Delinquent	1,032,000
90 Days Delinquent or in Foreclosure Process	1,820,000
REO	219,000
Total	3,071,000
Average Loan Value	$200,000
Total Loan Value of REO and Foreclosure Pipeline	$614 Billion
Average Discount in REO Sale Price Relative to Loan Value	40%
Loss to Tax Payer from REO Sales	$246 Billion
Short Sales (25% of Foreclosure Pipeline)	1,097,000
Total Loan Value of Homes Sold in Short Sales	$219 Billion
Average Discount in Short Sale Price Relative to Loan Value	40%
Loss to Tax Payer from Short Sales	$88 Billion
Total Losses to Taxpayer From Short and REO Sales	$333 Billion

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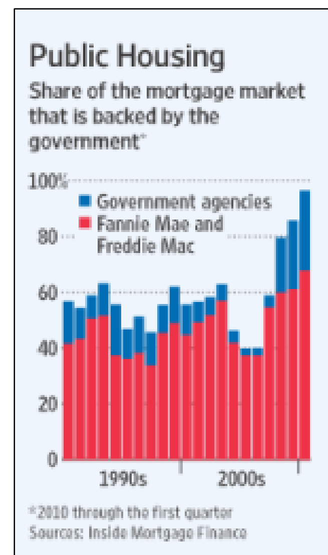
Although loan servicers and the GSEs have expended great efforts to help mitigate foreclosures through the Home Affordable Modification Program and Home Affordable Refinance Programs, only 341,000 permanent loan modifications have been completed with an additional 468,000 active trial modifications pending. According to Fannie Mae's March 31st disclosure, the re-default rate for the company's modified loans averaged 54%, six months after modification. As a result of loan modification efforts, the average time it takes for a homeowner who defaults on their mortgage to lose their property to foreclosure has increased 75%—from 251 days in January 2008 to 438 days in April 2010—further increasing the GSEs' losses on foreclosures, which averaged 44% (of the unpaid principal balance of REO properties sold) and 39% for Fannie and Freddie, respectively in the first quarter of 2010.

According to Zillow, the current median US home price is $204,900 is down 6.82% year-over-year on March 31st, while 23.3% of borrowers were underwater. The Zillow survey identifies 12 metro-markets in which 50% of area homeowners are underwater with heavy concentrations in California (5 metro markets), Florida (3), Nevada (2) and Arizona (1). Barring some unforeseen exogenous boost to housing, the price stability in the single-family real estate market will likely come to an end during the second half of 2010, as the unprecedented number of homes go into default and move through the foreclosure process.

FHA

Since 2006, FHA has expanded dramatically its presence in the mortgage market, increasing its originations from 3% to 30% of all mortgages in the first quarter of 2010. For the first time ever, FHA's mortgage originations in the first quarter, totaling $52.5 billion of home-purchase mortgages, exceeded that of Fannie and Freddie combined by more than 14%. FHA Commissioner David Stevens noted, "This is a market purely on life support, sustained by the federal government. Having FHA do this much volume is a sign of a very sick system."

On March 31, FHA insured nearly 6.2 million loans totaling $820 billion—of which 8.8% (536,858 loans) were severely delinquent and 12.23% were delinquent 30 days or more. Assuming the average FHA-insured loan balance of $132,300, FHA delinquent loan balances were an estimated $71.0 billion on March 31, 2010.



Federal Home Loan Banks

For nearly 80 years, the 12 FHLBs have served as a part of the U.S. housing finance infrastructure, providing a primary source of funding for its members. On June 30, these government-sponsored entities reported total assets of $937 billion and advances to members of $540 billion

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(collateralized largely by loan assets). In addition, the FHLB System has 7% of its assets ($67 billion) invested in mortgages that it acquired from member institutions. Approximately 80% of U.S. lending institutions relies on the FHLBs as a source of liquidity.

Over the past 20 years, the FHLB System has provided $3.7 billion of affordable housing grants to provide housing opportunities to underserved communities. For every $1 million that a FHLB lends, $14.3 million of additional housing units are built or rehabilitated, 158 jobs are created, and $24.6 million of general economic development is generated, wrote FHLB-Atlanta interim president Jill Spencer, in a comment letter to Treasury on reforming the housing finance system.

Challenges to Housing Reform

Market Dominance of GSEs

Complicating the policy options for reforming Fannie Mae and Freddie Mac is the mortgage market's heavy reliance on explicit government support of mortgages through the housing GSEs. Collectively, Fannie Mae, Freddie Mac, and FHA backed 96.5% of home mortgage originations during the first quarter of 2010, up from 90% a year ago. (The remaining non-government part of the origination market consisted of banks' portfolio lending, consisting largely of jumbo mortgages.) In aggregate, Fannie Mae and Freddie Mac's combined balance sheets of $1.6 trillion and mortgage guarantees comprise 53% of all outstanding U.S. mortgage debt today. Moreover, FHA's $820 billion of insured mortgages expands the government's mortgage guarantee to nearly 68% of all outstanding mortgages. Together, Fannie Mae, Freddie Mac, and FHA have become the mortgage industry's wastebasket for toxic mortgage debt. Simply put, the U.S. mortgage market would not function without the federal government's active involvement at this time.

Foreign Ownership of GSE debt and MBS

Foreign ownership of GSE debt and mortgage securities—not to mention that of the Federal Reserve Bank and Treasury—further complicate and likely limit the options for GSE reform. Prior to the 2008 financial crisis, Fannie Mae and Freddie Mac served as convenient off-budget tools for policymakers to subsidize housing through implicit guarantees of the GSEs. In September 2008, the government's implicit guarantee became explicit with the failure of Fannie Mae and Freddie Mac.

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In his recently published memoir, former Treasury Secretary Henry Paulson recounted how Russian officials approached Chinese officials in the summer of 2008, suggesting that both countries sell large blocks of GSE debt as a means of forcing the U.S. to explicitly back the GSEs' issuances.

Although Paulson claimed that China opted not to collaborate with Russia, both countries reduced their investments in GSE debt by some $220 billion during the last six months of 2008 ($170 billion by Russia and $50 billion by China). This fire sale, in turn, drove spreads between agency debt and U.S. Treasury debt higher, which forced U.S. banks to quickly provide more collateral to support their borrowings in the repo market, as the value of their collateral (GSE debt) declined. This episode, which clearly illustrates the political risk that the U.S. government faces in its heavy dependence on foreign borrowing, also has implications on GSE reform. What policy options will the owners of agency debt determine are acceptable? When, if ever, will foreign investors accept implicit guarantees, when investing in U.S. mortgage products?

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Impact of the Dodd-Frank Act

To address some of the excesses in the mortgage securitization market that contributed to the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act attempts to remove incentives embedded in the "originate-to-distribute" securitization model by requiring MBS sponsors to retain 5% of credit risk inherent in the collateral assets. However, provisions in the bill carve out exemptions for assets issued or guaranteed by the U.S. government, any state, or agency—such as FHA, VA, and Farm Credit—which consist of qualified residential mortgage loans that conform to parameters to be established by regulation. (While Fannie Mae and Freddie Mac are not considered U.S. agencies, analysts expect the GSEs' conforming loans to be deemed qualified residential mortgages under the Dodd-Frank Act regulations that are to be written, and exempted from the 5% retention provision.) These "skin-in-the-game" provisions are expected to result in the predominance of "plain vanilla" mortgages, insured by FHA, Fannie Mae, and Freddie Mac, in the mortgage market, and further expand the role and dominance of these agencies, as the sole conduits for residential mortgage credit for the foreseeable future.

The Mortgage Interest Deduction

As Congress turns its attention to GSE reform, several other larger policy issues will take center stage—starting with housing subsidies and their impact on the federal budget. In a July 21st commentary, John E. Silvia, chief economist for Wells Fargo, wrote:

> "For some time, at least since the 1960s, public policy in the United States has been criticized as over-subsidizing housing relative to other forms of investment and saving by households and for society at large. For housing, there are special tax deductions and home improvement credits. In 1998, a special capital gains break was given to housing. Special lending agencies, the Government Sponsored Enterprises (GSEs), were set up, along with the Federal Housing Administration (FHA), to subsidize the secondary home mortgage market. Housing and housing credit has been mispriced so much and for so long that it is impossible to truly gauge the extent of the public subsidy of housing. What we do know is that there is very little true guidance of what housing is really worth, and therefore we remain very concerned that the scale of all public and private institutions that are committed to housing is a function of public subsidies as much as private demand. This is a risky proposition given the financial breakdown of the GSEs and the scale of federal debt today."

The country's growing budget deficits have triggered a policy debate over the cost of home mortgage interest deduction, which is expected to cost $637 billion over the five year period ending 2015, according to OMB. In addition, the exclusion of capital gains on primary residences is expected to cost $215 billion over the next five years with the deductibility of state and local property taxes for primary residences adding an additional $151 billion five-year cost to the federal government. Collectively, these subsidies will reduce federal revenue by over $1 trillion over a decade, representing more than 10% of

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the federal government's projected $9 trillion deficit. The administration's National Commission on Fiscal Responsibility and Reform will address this issue in its recommendations to Congress to address the country's fiscal challenges.

An indication of the Obama administration's position on the mortgage interest deduction is reflected in its 2010 budget, which proposed cutting the interest deduction for wealthy homeowners to generate a savings of $208 billion over a ten year period. According to the *Washington Post* reporter Zachary A. Goldfarb:

> "The administration's narrower view of who should own a home and what the government should to do to support them could have major implications for the economy as well as borrowers. Broadly, the administration may wind down some government backing for home loans, but increase the focus on affordable rentals."

Sustainability of Home Ownership

Congress will likely debate the sustainability of home ownership. Homeownership levels, which ranged from 63% to 65% from 1965 to 1995, peaked in late 2004 at 69% (entirely through debt financing). Federal Deposit Insurance Corporation (FDIC) Chairman Shelia Bair recently argued that homeownership levels were pushed to unsustainable levels during the housing boom and urged policymakers to revisit the unintended consequences of the nation's housing policy. If policymakers conclude that higher homeownership rates simply are not sustainable, then lawmakers may consider shifting subsidies from homeownership to the multifamily rental-housing sector.

The 30-Year Fixed-Rate Mortgage

As lawmakers consider GSE reform, both Democrat and Republican Members of Congress remain committed to the 30-year fixed-rate mortgage product. This mortgage product, argues former HUD economist Susan Woodward, is something Americans view "as a part of their civil rights." If so, the federal government's role in the mortgage market will remain, as federal subsidies are essential to preserving this mortgage product. No country—other than the U.S.—makes the 30-year fixed-rate mortgage product available to its citizens. Other related issues for policymakers to consider regarding the 30-year fixed-rate loan product include (i) who is targeted to receive the subsidy; (ii) the subsidy's cost; and (iii) how to deliver the subsidy efficiently and at no cost to the taxpayer.

TBA Market

Participants in the securitization market will urge policymakers to preserve the "To Be Announced" (TBA) trading market, which serves as the link between the primary and secondary markets and allows borrowers to lock rates for up to 90 days prior to closing (but exposes lenders to interest rate risk). Specifically, in the TBA market, lenders contract to sell loans that do not yet exist (the loans are to be announced) for securitization into a GSE MBS on a future, specified date up to 90 days before the loans

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settle. At the time of this trade, neither the eact pool, number of pools, or loans comprising the pool are known. Instead, the trade – in fact the entire market – is made possible only because of the fundamental assumption of the homogeneity and fungibility of the loans.

Importantly, the TBA market's homogeneity is made possible by (i) the conforming (Fannie Mae and Freddie Mac eligible) loan product, which is standardized with established and uniform underwriting guidelines and uniform loan documents; and (ii) the GSE guarantee, which equalizes the MBS in terms of credit risk. Market participants contend that any GSE "reform" which doefs not accommodate or provide a suitable replacement for the TBA market will undoubtedly reduce the mortgage originators' options to "rate lock" and likely increase mortgage costs to the end consumer.

