NAR's Vision for Housing Finance Reform

On September 7, 2008, as a substantial breakdown in the American housing market left Fannie Mae and Freddie Mac (the Government Sponsored Enterprises or GSEs) in financial turmoil, the Federal Housing Finance Agency (FHFA) moved to place the GSEs into conservatorship. Today, more than a decade later, the financial crisis is long over, but the GSEs remain in conservatorship. To end this conservatorship, a new vision for the secondary mortgage market is outlined below by the National Association of REALTORS® in collaboration with Susan Wachter, the Albert Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania, and Richard Cooperstein, head of Risk Management at Andrew Davidson and Company, Inc.

Taking Stock: What Works Today in Housing Finance Secondary Markets

What do the GSEs do? Fannie Mae and Freddie Mac buy mortgages, package them into securities, and sell them to investors with a guarantee that assures them of timely payment. However, the GSEs are much more. They set, monitor, and enforce standards subject to their regulator for origination, credit, servicing, and prepayment in the $5 trillion conventional mortgage market. The GSEs also provide the large infrastructure and scale required in the investment markets for interest rate and credit risk, and facilitate more competition than would exist without them.

What was the GSEs flaw? The GSEs foundered due to: insufficient capital and guarantee fees that were set too low; inadequate regulatory oversight lacking externally imposed capital standards; and ruinous competition. The GSEs were disintermediated by unregulated risk providers (subprime) and then chased the market because returns and mission were not regulated. They could not capture the benefits of setting good credit standards.

Why do they appear to be succeeding now? Today the GSEs effectively deliver credit and pricing (capital) standards, enforcing credit standards for the market with a focused mission and transparency.

What Remains to be Done: A New Paradigm for Securing the Future

The need for a liquid, national mortgage market that is efficient and resilient to stress is ongoing. The mission to support the home financing needs of middle America and to improve access for underserved communities continues. Today, the taxpayer is exposed to losses without the cushion of private capital, which must change. Furthermore, the Great Recession itself, the continued absence of the private-label securities (PLS) market, and the drop in homeownership (especially for minorities) reinforce the continuing need for federal support of the secondary mortgage market.

A government-chartered utility is most capable of satisfying these objectives. Fannie Mae and Freddie Mac were government-chartered entities for decades before the crisis and conveyed very large value to the mortgage finance ecosystem. However, insufficient accountability and regulatory oversight led to limited transparency and inadequate capital standards. The absence of return limits allowed the GSEs to respond to the relentless pull to maximize short-run profits and franchise value. They guaranteed excessively risky loans to grow market share and amassed trillion-dollar mortgage-backed securities (MBS) portfolios, among other activities. One of the other flaws in the structure was the conveyance of a valuable federal franchise to private shareholders without return limits and mission focus.

This proposal rebalances the tension between market incentives and public mission by establishing a regulated utility. This structure strengthens governance for adherence to mission and regulates