Affordable Housing

The role and structure of the GSEs'—Fannie Mae, Freddie Mac, and the FHLBs—affordable housing goals will also be a contentious issue in the reform debate. Currently, 10% of the FHLBs' income is committed to an affordable housing fund that is then reinvested in affordable housing projects. The FHLB program is generally considered to be a success. Fannie Mae's and Freddie Mac's affordable housing goals are more complex and are set by their regulator annually. The GSE reform legislation passed in 2008 established an Affordable Housing Trust Fund and Capital Magnet Fund. While in conservatorship the GSEs' affordable housing commitments have been suspended, but the affordable housing issue will be a major point of contention, which will be debated along partisan lines in any reform effort. Republicans blame the affordable housing goals for "forcing" Fannie Mae and Freddie Mac to lower their underwriting standards and engage in funding risky loans, which they believe caused their massive losses.

Democrats and consumer advocates, who hotly contest this assertion, will work to ensure that the Affordable Housing Trust Fund survives in any final reform bill. Moreover, the Democrats will work to ensure that the reformed mortgage system generates fees dedicated to the Affordable Housing Trust Fund. Undoubtedly, the upcoming November elections will have an impact on the outcome of this issue. It is unclear, however, that the banking industry will engage on this issue, potentially opting instead to accept affordable housing as a cost of doing business, which will then be passed along to consumers.

Strengths and Weaknesses of the GSE Hybrid Model

Fannie Mae's and Freddie Mac's missions have been threefold: (i) facilitate the securitization of mortgages into MBS; (ii) stabilize and assist the secondary market for MBS; and (iii) support affordable housing, a responsibility assigned to the GSEs in the 1992 Federal Housing Enterprises Financial Safety and Soundness Act.

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Historically, Fannie Mae and Freddie Mac have enjoyed a number of privileges under their federal charters and regulatory framework, including:

- Lower capital requirements than other financial institutions, which allowed the GSEs to maximize their use of leverage. (The 2008 GSE reform bill directed the regulator to eventually increase their capital requirements, but left the timing and level of capital that would eventually be required to the discretion of their regulator, the Federal Housing Finance Agecny (FHFA).

- Lower cost of capital, either through direct access to the Treasury, or in the debt markets, where the GSEs were perceived to have implied government backing. The GSEs' implied [and now explicit] federal guarantee of their debt allowed the GSEs to issue bonds whenever they needed for funds, regardless of market conditions, at interest rates lower than those granted to the best fully-private companies.

- Lower perceived level of risk borne by GSEs in the "eyes" of the market. With an explicit federal guarantee of GSE debt, investors did not judge Fannie Mae and Freddie Mac with the same risk standard that was applied to private companies, providing a benefit to both their debt and their stock. In turn, the GSEs' high leverage provided the enterprises exceptional returns on equity during prosperous times.

- Advantages in the capital market that gave the GSEs added operating flexibilities. Federal support allowed the GSEs to increase their financial flexibility by issuing callable long-term debt. The GSEs' debt securities were eligible for open-market transactions by the Federal Reserve Board, and for investment by insured banks and thrifts. The GSEs' debt securities were eligible for collateral for the federal government's deposits of tax revenues in banks.

- Favorable treatment of GSEs' MBS under Basel II. Historically, the GSEs' securities held by banks and thrifts required only a 20% risk weighting, as compared to the 50% risk weighting assigned to prudently underwritten private MBS under the Basel Accord. To date, no changes have been proposed to risk-weighting for agency MBS under Basel III.

- Line of credit with the Treasury. The Secretary of the Treasury is authorized to purchase up to $2.25 billion of their securities, effectively providing each GSE a $2.25 billion line of credit to the U.S. Treasury. The amount is not large, but the federal backing is unique.

- Exemption from state and local taxes.

- Exemption from filing with the SEC for purposes of the 1933 and 1934 Acts for debt offerings, saving both the expense of filing and the time needed to compile

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and write SEC disclosures. (The 2008 GSE reform bill repealed their exemption from the 1934 Act, but the exemption from 1933 Act remains.)

- Exclusive charters, which are a barrier to creation of new competitors and which ensure the GSEs' duopsony status cannot expire without direct Congressional action.

To evaluate GSE reform proposals, it is important to identify not only what changes need to be made to the enterprise models, but also what elements should be preserved. As government-sponsored entities that are publicly owned, the enterprises have successfully provided liquidity for the U.S. mortgage market, making possible the 30-year fixed-rate mortgage product. The GSEs implemented the standardization of the mortgage origination and of automated underwriting, created the credit scoring process, standardized the underwriting and securitization process, facilitated the TBA market, and established the standard for determining "acceptable" levels of credit risk. Fannie Mae and Freddie Mac have provided access to mortgage credit during economic downturns with the support of the Federal Reserve Board and Treasury. Prior to entering conservatorship, the GSEs were the largest players in the market for purchasing and securitizing multifamily loans, responsible for nearly one third of all multifamily debt, and they accounted for nearly 40% of the Low Income Housing Tax Credit projects across the country. The GSEs have also been large purchasers of state housing finance bonds; have partnered with non-profits to expand the secondary market for loans to low- and moderate-income buyers, and have made significant contributions to the low-income population, particularly in the metropolitan D.C. area, through their philanthropic activities.

The key disadvantage of the current GSE model is the moral hazard of the government's implicit guarantee of the enterprises. Specifically, the privately owned enterprises sought to expand their market share and profits through lower underwriting standards and distorted portfolio investments to maximize short-term profits. Ultimately, the taxpayers have borne the cost of the GSEs' moral hazard—$147.2 billion and growing. Some argue that the GSEs' implicit subsidy was not well-targeted to underserved borrowers, instead enriching select stakeholders, such as the GSEs' executives, GSE stockholders, realtors, and homebuilders. The GSEs' political power allowed the companies to avoid proper regulatory oversight, which permitted their rapid growth into "too big to fail" enterprises which resulted in cataclysmic losses.

In addition, despite the benefits that the GSEs brought to the mortgage market place, the GSEs, in their later years, stymied, rather than facilitated, advances in the mortgage system unless those advances specifically benefitted their bottom line.

On balance, the inherent weaknesses of the current GSE model to be addressed in reforming Fannie and Freddie include: (i) moral hazard arising from the government's implicit guarantee; (ii) concentration of risk, making the enterprises too big to fail (TBTF); (iii) the duopsony structure of Fannie and Freddie, which inhibited competition and innovation; (iv) inadequate capital; (v) weak regulatory oversight; (vi) lack of

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transparency of the loan underwriting process through the GSEs' automated underwriting system; (viii) GSEs' 37 broad patents, covering the loan underwriting process, automated underwriting systems, and cap-and-trade electronic systems, which have contributed to the enterprises' market dominance and have limited competition; and (vii) the enterprises' enormous political influence.

Fannie Mae and Freddie Mac Under Conservatorship

The GSE Agreements with Treasury

On September 6, 2008, Fannie Mae and Freddie Mac went into conservatorship and entered into agreements with Treasury (the Agreements) under which Treasury agreed to provide funding of up to $100 billion for each GSE, in exchange for dividends and other compensation to Treasury.[1]

On May 6, 2009, the Agreements were amended to increase amount of capital Treasury could supply, from $100 billion for each GSE to $200 billion for each.

On December 24, 2009, the Agreements were amended to remove the cap on possible Treasury funding. That cap now reads, for each GSE (emphasis added):

"Maximum Amount" means, as of any date of determination, the greater of (a) $200,000,000,000 (two hundred billion dollars), or (b) $200,000,000,000 plus the cumulative total of Deficiency Amounts determined for calendar quarters in calendar years 2010, 2011, and 2012, less any Surplus Amount determined as of December 31, 2012, and in the case of either (a) or (b), less the aggregate amount of funding under the Commitment prior to such date.[2]

The cap is $200 billion per GSE, or $400 billion in total, plus their Deficiency Amounts for 2010 through 2012, less amount of funding under Treasury's commitment, which began in 2008, through 2012. The amount Treasury funded under its commitment from inception through 2009 is $125 billion for both GSEs combined. While the amount of funding provided by Treasury for FY2010 through FY2012 is unknown, these funds are added to the cap and then backed out, so they may be ignored for this calculation.

The combined cap for both GSEs is $400 billion less $125 billion funded before 2010, for a total of $275 billion.[3] There is no sunset date by which Treasury must fund the GSEs. If a GSE were liquidated, Treasury's commitment would expire for that GSE. While Treasury is committed to preventing a GSE from having negative equity, there is no other requirement that it must commit all of its $275 billion by December 31, 2012.

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[1] www.ustreas.gov/press/releases/reports/seniorpreferredstockpurchaseagreementfnm1.pdf
[2] http://financialstability.gov/docs/HAMP/12242009/Fannie.pdf
[3] See this link for Treasury advances made prior to 2010: www.fhfa.gov/webfiles/15747/1Q10CapitalDisclosure52010.pdf

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Conservatorship vs. Receivership

The powers of a conservator and of a receiver are similar in that each has power to operate the GSE. A conservator for Fannie Mae or Freddie Mac is permitted to take necessary actions to put the GSE in a sound and solvent condition.

A receiver, but not a conservator, "shall" place the GSE in liquidation and "realize upon its assets" including through asset sales or through transferring assets to a limited-life regulated entity. If a receiver were to use a limited-life regulated entity, that entity would succeed to the GSE's charter. FHFA would be required to wind down the affairs of the limited-life regulated entity, although only Congress may revoke the charter.

A receivership may wind down a GSE, while a conservator is designed to restore a GSE and keep its charter intact. This difference will make the conservatorship route more attractive to policymakers and other stakeholders interested in the survival of one or both GSE charters.

Divesting Toxic Assets

Both a conservator and a receiver have authority to transfer or sell any asset or liability of the GSE "without any approval, assignment, or consent[.]"

The Agreements restrict the GSEs' ability to sell assets if they are not in receivership. There are two significant exceptions:

They may sell assets "in the ordinary course of business consistent, with past practice[.]" These are not defined terms. Relevant here is that there may not be anyone challenging whether an asset sale is permissible. They may also sell assets to shrink their portfolios as the Agreements require. The Agreements set a maximum portfolio size, but not a minimum. It is possible that asset sales in any amount would be permissible under this exception.

FHFA's actions as a conservator, such as selling GSE assets, "shall not be subject to the direction or supervision of any other agency of the United States or any State[.]" These existing authorities provide flexibility to deal with the GSEs' assets in a number of ways.

Treasury's Preferred Stock Dividends

The Agreements currently require the GSEs to pay 10% dividends to Treasury on the amount of the Treasury funding (plus ten percent of an initial $1 billion "liquidation preference" fee, although Treasury did not fund this amount). The dividend payments are costly to the GSEs, currently $1.9 billion and $1.3 billion quarterly for Fannie Mae and Freddie Mac, respectively. Recently, the National Association of Realtors called upon the Obama administration to eliminate the GSEs' dividend payments, arguing such a move would provide support the housing market.

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The GSEs' dividend payments could be lowered or eliminated by simply amending the Agreements. Given the history of amending the Agreements to the GSEs' benefit, this would not be unprecedented. Further, the September 2008 Agreements required the GSEs to pay Treasury a quarterly "periodic commitment fee" beginning in March 31, 2010, in an amount to be "mutually agreed" by Treasury and the GSEs, in consultation with the Federal Reserve. That Agreement provides that the Treasury may waive the fee for up to a year at a time, "in its sole discretion, based on adverse conditions in the United States mortgage market." The December 24, 2009 amendments to the Agreement did just that. It remains to be seen whether Treasury will ever require a periodic commitment fee.

Cost of the Government's "Implicit" Guarantee of Fannie Mae and Freddie Mac

In the Federal Reserve Bank of Atlanta's Economics Quarterly [First Quarter 2002], economists W. Scott Frame and Larry D. Wall wrote, "A subsidy in the form of an implicit guarantee creates the appearance of something for nothing: a lower-cost funding for the housing GSEs at no cost to the taxpayers. However, as with co-signing a loan, a seemingly costless guarantee can turn out to be very costly. Moreover, providing an implicit guarantee to cover debt obligations may increase risk-taking incentives if the GSE becomes financially distressed."

The authors' warning was clearly prescient—given the GSEs' failure six years later and subsequent financial crisis. With the benefit of hindsight, it is clear that the government's implicit guarantee of Fannie Mae and Freddie Mac has cost taxpayers some $150 billion today (and growing); the largest federal bailout in U.S. history. Many argue that the government's indirect support of homeownership through the GSEs were at the heart of the financial crisis—fueling demand for homes, driving up the cost of homeownership, and putting pressure on the marketplace to provide "affordable" mortgages by lowering underwriting standards. Ultimately, the mortgage finance system imploded and real estate values fell nearly 20% from their peak, triggering more than $885 billion of losses for U.S. banks and approximately $2.28 trillion of asset write-downs globally, according to an April 2010 estimate by the International Monetary Fund.

On balance, household wealth in the U.S. fell by approximately $17 trillion between 2007 and 2009. According to Pew Briefing Paper #18 by Phillip Swager, the economic and fiscal impact of the financial crisis has resulted in a loss of more than $105,000 per household in the U.S.

	Total impact of the crisis	**Per Household Loss**
GDP (total lost income)	$650 billion	$5,800
Employment (lost jobs)	5.5 million jobs	
Wages (total lost wages)	$360 billion	$3,250
Real estate wealth (July 08-March 09)	$3.4 trillion	$30,300
Stock wealth (July 08-March 09)	$7.4 trillion	$66,200
Fiscal cost (losses on TARP + GSEs)	$230 billion	$2,050

Source: Pew Briefing Paper #18, Cost of the Financial Crisis, Phillip Swagel, March 18, 2010

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Reform Proposals

Appendix A provides a description of the proposals that various stakeholders have made concerning the reform of the housing financial system in general and GSEs specifically. In some cases, the stakeholders have set forth a list of reform principals or other commentary, which is noted accordingly. Table 1 provides a summary the stakeholders' proposals, which reflects a general coalescing around a privatization of Fannie Mae and Freddie Mac, operating either as co-operatives or privately-owned entities that operate under the utility model. In general, most stakeholders believe that some form of government subsidy, generally in the form an explicit guarantee of MBS for catastrophic losses, is needed to ensure the viability of the 30-year fixed-rate mortgage and other fixed rate products.

GSE Reform Issues

The stakeholders identified the following issues that need to be addressed in reforming Fannie Mae and Freddie Mac:

- Survival of the 30-year and 15-year fixed-rate mortgages;
- Government guarantee—form (explicit, implicit, or none) and element covered (MBS only and GSE debt);
- GSE debt and degree of allowable leverage;
- Retained mortgage portfolio;
- Support of affordable housing;
- Conforming loan limits;
- Affordable housing goals;
- Taxpayer protection, including loan buybacks and pursuit of fraud;
- Higher mortgage down payment requirement;
- Number of GSEs to resolve TBTF;
- How to raise capital for the new entities;
- GSE charter provisions;
- GSE patents and automated underwriting and information systems; and
- Names of these entities ("actually very critical component" of reforming the GSEs, according to a Wall Street analyst).

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Table 1: GSE Reform Proposals

Stakeholder	Business model	Government Guarantee	Retained Portfolio	Regulator	Affordable Housing
Federal Reserve	Cooperative	Explicit-Tail Risk	De minimis	--	--
Trade Groups					
American Bankers Association	--	--	--	“Strong”	None
Housing Policy Council	Private Ins.	Explicit[1]	De minimis	FHFA	Fees to NHTF
Independent Community Bankers of America	--	Implicit	--	--	From Earnings
Mortgage Bankers Association	Utility	Explicit[1]	--	--	None
National Association of Home Builders	Private	Explicit[1]	--	--	--
National Association of Realtors	Cooperative	Explicit	--	--	Mission
National Low Income Housing Coalition	--	--	--	--	First Priority
Securities Industry and Financial Markets Assn.	--	Explicit[1]	--	“Strong”	--
Commercial Banks and Wall Street					
Bank of America	Multiple Models	(Based on Model)	Covered Bonds	--	--
Credit Suisse	Co-op or Utility	Explicit[1]	Smaller	FHFA	--
Wells Fargo	--	Explicit[1]	De minimis	“Strong”	--
Andrew Davidson & Co.	Cooperative	Explicit Sr. Bonds	--	--	--
Keefe Bruyette & Woods	Cooperative	Explicit (MBSs)	De minimis	(phase out)	--
Redwood Trust	Cooperative	Explicit (MBSs)	None	“Strong”	--
Foundations					
American Enterprise Institute	Private	--	--	--	None
Cato Foundation	Co-op	None	None	“Strong”	--
Center for American Progress	Utility/Co-op	Explicit (MBS)	De minimis	“Strict”	Fee on MBSs
Economic Policies for 21st Century	Private	Explicit[1]	None	--	--
Reason Foundation	Eliminate GSEs	None	--	--	FHA

[1]Explicit government guarantee on MBSs to cover catastrophic losses

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GSE Transition Issues

The critical transition issues identified by stakeholders include:

- Good bank/bad bank structure with the 2005-2007 legacy assets largely comprising the bad bank;
    - Impact of FAS 166 and 167;
- Continued explicit guarantee of GSE debt and MBS;
- Retained portfolio run-off; and
- TBA market.

It is unclear which structural options Treasury will use for the GSEs during a transition to a reformed state. The structural options for the transition period include:

- ***Creation of a "Bad Bank."*** Under this scenario, an entity (the "Bad Bank") would be created to aggregate the toxic and perhaps most if not all of their portfolio assets, particularly the low-yielding assets of both GSEs. The aggregator institution could be supported by the GSEs (Treasury) and, private investors, or both. Treasury adopted a similar structure in the bailout and reorganization of Citigroup. If implemented before December 31, 2012, Treasury can advance an unlimited amount to the Bad Bank to cover its current and future losses. Under this framework, it may be possible for both GSE charters to survive.

- ***Creation of the "Good GSE(s)."*** Once freed of their troubled assets and with access to approximately $275 billion from the Treasury even after the end of 2012, one or both of the GSEs would be sufficiently capitalized to continue their guaranty business and potentially fund a small portfolio to support multi-family lending. Especially when the $275 equity infusion is combined with the GSEs' market dominance, the "Good GSE(s)" may be able to raise private capital through an initial public offering, similar to the General Motors ongoing public offering, the proceeds of which will be used toward the partial repayment of the taxpayers' bailout of the auto company.

- ***Implementation of a HERA tax on the GSEs to support affordable housing.*** Congress imposed a tax on Fannie Mae and Freddie Mac MBS issuances to support low-income housing. It was enacted in the Housing and Economic Recovery Act of 2008 (HERA), but FHFA suspended it when the agency placed Fannie Mae and Freddie Mac into conservatorship. GSE survival could activate this tax. Further, the 27% low- and very low-income home purchase mandates in HERA and in FHFA regulations, which were also weakened by the conservatorships, would also become fully applicable. The affordable housing groups and their policymaker allies can be expected to support such reinstituting these requirements on the "Good GSE(s)."

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One potential impediment to this "Good GSE(s)" / "Bad Bank" structure is that the GSEs' guaranty will continue even if the assets are sold to a "Bad Bank." Under FAS 166 and 167, the GSEs will not be able to "cleanse" their balance sheet of this liability even by selling the assets. However, Fannie Mae, Freddie Mac, Treasury, and the Federal Reserve Board own much of the outstanding MBS, so the government might waive and absolve the GSEs of their guaranty obligations for the government-owned MBS. For privately-held MBS, though, the guaranty and the subsequently liability would continue. Under GAAP, the GSEs would need to continue to reflect this liability on their balance sheets.

To address this problem, FHFA could potentially treat one of the GSEs as a "Bad Bank" to absorb the toxic and low-yielding assets of both GSEs and potentially place the ""Bad Bank" into receivership. The other GSE would have a clean balance sheet, possibly receive a Treasury capital infusion, retain its charter, and make a clean start. Although unusual, the assets in the "Bad Bank" would continue to retain a guaranty by a GSE, albeit a different one for the assets transferred over from the "good" GSEs.

Whether these or other options are considered, it is possible that one or both GSEs could be returned to health without Congressional action or substantive reform. While the GSEs would eventually face increased capital requirements that would likely be phased in over time, the Good GSE(s) would continue with the implied backing of the Federal Government, as well as the other advantages the enterprises are provided under such a scenario.

Prospects For Reform

The prospects for GSE reform in the 112th Congress (2011-2012) are considered by many to be "highly likely." On Capitol Hill, insiders say that the administration's goal is to pass reform of the housing finance system, including Fannie Mae and Freddie Mac, before the 2012 presidential election— a move that would reframe the GSE bailout on the president's terms and take the issue off the table for the election cycle. Given the administration's legislative actions in health care and financial reform in the 111th Congress, "bold" action on housing policy and GSE reform by President Obama would not surprise observers, particularly if framed in the context of impact on the federal budget.

That said, the administration will likely be dealing with a very different Congress in the 112th session. Current polling trends could translate to significant Republican gains, which may threaten the Democrat's control of the House and severely reduce their Senate majority.

However, others argue that the administration will hold public relations events—listening sessions, participating in Congressional hearings—but will defer actual reform efforts until after the 2012 presidential election. Some argue this "discuss and delay" strategy

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affords the White House a number of advantages such as (i) providing additional time for the housing markets to stabilize and for private capital to return to the markets; (ii) resolving the issue of the mortgage deduction and any reduction—or elimination—as a means of dealing with growing deficits; and (iii) engaging in the reform debate with the 113th Congress having perhaps more Democratic members. Under this scenario, observers argue that pressure to reform the GSEs will have subsided and that only limited changes to Fannie Mae and Freddie Mac would be necessary.

Many are under the impression that the government's backing of the GSEs ends on December 31, 2012 and, as a result, a resolution of the GSEs status needs to be accomplished well before that date. We found that this is not correct. On a combined basis, the Treasury Department may advance approximately $275 billion to the GSEs after 2012.

Therefore, the only real driver to reform will be the political environment, which will be impacted by both public opinions and general economic conditions in an upcoming presidential election year.

There is also an emerging view that the way to transition the existing GSEs to a reformed system is to set up a "Good Bank" / "Bad Bank", whereby the toxic assets could be bled off into a "Bad Bank" where they could be restructured or liquidated. The thought was that one or both of the GSEs could take advantage of their Treasury backing, divest toxic assets, receive a Treasury recapitalization, and emerge from conservatorship with the GSE charter act intact. In the event of political gridlock over GSE reform, Treasury has the financial resources available to restructure Fannie Mae and Freddie Mac in conservatorship. Under this scenario, no further Congressional action would be needed for GSEs reform.

As noted earlier, though, FAS 166 and 167, which became effective on January 1, 2010, however, might mask the benefits of creating a "Bad Bank."

Treasury Begins the Reform Process

In testimony before Congress, Treasury Secretary Timothy Geithner told lawmakers that his agency plans to provide Congress a plan for GSE reform in early 2011—roughly six months after enactment of the Dodd-Frank Act. Treasury has engaged a team of Wall Street investment bankers to help the administration address the reengineering of the housing finance system, including the reform of the Fannie Mae and Freddie Mac post conservatorship. The consultants are expected to issue a "McKinsey-like" report analyzing the housing sector and the government's housing support programs (including the mortgage interest deduction), and making reform recommendations. The administration also announced that reform should potentially alter the current policies promoting homeownership in favor of rental housing.

On April 17, the Treasury Department requested public input (by July 23) on seven fundamental questions that would drive the reengineering of the mortgage system and

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reform of Fannie Mae and Freddie Mac. Treasury and HUD received 571 comment letters from a wide array of banks, trade groups, construction firms, state housing agencies, and affordable housing advocates, concerning the future of housing finance and reform of Fannie Mae and Freddie Mac. A summary of the major reform proposals is provided in Appendix A.

On August 17, Treasury held the Conference on the Future of Housing Finance in which administration and industry representatives, academics, and consumer advocates began the debate on GSE reform. A video of the Conference is available from CSPAN at http://www.c-spanvideo.org/program/295074-1. At the Conference, Treasury Secretary Geithner said: "[T]his Administration will side with those who want fundamental change. It is not tenable to leave in place the system we have today. We will not support returning Fannie and Freddie to the role they played before conservatorship, where they fought to take market share from private competitors while enjoying the privilege of government support. We will not support a return to the system where private gains are subsidized by taxpayer losses." Geithner believes that there's a "strong case to be made for a carefully designed [government] guarantee program in a reformed system"—with the challenge being to make certain that the any government guarantee is priced to cover the risk of losses and structured to minimize taxpayer exposure.

At the Conference, the banking community (and the Center for American Progress) appeared to coalesce around the GSE reform proposal by the Financial Services Roundtable. Under this proposal, the functions of Fannie Mae and Freddie Mac would be transferred to private entities owned by the top tier banks, which control roughly 80% of mortgage originations and securitizations. Substantively, this proposal could further expand the market penetration and role of these too-big-to-fail banks and ultimately transform these banks into new government-sponsored entities.

In a speech to the National Association of Real Estate Brokers, HUD Secretary Sean Donovan cautioned against taking "extreme measures" in reforming Fannie Mae and Freddie Mac, noting that the agencies "legacy assets are what's causing the problem today," not the profitable loans they are making today. The Secretary further stated: "In fact . . . [we] would see significantly more trouble in the housing market if we were to withdraw credit completely. A lot of those proposals just don't make sense when you think through exactly what's causing the problem, which are these legacy loans."

Treasury seems to be leaning towards a private industry solution, rather than a nationalization effort. Such an approach would put private capital at risk—through private equity in the GSEs' successor and through private mortgage insurance—ahead of the government, which would provide a catastrophic loss guarantee for mortgages. It is still early in the process, so the administration's final proposal is far from certain at this time.

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House Financial Services Committee Moves Ahead with Reform

In an August 17 interview with Neill Cavuto on Fox Business, House Financial Services Committee Chairman Barney Frank said, "[Fannie Mae and Freddie Mac] should be abolished. The only question is what do you put in their place. . . . There is no more hybrid private-public. If we want to subsidize housing then we could do it upfront and let the budget be clear about that." FHA should be fully self-financing and Fannie Mae and Freddie Mac should be replaced with a new mechanism to help subsidize housing, Frank added.

Frank said his Committee will resume hearings on revamping the housing finance system when Congress returns from its August recess. He intends to move legislation next year, adding: "Look, you know, it depends on who wins the House." According to Committee staff, the Chairman plans to release a white paper outlining his plans to reform the reform of the housing finance system based upon the Financial Services Roundtable's reform proposal, in early October, before the November elections and in advance of any proposal being introduced by the administration and Treasury.

House Republicans' Views

Republicans on the House Financial Services Committee have outlined ten principles for GSE reform, which call for (i) winding down of Fannie Mae and Freddie Mac within four years; (ii) phasing out the elevated conforming loan limit over a two-year period; (iii) reducing the GSEs' retained mortgage portfolios by 25% over four years; (iv) phasing in higher capital requirements for the GSEs to reduce their leverage; (v) creating a regulatory framework for covered bonds in the U.S.; (vi) creating a regulatory safe-harbor for mortgages that meet underwriting standards consistent with the Federal Reserve's final HOEPA (high-cost mortgage loan) rule; (vii) eliminating the maturity mismatch that allows the GSEs to use very short-term borrowings to fund long-term assets; (viii) creating an Inspector General for FHFA and requiring the Inspector General to submit regular reports to Congress on the agency's GSE conservatorship activities; (ix) placing the GSEs' operations "on budget" and subjecting the enterprises' debt issuance to the national debt limit; and (x) immediately suspending the compensation packages for the GSEs' senior management and establishing a compensation system in accordance with the federal government's rates of pay for executive and senior level employees. "House Republicans support establishing a framework to reinvigorate housing finance that does not rely on government guarantees," said Representative Spencer Bachus (R-AL), the panel's ranking member.

In the event the Republicans win control of the House of Representatives, Representative Scott Garrett (R-NJ) would serve as chairman of the House Financial Services (HFS) Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprise. Thus, he will be in a position to advance the Equal Treatment for Covered Bonds Act, a

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bill he sponsored. Covered bonds are debt securities backed by cash flows from loans. Unlike with MBS, with covered bonds, the assets remain on the issuer's balance sheet. Specifically, his bill calls for (i) an amendment to the Federal Deposit Insurance Act to provide the same treatment for covered bonds as for other qualified financial contracts; (ii) defining a covered bond as a non-deposit recourse debt obligation of an insured depository institution; (iii) creating a minimum term of maturity for a covered bond of at least one year with no maximum term of maturity; (iv) allowing for a wide variety of asset classes to be eligible as collateral in the cover pool; (v) ensuring that a bank failure will not impair the value of the covered bonds; and (vi) establishing joint rulemaking authority for the Secretary of the Treasury, the Federal Reserve, Office of the Comptroller of the Currency, and the FDIC for new regulations affecting covered bonds.

During the Conference Committee negotiations on the Dodd-Frank Act, Garrett proposed that the covered bond provisions be added to the reform legislation—a proposal supported by House Financial Services Committee Chairman Barney Frank (D-MA) but successfully blocked by the Treasury Department. (Republican lawmakers view covered bonds as a securitization vehicle for the private sector, which would be viable only in a non-Fannie Mae and Freddie Mac world.) On July 28, 2010, however, Garrett's covered bond bill was separately marked-up and passed out of the House Financial Services Committee.[4] While it is doubtful that his bill will be enacted this year, it is a clear sign that it will be part of the overall reform debate.

The Taxpayers' Views

Another wildcard in this debate is public reaction to GSE reform, which will be driven by how the issues are packaged and sold to the American public. As noted by Robert Stowe England in the May issue of *Mortgage Banking*, "[A]ny proposal that emerges from Congress needs not just the support of the 'stakeholders' in mortgage finance, but the broad support of the public, too. Ultimately, both the fate of Fannie and Freddie, as well as reform of the mortgage finance market, will likely need to respond to the considerable public backlash against government over-reaching, rising deficits and debt, and wariness—if not weariness—about markets, companies and arrangements that involve government guarantees." The most important stakeholder of all with the largest financial stake in this issue—the U.S. taxpayer—may also play a role in the outcome of this political debate, particularly in a more Republican Congress.

[4] H.R. 5823, legislation sponsored by Rep. Scott Garrett (R-NJ), was passed by the House Financial Services Committee on July 28, 2010. Click here for information on the bill: http://www.thomas.gov/cgi-bin/bdquery/D?d111:1:./temp/~bdAbb7:@@@L&summ2=m&|/home/LegislativeData.php . Click here for the text of the bill: http://www.thomas.gov/cgi-bin/query/z?c111:H.R.5823 .

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Summary

The debate over the reform of the nation's housing finance system, which has just begun, could prove to be as significant as the deliberations over the reforms to the nation's health care and financial services systems, which just concluded with the enactment of legislation this year.

Given the political controversy surrounding the GSEs, it seems likely that elected officials will want to enact some type of reform before the 2012 elections. The complexities involved, however, are significant. Sorting through the issues and designing a new system will be challenging and critically important, given that housing constitutes 15% of the country's GDP.

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Appendix A: GSE Reform Proposals

Government Reform Proposals

Government Accountability Office (GAO)

In an October 2009 report, the GAO outlined the various options for structuring Fannie Mae and Freddie Mac post-conservatorship. Specifically, GAO proposed three structural frameworks for the reforming the GSEs:

Government agency

The housing GSEs could be transformed into a government entity that would (i) eliminate the enterprises' retained mortgage portfolios over time; (ii) establish sound underwriting standards and risk-sharing arrangements with the private sector; (iii) establish financial and accountability requirements for lenders; (iv) institute consumer protection standards for borrowers; and (v) eliminate responsibility for the affordable housing goals (instead, FHA's mortgage insurance programs would be expanded to address this objective).

A government entity, with access to Treasury-issued debt, may be ideally positioned to provide liquidity to the mortgage market during normal economic periods. However, a government entity that does not have a retained portfolio may face challenges supporting mortgage markets during time of financial stress and would require the support of Treasury or the Federal Reserve to purchase mortgage assets under such circumstances. A government entity would be expected to pursue housing opportunity programs for targeted groups given its public status. However, the agency may face challenges in managing a housing goal program, since some types of affordable loans, like multifamily loans, may be difficult to securitize and often have to be held in portfolio. Alternatively, fees could be assessed on the government entity's activities to support housing opportunities for targeted groups or FHA's mortgage insurance programs could be expanded.

The entity structure may represent less risk than the hybrid GSE structure because MBS issuance is less complicated and risky than managing a retained mortgage portfolio. However, this structure would be more complicated than that of Ginnie Mae's and could result in substantial taxpayer losses if mismanaged. A government entity could face greater challenges than private-sector entities in securing human and technological resources to manage complex processes or it might lack the operational flexibility to do so.

Key elements for regulatory oversight of a government agency structure would include (i) certain operational flexibilities to obtain appropriate staff and information technology to carry out responsibilities, (ii) risk-sharing agreements with private lenders or mortgage insurers, (iii) appropriate disclosures in the federal budget of risks and liabilities to ensure financial transparency, and (iv) robust Congressional oversight of operations.

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Supporters of a government agency structure argue the implied federal guarantee and the enterprises' need to respond to shareholder demands to maximize profitability encouraged excessive risk-taking and ultimately resulted in their failures. In contrast, a government entity, which would not be concerned about maximizing shareholder value, would best ensure the availability of mortgage credit for primary lenders while minimizing risks associated with a hybrid GSE structure. Establishing a government agency also would help ensure transparency through appropriate disclosures of risks and costs in the federal budget.

Reconstituted GSEs

Fannie Mae and Freddie Mac could be reconstituted under a utility-business model by (i) reducing or perhaps eliminating retained mortgage portfolios as deemed appropriate depending on prioritization of numeric housing and safety and soundness objectives; (ii) establishing capital standards commensurate with relevant risks; (iii) developing additional regulations such as executive compensation limits; (iv) requiring appropriate financial disclosures in the federal budget to enhance transparency; and (v) ensuring strong congressional oversight of the enterprises' and FHFA's performance.

While the reconstituted GSEs may provide liquidity and other benefits to mortgage finance during normal economic times, the enterprises' ability to provide such support during stressful economic periods is questionable given current experience. With significantly smaller (or eliminated) retained mortgage portfolios, the capacity of reconstituted enterprises to provide support to mortgage markets during periods of economic distress also may be limited.

Reconstituted GSEs, with their responsibility to maximize profits for their shareholders, might find it difficult to support some public policy housing initiatives. Moreover, without a retained mortgage portfolio, the reconstituted GSEs may face challenges in implementing an affordable housing goal program. Alternatively, a reconstituted GSE could be permitted to maintain a relatively small portfolio to support affordable housing goals or by supporting housing opportunities for targeted groups through assessments on its activities.

The financial crisis highlighted problems with the hybrid GSE structure, including incentives to increase leverage and maximize portfolios. Reconstituting the GSEs would reestablish and might strengthen the incentive problems, which could lead to even greater moral hazard and safety and soundness concerns and increase systemic risks. Proposals to regulate GSEs like public utilities in principle could constrain excessive risk-taking, but the applicability of this model to the enterprises has not been established. Further, FHFA has not been tested as an independent safety and soundness and housing mission regulator, as the agency has largely acted as a conservator since its creation in July 2008.

Supporters of this proposal believe that reconstituting the enterprises would help ensure that they would remain responsive to market developments, continue to produce innovations in mortgage finance, and would be less bureaucratic than a government

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agency or corporation. They also advocate a variety of additional regulations and ownership restrictions to help offset the financial risks inherent in the for-profit GSE structure, including (i) eliminating or substantially downsizing the enterprises' mortgage portfolios; (ii) breaking up the enterprises into multiple GSEs to mitigate safety and soundness and financial stability risks; (iii) establishing public utility-type regulation for the enterprises that would establish limits on their profitability; and (iv) converting the enterprises into lender-owned associations to create incentives for mortgage lenders to engage in more prudent underwriting practices.

<u>Privatization or termination</u>

Privatizing or terminating the enterprises would eliminate many problems with the hybrid GSE model, including the conflict between public policy and private shareholders. Supporters of this proposal argue that privatized entities would align mortgage decisions more closely with market factors and that the resultant dispersal of credit and interest rate risk would reduce safety and soundness risks. Federal Reserve Chairman Ben Bernanke has suggested that privatized entities may be more innovative and efficient than government entities, and operate with less interference from political interests.

Under this structure, a transition period would mitigate any potential market disruptions and facilitate the development of a new mortgage finance system. A federal entity would be created to provide catastrophic mortgage insurance for lenders and help ensure that mortgage markets would continue functioning during stressful economic periods.

If key enterprise activities such as mortgage purchases and MBS issuances are provided by financial institutions, liquid mortgage markets could be reestablished in normal economic times. However, the capacity of private banks to support mortgage markets in times of financial distress without government support is questionable, given the failure or near failure of key financial institutions and the absence of private-label securitization during the current financial crisis. A federal mortgage insurer could help private lenders provide liquidity and other benefits in times of financial stress.

Privatization or termination would remove the traditional legislative basis, government sponsorship, for the enterprises to implement programs to serve the mortgage credit needs of targeted groups. However, the basis for such programs may remain if a government insurer for mortgage debt is established and the federal government guarantees its financial obligations. Furthermore, Congress might justify the programs on the grounds that large lenders that assume responsibility for key enterprise activities or purchase their assets are viewed as "too big to fail" and benefit from implied federal guarantees of their financial obligations.

Termination and reliance on private-sector firms would leave market discipline and regulators of financial institutions with responsibility for promoting safety and soundness. Moral hazard concerns would remain if some mortgage lenders were deemed "too big to fail." These concerns may be heightened because the current financial regulatory system already faces challenges in overseeing such organizations.

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Additionally, safety and soundness concerns may remain if a federal entity were established to insure mortgage debt and did not charge appropriate premiums to offset the risks it incurred. FHA and the FHLB System may become more prominent if the enterprises were privatized or terminated.

The need for a new financial regulatory system, due to concerns about the current fragmented system, may be heightened to the extent that terminating or privatizing the enterprises results in larger and more complex financial institutions. In considering a new system, Congress should consider the need to mitigate taxpayer risks and consider establishing clear regulatory goals and a system-wide risk focus. If a new federal mortgage insurer is established, there should be an appropriate oversight structure for such an entity. This structure might include appropriate regulations and capital standards, the disclosure of risks and liabilities in the federal budget, and congressional oversight.

In a white paper, *Key Considerations for the Future of the Secondary Market and Government Sponsored Entities*, the Mortgage Bankers Association outlined nine possible models that could serve as potential redesign of Fannie Mae and Freddie Mac. Chart 1 provides a summary of these models and the types of investment products they could bring to the market.

Chart 1. High-level Menu of GSE-like Models

	Fully privatized	Covered bond	Hybrid covered bond	Co-op	Open charter	Limited charter	Improved GSE	Utility	FHA-Ginne-Type
Private Ownership	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Government guarantee	No	No	No	Govt backstop	Insurance fund	Insurance fund	Govt backstop	Govt backstop	Explicit
Regulator	Bank/other regulators	Bank regulators	Bank regulators	FHFA-type	FDIC-type	FHFA-type	FHFA	FHFA-type	n.a.
Required portfolio	Market-driven	Yes	Yes	*de minimus*	*de minimus*	*de minimus*	Safety & soundness	*de minimus*	No
Investment vehicles brought to market									
Whole loans	Yes	No	No	No	No	No	No	No	No
Pass-thru MBS	Yes	No	No	Backstop	Govt	Govt	Backstop	Backstop	Govt
Structured MBS	Yes	No	No	Yes	Yes	Yes	Yes	Yes	Yes
(Re-)REMIC/CDO	Yes	No	No	Yes	Yes	Yes	Yes	Yes	No
Mortgage REIT	Yes	No	No	No	No	No	No	No	No
Corporate debt	Yes	No	No	n.a.	n.a.	n.a.	Yes	n.a.	n.a.
Secured debt	Yes	Yes	Yes	n.a.	n.a.	n.a.	No	n.a.	n.a.
Shareholder equity	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No

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Federal Reserve

In *The Regional Economist*, James Bullard, president and CEO of the Federal Reserve Bank of St. Louis, wrote, "At a minimum, we need to break up these GSEs—perhaps into regional companies—to open up the market to private players and restructure the incentives under which they operate."

On May 13 at the Federal Reserve Bank of Philadelphia's Reinventing Older Communities conference, Joseph Tracy, Executive Vice President (EVP) and senior advisor to the president of the Federal Reserve Bank of New York, presented a proposal to reform Fannie Mae and Freddie Mac using a lender cooperative model. Tracy's design principles for the lender cooperative model included (i) preserving what has what has worked well in the past—specifically standardized underwriting and the TBA market; (ii) incorporating economies of scale and scope; (iii) providing transparent and on-balance sheet subsidies with new entities focused on the "core" housing market and having FHA focused on affordable housing goals and mission; (iv) tasking fiscal authorities to conduct fiscal policy with Treasury being the "buyer of last resort"; and (v) assigning the "tail-risk" in housing to government through explicit government insurance that has a transparent price.

Tracy urges policymakers to preserve the TBA trading market, which serves as the link between the primary and secondary markets and allows borrowers to lock rates for up to 60 days prior to closing (but exposes lenders to interest rate risk). Under Tracy's proposal, lenders would hedge this risk efficiently by selling mortgages one to three months forwards, while lenders would have to stockpile these loans in a conduit for private label securitizations. Liquidity would be provided through standardized underwriting, diversification through pooling of loans, and the assumption of homogeneity through guarantees and forward trading. The benefits of the TBA market include enhanced liquidity and reduced hedging costs.

According to Tracy, the requirements for TBAs would include (i) a small number of issuers (since privatization and fragmentation are not compatible); (ii) some actual homogeneity of mortgages through standardized underwriting criteria and procedures, along with the government guarantee; and (iii) significant back-office operations and creditworthy counterparties. Under the lender cooperative model, mutually-owned co-ops—akin to the Federal Home Bank System structure—would engage only in residential lending. Only member institutions with an equity stake in the organization could sell mortgages to the co-op to be securitized. Guarantee fees would be assessed to pay for the government's tail risk premiums and to contribute to the cooperative's credit loss pool. In designing this cooperative structure, policymakers would have to address a number of design issues, including (i) triggers for government's tail risk insurance, such as MBS level, vintage level or size of mutual loss pool; (ii) the types of mortgage products the co-op could securitize, with a focus on standardized products with sufficient history to price tail insurance; and (iii) the number of cooperatives to form, recognizing that a small number preserves economies of scale.

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Tracy argued that the co-operative model offers a number of advantages. First, this structure preserves the TBA market and would encourage loan standardization. The business model would have little incentive for "mission creep" or to create a concentration of power over lenders, since profits would flow back to the members. The co-op's mutual credit loss pool would provide financial incentives for members to monitor risk. Moreover, the structure reduces moral hazard, since the co-op would absorb loan losses ahead of the government. The disadvantages of the co-operative model include (i) limited access to capital markets; (ii) weaker incentives to innovate than the private model; and (iii) potential for weaker governance relative to other models.

Trade Groups

American Bankers Association (ABA)

In a July 21 comment letter on the reform of housing finance, the ABA did not endorse a specific model for reforming Fannie Mae and Freddie Mac. Instead, the trade group outlined 11 guiding principles to govern reform of the housing finance system, including: The primary goal of any government-sponsored enterprise in the area of mortgage finance should be to provide stability and liquidity to facilitate the ability of the primary mortgage market to provide credit for borrowers who have the credit and skill sets required to maintain homeownership.

In return for the GSE status and any benefits conveyed by that status, these entities must agree to maintain their mission in all economic environments.

Strong regulation, examination, and authority for prompt corrective action of any future GSE must be a key element of reform. Regulation also must include review and control for systemic risk.

Any GSE involved in the mortgage markets must be strictly confined to a well-defined and regulated secondary market role and should not be allowed to compete with the private, primary market.

Any reform of the secondary mortgage market must recognize the vital role the FHLBs play and must in no way harm the traditional advance businesses of FHLBs or access to advances by their members, particularly for community banks which play a vital role in providing mortgage finance and economic development.

GSEs must be allowed to pursue reasonable risks and rewards, but the risk/reward equation must be transparent and more rigorously defined and regulated.
GSEs must operate within a framework of market procedures and regulation governing the securitization of all mortgage assets.

Strong minimum regulatory standards are necessary to ensure sound underwriting for all mortgages. Insured depositories already comply with strong underwriting standards and

are subject to vigorous examination. Comparable standards should be established for all loan originators with comparable levels of effective regulatory oversight.
True sales treatment and regulatory capital charges should appropriately reflect the reality of true risk-shifting activities, as well as balance sheet exposures. Accounting and regulatory changes should reflect and align the risks of mortgage securities and their underlying assets.

Affordable housing goals or efforts undertaken to broaden housing affordability are more suited to other programs and entities than the GSEs—whose principal focus should be on providing stability and liquidity to the primary market. Any affordable housing goals required of the GSEs should be in furtherance of their primary goals of promoting primary market stability and liquidity and should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects. GSEs must provide for fair and equitable access to all primary market lenders selling into the secondary market through the GSEs.

American Securitization Forum (ASF)

In a July 21 comment letter on reform of the Housing Finance System, the ASF urged policymakers to carefully consider and evaluate how reforms of the housing finance system will impact the securitization market, specifically with regard to the TBA Market. Tom Deutsch, Executive Director of ASF, wrote, "Any GSE 'reform' which does not accommodate, or suitably replace, the existing GSE MBS TBA market will undoubtedly impact mortgage originators both severely and negatively by reducing the originators' options to "rate lock" and thus satisfy consumer needs. As is always the case, these impacts will surely disproportionately fall on the nation's smaller finance companies as well as the community bank sector." Deutsch also cautioned that any hard and fast policy that would prohibit the maintenance of GSE portfolios would narrow the universe of available options to the government in times of crisis. Deutsch also points out to policymakers, "[T]he best solution [for minimizing real estate bubbles] is probably a structural one, to encourage borrowers and lenders to focus relatively more on personal credit, and relatively less on real estate values, thus helping to re-order the housing finance system, at least as regards securitization, more strongly to a proper fixed-income market."

Given the current legislative, regulatory and legal pending actions that currently cloud the mortgage securitization market for "at least" the next two years, "ASF strongly believes that federal housing finance policy should work to restart the non-agency residential secondary market in a rational and coordinated way," wrote Deutsch. " We believe that a single, national standard arising out of the Dodd-Frank Act, and implemented by joint interagency regulatory rulemaking will best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach. A fragmented approach to regulating these markets, in which various regulatory bodies (and, indeed, all three branches of government) develop slightly different rules governing the exact same

subject matter, is unlikely to produce efficient results and prove to be a drag on the mortgage market. Risk retention mandates associated with residential mortgage credit risk need to be practical and flexible, and need to recognize that there are many paths to the mountaintop. … Responsible, user-friendly non-agency securitization markets should be viewed as a tool to help gradually reduce concentrations of these risks in …[FHA and Ginnie Mae], as well as transferring these risks outside of the banking system."

Financial Services Roundtable (FSR)

On April 14, Anthony Reed, VP of Capital Markets for SunTrust Mortgage, testified before the House Financial Services Committee on behalf of The Housing Policy Council of the Financial Services Roundtable (HPC) regarding reform of the housing finance system.

Reed set forth three goals for reforming the secondary market, including (i) ensuring the steady flow of capital to the housing market to support the 30-year, fixed-rate mortgage; (ii) minimize losses to taxpayers by eliminating the government's implicit and explicit guarantees to the GSEs' successors; and (iii) a mechanism to ensure adequate funding for affordable housing.

Specifically, the HPC proposes the creation of four to eight federally-chartered, privately-owned Mortgage Securities Insurance Companies (MSICs) to provide the credit enhancement function and the establishment of a (single) Mortgage-Backed Security Issuance Facility to create and administer MBS that are guaranteed by MSICs. The MSICs would support affordable housing initiatives through the contribution of revenue that would be distributed to state and local housing finance agencies. Any successors to the GSEs would NOT be required or permitted to maintain large mortgage portfolios for investment purposes. Instead, the MSICs could maintain small portfolios to facilitate the development of new products and to support certain types of mortgages, such as multifamily loans, that have limited markets. The MSICs would be chartered and regulated by the FHFA, which would establish strong capital and liquidity requirements, set underwriting standards, and establish loan limits. The federal government would be called on to provide an "explicit" back-up guarantee—in the form of catastrophic re-insurance—directly to MBS issuances, but not to the MSICs themselves. Losses would be incurred by the borrower (the down payment), PMI, MSIC's equity, and the MSIC's reserve fees—ahead of the government's guarantee on MBS losses.

Independent Community Bankers of America (ICBA)

On April 14, Jack E. Hopkins, testified on behalf of the ICBA before the House Financial Services Committee regarding reform of the housing finance system. Instead of submitting a proposal for GSE reform, the Hopkins outlined ICBA's key reform principles that should guide reform of the secondary market and the GSEs' successor(s). The group's principles call for the creation of a strong and reliable secondary market that is impartial, and secondary market entities (GSEs' successors) with a limited mission focused on supporting residential and multifamily housing in all U.S. communities.

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Reform efforts should result in the creation of multiple secondary market entities that have operational flexibility to hold mortgages in portfolio when market conditions dictate. The reform efforts should eliminate the conflicting requirements of a public mission with private ownership and dedicate a portion of the secondary market entities' earnings to support affordable housing programs. Government "ties" should continue with the GSEs' successor to ensure "continued and steady access to the capital markets."

Mortgage Bankers Association (MBA)

In an August 2009 white paper, MBA outlined a GSE reform proposal, calling for the creation of a new line of MBS, which would have a security-level, federal government guaranteed "wrap" (the "GG") and private, loan-level guarantees from privately-owned, government-chartered and regulated mortgage credit-guarantor entities (MCGEs). The GG, modeled after Ginnie Mae, would explicitly carry the full faith and credit of the U.S. government, supported by risk-based fees charged on the securities at issuance and on an on-going basis. MCGEs would manage credit risk through (i) risk-based pricing; (ii) originator retention of risk through representations and warranties; and (iii) private mortgage insurance. Through the GG and MCGEs, the credit risk from the mortgages would be "removed" from the MBS, while the security investor would bear the interest rate risk. The GG is not intended to support the entire mortgage market, but only those mortgage products needed to keep the secondary market for core mortgage products liquid and functioning in all environments.

Initially, two or three MCGEs private-owned, mono-line institutions would to be chartered to focus solely on the mortgage credit guarantee and securitization business. These entities would be overseen by a strong regulator, who would grant charters, determine underwriting guidelines, approve new products, and assure capital adequacy. The regulatory regime would be similar to that of a public utility with the MCGEs earning a conservative return on equity. While the MCGEs would have standard corporate powers to raise debt and equity, none of the entities' issuances would be guaranteed—either implicitly or explicitly—by the federal government.

MBA contends that any federal mortgage securitization and guarantee program must not be distorted by any additional public or social housing policy goals. Instead, these policy goals should be implemented through FHA, VA, RHS, and Ginnie Mae, which provide government credit support for affordable housing.

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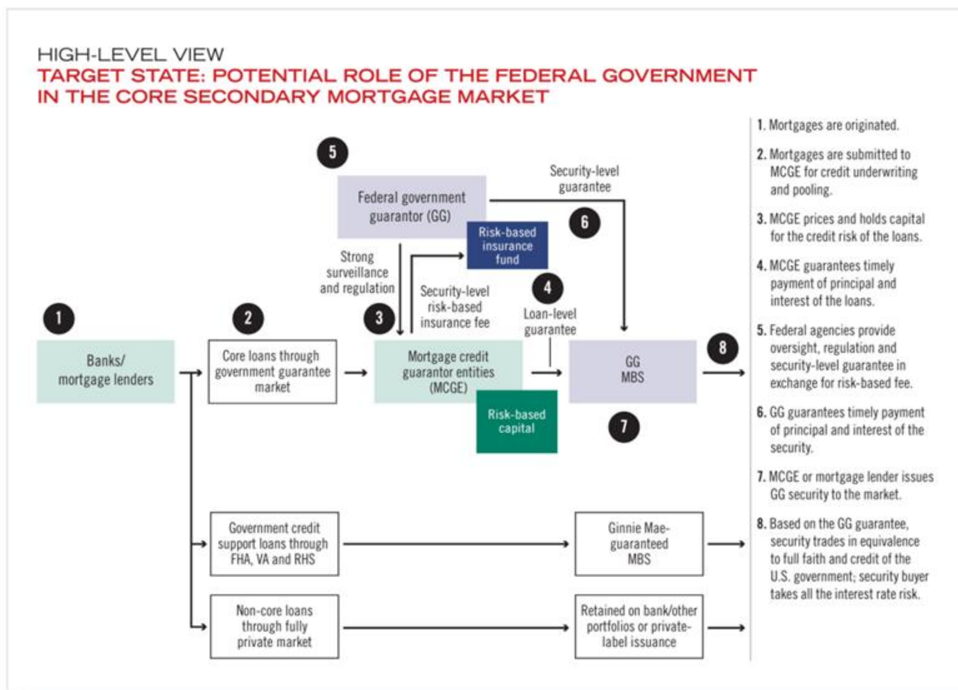

Mortgage Insurance Companies of America (MICA)

In a July 21 comment letter on reform of the housing finance system, Suzanne Hutchinson, EVP of the Mortgage Insurance Companies of America, urged the administration to continue the role of private mortgage insurance in the housing finance system, as a means of placing private capital at risk to defray mortgage losses in the housing market. Hutchinson noted that PMI companies are well positioned to help expand affordable housing opportunities in a responsible manner. "MICA strongly recommends that [private] mortgage insurance remain a required and structurally integrated component of the housing finance system," wrote Hutchinson. MICA also recommends that automated underwriting programs of new securitizers be carefully reviewed by their regulators with input made available by all parties related to the underwriting and insurance of loans. Further, MICA urges the regulator to consider allowing all parties to comment on the desirability of proposed changes to the automated underwriting systems, specifically related to the underwriting terms and major changes to the securitizing entities' internal models concerning default probability and depth of losses for high risk loans. MICA recommends that the regulator give serious consideration to requiring mortgage insurance on all loans with combined LTV ratios of 75% or more.

National Association of Home Builders (NAHB)

On April 14, Rich Judson testified on behalf of NAHB before the House Financial Services Committee regarding reform of the housing finance system. Judson told lawmakers that NAHB supports the creation of private companies, called conforming mortgage conduits (CMCs) to purchase mortgages from approved institutions—banks,

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savings institutions, and credit unions—and to securitize these assets in MBS. While the CMCs would guarantee the timely payment of the collateral that securitizes its MBS, the federal government would not provide an implicit or explicit guarantee of these payments. Instead, the entities would pay an insurance fee for mortgage securities that receive a federal guarantee, which would support the conventional mortgage market (using conforming loan limits) under catastrophic conditions. CMCs' reserves, the federal guarantee, and private mortgage insurance would cover loss exposure in CMCs' MBS. The CMCs would have to maintain adequate capital and loan loss reserves appropriate for their risk exposure.

National Association of Realtors (NAR)

In a July 21 comment letter on reform of the housing finance system, the NAR advocated using the co-operative model for the creation of two non-profit, government-chartered market authorities ("market authorities"), which function as self-sustaining organizations. These entities would ensure strong, robust financing environment for homeownership and multifamily housing with a mission of promoting housing affordability for the under-served segment of the population. The market authorities "excess" revenues would be used to accumulate a strong capital base to support the secondary market, to withstand countercyclical downturns, and to support innovation. Under this proposal, the federal government would clearly and explicitly guarantee the business of the market authorities, which would be off-set by mortgage insurance (for loan-to-value (LTV) ratios greater than 80%) and MBS guarantee fees. The entity, governed by a chief executive officer and board of directors comprised of industry participants and consumer representatives, would be supervised by a strong regulator, FHFA, with the entities' political independence "mandatory." The market authorities would ensure that sound and sensible underwriting standards are established for loans purchased and securitized with transparency and verifiability for MBS collateral. NAR noted, however, that reform of the credit rating agency sector is also necessary to address the inherent conflict of the current system.

National Low Income Housing Coalition (NLIHC)

On April 14, Shelia Crowley, President of the NLIHC, testified before the House Financial Services Committee regarding reform of the housing finance system. Crowley outlined six principles to guide reforming the U.S. housing finance system, which included:

- Federal subsidies to the housing sector should be directed to meeting the needs of those with the most serious housing problems first.
- All segments of the housing finance sector have a duty to contribute to solving the most serious housing problems.
- Federal policy should not favor one form of tenure over another; rather, federal policy should incentivize balance in the housing market and the full range of housing choices in every community.

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- Federal policy should reward housing forms that are of reasonable size and are earth friendly, that is, policy should reward moderation, not excess.
- Federal policy should make sure the housing finance system has enough liquidity to assure a robust single-family and multifamily housing market at affordable interest rates.
- Federal policy should maximize the capacity of mission driven, public or non-profit housing providers to achieve tangible results in solving the nation's housing woes.

Crowley recommended that lawmakers immediately provide $1.065 billion of capital to fund the National Housing Trust Fund. Moreover, the National Housing Trust Fund campaign recommends that Congress provide at least $15 billion annually over the next decade to meet affordable housing needs. Crowley recommended that this funding level be accomplished through a five basis point annual fee on financial institutions' borrowings from the Federal Reserve Bank and the FHLB System. In addition, Congress could levy a fee on mortgage securitizations by any capital market participant. Crowley also suggested that Congress reform the mortgage interest deduction and enact a federal rent credit to provide low-income renters a subsidy similar to that received by homeowners.

Securities Industry and Financial Markets Association (SIFMA)

In a July 20 comment letter to Treasury regarding reform of the housing finance system, SIFMA wrote, "[I]f some form of a GSE exists in the future, it should be established with a limited specific charter that outlines a limited and specific mission, along with a strong regulator empowered to regulate and manage the activities of the entity in all appropriate ways, but acts in coordination with entities such as Treasury and [the] Federal Reserve to ensure the safety and soundness of the broader financial system. Changes to this charter and mission should be solely within the purview of Congress." SIFMA urged policymakers (i) to determine what they want from mortgage market before addressing what to do with the GSEs; (ii) to foster the forward market for MBS (the TBA market), which is key to a successful, liquid, affordable and national mortgage market; (iii) to provide some form of explicit government guarantee on MBS to maintain liquidity in the TBA market, possibly through a government insurance wrap that stands behind any private sector or other corporate guarantee; and (iv) to avoid bifurcating the market into pre- and post-reform markets, as the administration addresses GSE legacy issues.

Commercial Banks

Bank of America

In a July 21 comment letter, Bank of America's General Counsel Gregory Baer said GSE reform could consist of multiple reform models, each dealing with a different type of mortgage. For example, a government guarantee could be provided for low-income loans, while an FDIC model could be applied to loan balances up to a conforming loan limit and a purely private sector model could apply to loans above the conforming loan

limit. Specifically, securitization of low-dollar balance mortgages to underserved communities could be managed by a government run or guaranteed entity, which is exclusively charged with an affordable housing mandate. FHA or a new entity would serve as a pure government instrumentality and appear "on-balance sheet" to ensure transparency. This entity could also focus on increasing rental availability and promote first time homebuyer assistance.

With regard to restarting the non-agency residential mortgage secondary market, Baer suggested that a single, national standard arising from the Dodd-Frank Act and implemented by a joint interagency regulatory rulemaking will "best achieve the housing finance policy goals of promoting responsible underwriting and market transparency, while addressing the need of industry participants to have a clear, practical and efficient approach."

Baer wrote, "The government should attempt to encourage the growth of the covered bond market, which allows banks to make and hold mortgage loans at relatively lower cost, but subject to capital requirements and proper underwriting incentives. This model has proven effective around the world but never developed in this country because of the presence of Fannie Mae and Freddie Mac." Baer also noted that a public or public-private solution will be required to address the GSEs' legacy assets and obligations.

Credit Suisse

In an October 2009 white paper, Credit Suisse set forth five key objectives for GSE reform, which include (i) preserving TBA market liquidity; (ii) minimizing disruption to the market and maximizing continuity, (iii) improving the GSEs' control and risk management, (iv) minimizing operational involvement by government, and (v) continuing operations even in the event of a catastrophic credit event. Credit Suisse's proposal focuses on preserving the GSEs in order to avoid disrupting the housing finance market.

Under this proposal, the GSEs would be broken up into "good GSEs," called primary mortgage guarantors (PMGs) that retain healthy guarantee and portfolio assets, and "bad" GSEs that house and run off toxic assets, bearing the "full faith and credit" government insurance wrap for catastrophic losses. The PMGs would run scaled-backed portfolios, roughly half their current size, to smooth out market distortions and maintain their role as counter-cyclical buyers of mortgages. To avoid mission creep, both FHFA and Congress would review the PMGs' product proposals. The PMGs would have a line of credit with the Federal Reserve, which would be collateralized with MBS purchased with credit. The PMGs would be restricted to basic mortgage products with known risk profiles and prohibited from buying non-prime mortgages, such as Alt-A and subprime loans. They would be strictly regulated by FHFA and have their capital requirement doubled immediately and then doubled again over the next couple of decades. The new GSEs would have affordable housing goals only for the multifamily market.

Wells Fargo

In a July 21 comment letter, John Gibbons, EVP of Wells Fargo's Home Mortgage Capital Markets, endorsed the framework for GSE reform proposed by the HPC and MBA. Specifically, Wells Fargo suggested that Fannie and Freddie be replaced by a small number of federally-chartered, privately-capitalized mortgage conduits that would have exclusive access to the government's explicit guarantee of mortgages for catastrophic losses. Wells Fargo wrote,

> "Assuming a private sector solution is desired, one can either adopt a regulated utility model or rely on competition and lower barriers to entry to limit monopolistic returns."

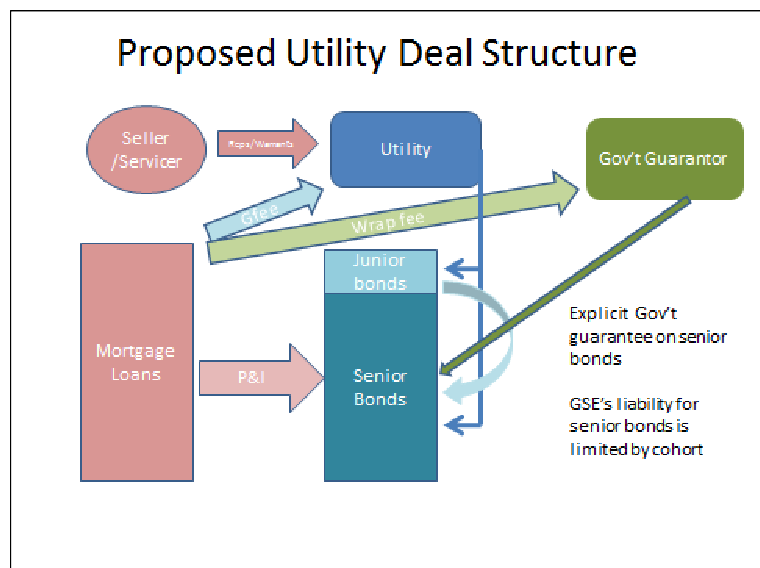
These single-purpose entities charter would restrict their activities to mortgage securitization, which would be allowed to hold a limited mortgage portfolio for operational and other specified purposes. The conduits would have limited charter privileges, which are limited to support of the liquidity of new securities, and exclude current GSE privileges such as exemptions from state and local taxes, use of the Federal Reserve as a fiscal agent, and a direct line of credit from Treasury. A strong regulator, who would serve as the chartering authority, would (i) ensure that the entities maintained high capital levels; (ii) approve the conduits' products and underwriting guidelines; (iii) establish portfolio limits; and (iv) serve as receiver in the event of impending failure.

Wells Fargo estimates that this proposed structure would be "tolerable" with conduits charging an estimated 72 basis points to guarantee a loan, which would increase mortgage rates about 50 basis points above current levels.

Wall Street

Andrew Davidson & Co.

In the spring of 2009, Andrew Davidson & Co., a leading provider of risk analytics and consulting for the mortgage and asset-backed securities industry, proposed that the GSEs be reconstituted as securitization-only vehicles, called Federal Securitization Co-operatives (FSC). These entities would create MBS with senior bonds, explicitly guaranteed by the federal government, and junior bonds, guaranteed by the utility. Andrew Davidson argues that allowing the FSCs to sell junior



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bonds in the marketplace will provide more efficient pricing of MBS and, if implemented appropriately, would create market discipline for mortgage credit. Moreover, the use of junior bonds would allow the government to increase its protection from losses without significantly increasing mortgage rates. Andrew Davidson recommends that these entities—two to five in number—be based upon the utility model with ownership structured as co-operatives, owned by the mortgage originators.

Keefe Bruyette & Woods (KBW)

In a July 10 comment letter to Treasury regarding reform of the housing finance system, KBW's Chairman and Chief Executive Officer John G. Duffy outlined a co-operative framework for reforming the GSEs, using the FHLB System template as a model.

Specifically, Duffy recommended a phasing out of the GSEs' portfolio retention activities, which would involve segregating the enterprises' legacy assets into a Bad GSE (a vehicle with no equity, used only to run off assets) and Good GSE with a "meaningful" minimum capital requirement of 5% for mortgages on which the entity retains credit risk. Under the cooperative model, any bank that originates an agency conforming loan for sale to the GSE would be required to retain 5% of the loan balance as an equity investment in the GSE. For the industry as a whole, a 5% capital requirement would approximate $43 billion of which $2.2 billion would be Tier One capital, representing approximately 25 basis points of total capital. Given banks' ability to leverage, non-banks would be at a disadvantage under this proposed structure and may require a special capital structure to ensure they are able to compete effectively with banks in the mortgage origination market. Similar to the FHLBs, the cooperatives would have board of directors representing their institution's ownership capital in the entities.

KBW estimates that the transition of mortgage assets to the Good GSE would take five to seven years—at which point the entity would have capital of approximately $250 billion. This level of capital would allow the entity the ability to maintain "moderate" investment portfolios needed to guarantee mortgages with little, if any, leverage needed. KBW believes that the new entity would need to hold some mortgages in portfolio in order to facilitate securitizations and improve the market's liquidity.

KBW's proposed GSE structure would likely result in higher rates for 30-year fixed-rate mortgages, which would likely move borrowers towards adjustable rate hybrid ARMs with shorter term resets of 5 to 7 years. Borrowers would clearly bear more interest rate risk, which KBW argues is a reasonable price to pay for financial stability. KBW believes that the issue of explicit government guarantees is moot in today's environment. That said, the explicit government guarantee would have a budgetary impact only to the extent that the new entity's capital and revenue are insufficient to cover potential losses, similar to FHA. Thus, KBW believes that the GSE successor entities should be set up to issue MBS with an explicit government guarantee.

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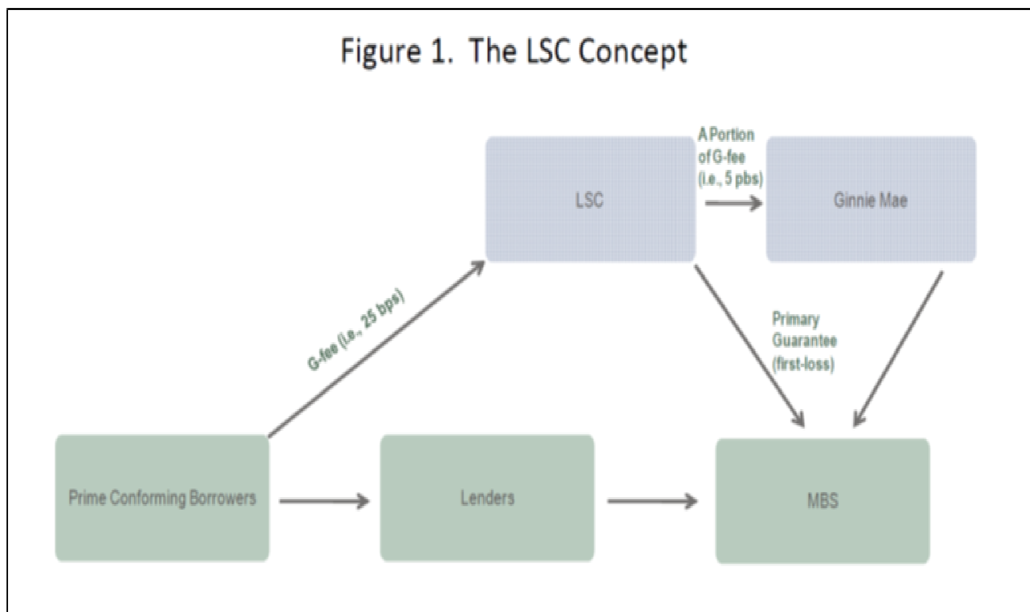
REIT

Redwood Trust

In a July 25 comment letter on the reform of the housing finance system, Martin S. Hughes CEO of Redwood Trust [a Mill Valley, CA-based REIT], said the long-term objective of reform should be a mortgage market divided into two segments—one public, one private, both robust and with private capital filling the majority of the market's needs. However, given the complexities of the U.S.'s $11 trillion mortgage market, Hughes cautioned it will take years to transform the market into a structure that achieves that objective. Thus, a "credible, actionable transition plan" is needed, which provides an uninterrupted flow of mortgage credit to borrowers, while significantly reducing excessive reliance on government financing and the resulting burden on taxpayers. Specifically, Hughes proposes the creation of a Lender Sponsored Cooperative (LSC) to serve as a transition entity, which would continue to serve the liquidity needs of the prime conforming segment of the residential mortgage market by guaranteeing prime conforming MBS. The LSC, which would function similar to FHA with no leverage or portfolio activity, would be lender-owned to ensure that the lenders maintain appropriate levels of "skin in the game."



Similar to Fannie Mae and Freddie Mac, the LSC would collect a guarantee fee from mortgage remittances to cover the costs of the cooperative's guarantee. Ginnie Mae, or some other government entity, would also provide a backup guarantee on the MBS for which it would receive a portion of the guarantee fee. A LSC transition structure would have several benefits, including (i) taking the government out of the first-loss position on new mortgage debt and putting private capital at risk ahead of the government, except for a limited part of the market; (ii) preserving the TBA market and the 30-year fixed rate

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mortgage; (iii) providing a relatively simple plan that uses the existing platforms of the GSEs through a merger and transfer of the enterprises' infrastructures to the LSCs; (iv) utilizing the self-policing structure of a cooperative; and (v) facilitating a restart of the private securitization market as the conforming loan limit is phased down to $325,000 and limits for high cost areas are adjusted, as appropriate.

The Redwood Trust plan calls for a sunset provision to help ensure that this structure is used only for a transitionary period. Hughes calls for a strong regulator for the LSC, who would require at least double the 45 basis points capital requirement previously mandated for Fannie Mae and Freddie Mac. The multiple layers of credit enhancement under the Redwood Trust plan would include (i) strict, safe loan underwriting standards; (ii) substantial down payment requirements, ranging from 10% to 20% depending on the borrower's credit profile.; (iii) the LSC's strong capital and reserve levels; (iv) representations and warranties from creditworthy lenders with appropriate enforcement mechanisms; (vi) provision of a capital call for LSC members under certain circumstances; (vii) a strict safety and soundness regulator for the LSC; (viii) the LSC guarantee; and (ix) the government back-up guarantee.

Foundations

American Enterprise Institute (AEI)

In April 14 testimony before Congress, AEI resident fellow Alex J. Pollock proposed seven steps toward a sound mortgage finance system in the U.S., which included (i) creation of a private secondary market for prime conforming mortgages in which private capital is at risk; (ii) transition to a "no" GSE world with subsidies merged into HUD structures and subject to the budgetary process and on budget, using fair and transparent accounting; (iii) facilitation of credit risk retention by the loan originators; (iv) the development of countercyclical strategies, such as falling LTV ratios as asset prices inflate and higher loan loss reserves during "good' times; (v) development of clear, straightforward disclosures of key information to borrowers; (vi) the reintroduction of savings as an explicit goal of mortgage finance; and (vii) in the event GSEs survive, avoid the use of government-insured banks to promote the enterprises' finances.

Aspen Institute

In a July 20 comment letter to Treasury regarding reform of the housing finance system, the Aspen Institute proposes to transform the U.S. housing policy through a dedicated down payment savings vehicle, called Home Savings Accounts (HSA), with government incentives for low- and middle-income Americans. The Institute argues that HSAs are a pragmatic way to give these groups a safer and more secure path to homeownership. Under the proposal, savers with incomes under $50,000 ($100,000 for married couples) would get a 50% match on their contributions, up to a lifetime cap of $5,000. HSAs could only be withdrawn for down payment and closing costs, when buying a home, but could be converted into retirement accounts without penalty. These interest-bearing accounts would be FDIC-insured. The Aspen Institute projects that approximately 4.5

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million HSAs would be opened over a five year period for an estimated cost to the federal government of $10 billion. While not trivial, this program's cost would be inconsequential relative to cost of the federal government's current housing policies, projected to total $850 billion from 2009 to 2013 by the Joint Committee on Taxation.

The Cato Institution

In March 23 testimony before Congress, Mark Calabria, director of Cato's Financial Regulation studies, recommended privatizing Fannie Mae and Freddie Mac and perhaps using the FHLBs' co-operative model. Whether public or private, Calabria suggested breaking up Fannie Mae and Freddie Mac into a dozen equal sized entities that are not too big to fail. The new entities' securities should be subjected to the 1933 Securities Act and 1934 Securities Exchange Act, and statutory treatment of GSEs' debt as "government debt" should be eliminated. These new entities should (i) be chartered by the regulator, not Congress; (ii) be subject to the bankruptcy code; (iii) be allowed to issue only MBS; (iv) be prohibited from participating in the guarantee business; (v) require cash down payments of 5% for mortgages they purchase, which would increase to 10% over several years, with piggy-back loans prohibited; (vi) eliminate loan limits and housing goals by setting loan sizes based upon income for a given geographic area, such as three times the state's median income; and (vii) be prohibited from issuing unsecured debt; (viii) limit or bar foreign central banks from holding GSE debt; and (ix) be prohibited from retaining mortgage portfolios. Additionally, bank regulators should be required to treat GSE debt as non-government corporate debt.

Center for American Progress (CAP)

In a December 2009 white paper, CAP published a white paper on GSE reform, calling for the creation of a limited number of charter mortgage issuers (CMIs) to issue government-guaranteed MBS for both single-family and multifamily mortgages in exchange for a small fee, used to create an actuarially sound Taxpayer Protection Insurance Fund. While the CMIs' MBS would be explicitly guaranteed by the federal government, the entities debt and equity would explicitly NOT be guaranteed.
CAP recommends that the GSEs' affordable housing goals be eliminated. Instead, all MBS issuers would be called upon to support underserved communities through a fee charged on each MBS issuance that would support the Affordable Housing Trust Fund, the Capital Magnet Fund (for CDFIs) and perhaps other vehicles for financing affordable housing. In addition, CAP calls for the CMIs to maintain a limited retained mortgage portfolio to the extent that it serves certain public purposes, such as providing countercyclical liquidity and liquidity for affordable multifamily housing for both fixed-income and mixed use development and small multifamily. (The roles of FHA, VA, Ginnie Mae, and RHS would continue.)

The CMIs would also be subject to the general duty to serve underserved communities. CAP suggests measuring the CMIs' securitization activities in underserved markets by examining the percentage of the issuer's overall securitization, based upon the number of loans securitized (not the dollar amount), that fall into underserved markets relative to

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that for all other non-CMI issuers. CAP suggests also factoring in whether the issuer is enhancing access to credit in underserved markets in other ways, such as through participation in deals, investments and grants with other organizations, such as CDFIs, that effectively serve these markets. If an issuer fails to meet this evaluation, it would be penalized with heightened requirements to serve underserved communities, which might include grants, volunteering, counseling and/or payment of substantial additional fees to the Affordable Housing Trust Fund or Capital Magnet Funds.

Under this proposal, the CMIs would be structured under the utility model (with the co-operative model considered as an alternative), as privately-owned entities whose profits are subject to regulation. CAP notes that the success of this framework hinges on the ability of new CMIs to attract sufficient levels of private capital, which the authors fear may be problematic due to profit constraints, higher capital requirements, and a stricter regulatory structure.

CAP proposes a stringent regulatory regime for the CMIs to address product approval, capitalization requirements, reserve requirements, and operational and credit risks. CAP proposes reducing the size of the CMIs' retained mortgage portfolios, by allowing (only) investments for certain purposes, such as mixed-income and mixed-use development and small multifamily, providing capacity for crises and financial downturns, and testing new products.

The CMIs' primary regulator would (i) determine the specific characteristics of the mortgages eligible for securitization; (ii) set the conforming loan limits; (iii) require adequate capital levels to cover mortgage risk and ensure adequacy of the taxpayer protection insurance fund to protect against catastrophic loss; (iv) set managed returns to ensure durable capital investment to support the housing market without encouraging risky behavior or "undu[e] capture" of the value provided by a government guarantee; (vi) have the authority to place CMIs into conservatorship; and (vii) ensure that the CMIs serve all markets at all times in a fair and equitable manner.

CAP also recommends uniform comprehensive regulation of any institution seeking to securitize any U.S. mortgage. This regulatory system should (i) set strict limits on the types of MBS that could be issued for all loan collateral types and amounts; (ii) require approval to issue all MBS, including those collateralized by jumbo mortgages, to level the playing field and eliminate competition from unregulated entities; (iii) establish a strong prudential risk oversight regime, including rigorous capital and risk standards; (iv) require some form of "skin in the game" risk retention for all mortgage originators; (v) set standards for acceptable underwriting and mortgage characteristics; and (vi) set a small fee to support the Affordable Housing Trust Fund and Capital Magnet Funds (funds that Congress created in 2008 for Fannie Mae and Freddie Mac).

The CAP proposal leaves open a number of issues, including (i) how many CMIs would be formed; (ii) which model—the utility or cooperative structure—should be used; (iii) how to make certain the entities can raise adequate capital; and (iv) how the structure would promote innovation.

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Economic Policies for the 21st Century

In a May 24 white paper issued by Economic Policies for the 21st Century, authors Donald Marron and Phillip Swagel argue that the reformed GSEs should be private companies, with a narrow focus on buying and securitizing conforming mortgages, and that qualify for government backing. These fully private entities, with no remaining linkage—implicitly or explicitly—to the federal government, would be subject to rigorous regulatory oversight. These new entities would have no retained mortgage portfolios, other than a warehouse line, and have no associated debt. They would compensate the government for its explicit backing of MBS by paying actuarially-sound fees to pay taxpayers for the insurance. The government's backstop for MBS would be triggered only after a firm's shareholders are wiped out.

Under this model, all special government benefits for Fannie Mae and Freddie Mac would be repealed and their lines of credit with Treasury would be terminated. Over time, the authors believe that Fannie Mae and Freddie Mac would evolve into either specialized firms focused on securitization or would become part of a vertically integrated financial services firm that both originates and securitizes mortgages. Support for affordable housing could be structured through a fee on mortgage securitizations or tax on the entities themselves, but carried out transparently through regular appropriations channels.

The authors believe that securitization of conforming loans should be opened to competition and the government should encourage other firms, also subject to regulatory oversight, to participate in this market. These private firms may also purchase from the government the MBS-level guarantee. Competition in the securitization market helps ensure that the subsidy embedded in the government guarantee is passed along to homeowners and homebuyers. Following a long transition period for competition in the securitization space to evolve, operating restrictions on the new Fannie and Freddie could be allowed to roll off over time. Eventually, these entities could be allowed to have retained portfolios, along with their competitors. Eventually, these new entities could become vertically integrated or acquired by banks.

Reason Foundation

In April 14 testimony before Congress, Anthony Randazzo, Reason's director of economic research, urged policymakers to begin taking steps now to phase out Fannie Mae's and Freddie Mac's operations through (i) a four to five year divesture of the GSEs' mortgage portfolios and liabilities, liquidation of assets, and winding down of their purchasing and securitization operations; (ii) shifting the GSEs' bad assets into a bad bank holding company entity, preferably serviced by a private sector asset manager; and (iii) shifting the GSEs' affordable housing mission to FHA. Randazzo argues that reform efforts should begin now, by reducing conforming loan limits to restrict the GSEs' operations the jumbo market and limit the timeframe in which the GSEs can hold individual mortgages and MBS in their portfolio. He urges Congress to provide a

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framework that identifies ways the private sector can assume the GSEs' current role in the market.

Urban Institute

In a May 2010 white paper issued on behalf of the Urban Institute, the New York University's Furman Center for Real Estate evaluated the major reform proposals for Fannie Mae and Freddie Mac proposed by the Center for American Progress, Credit Suisse, the Mortgage Bankers Association, and the HPC. The authors, Ingrid Gould Ellen, John Napier Tye and Mark A. Willis, noted that few, if any, proposals explicitly address multifamily housing finance and suggested it may be possible to create mortgage insurance funds at the state and local levels, similar to those run by the State of New York Mortgage Agency (SONYMA). The SONYMA works with pre-approved lenders to develop loan programs tailored to meet local needs, and with government subsidies, in the form of 100% credit insurance on loans sold to pension plans and 75% first-loss insurance for loans sold to private investors. As a result of its own revenue stream from the mortgage transfer tax and limited losses, SONYMA has been able to achieve an AA rating. The authors question if this success could be replicated and expanded over a broader geographic region through a federal government MBS wrap and prudent creation of criteria for structuring the insurance funds (e.g., addressing the level of top loss provided on individual transactions, the ratio of reserves to risk, the mechanisms for claims payment, and criteria for selecting originators). The explicit government guarantee would provide an investment grade rating, which could be used to help create a secondary market for these locally-underwritten and locally-tailored loans. The goal of such a system would be to standardize origination of the loans and their subsequent purchase by institutional investors.

The authors also note that covered bonds are another vehicle that could expand the amount of funds available for a bank to lend, and would have three distinct advantages over MBS as a method of mortgage finance. These include (i) the potential of reducing principal-agent problems, because the banks themselves hold the mortgages securing the covered bonds; (ii) the banks can modify these mortgages if necessary, because the mortgages remain on their balance sheet; and (iii) these bonds also have the potential—depending on their structure—of improving the options for homeowners who find themselves underwater. The authors note that there is uncertainty regarding the level of liquidity that covered bonds can provide relative to MBS. Moreover, it may be difficult for covered bonds to achieve "the minimum efficient scale" to compete with the GSEs' MBS, wrote the authors. There are also important questions about whether covered bonds could be cost-competitive with existing mortgage finance options that are available today, in light of their economies of scale and the government subsidies that are in place. Instead of replacing existing mortgage products, covered bonds may be a useful vehicle to increase market liquidity for non-conventional mortgage products, such as jumbo mortgages.

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[i] Click on document name to access on the Internet

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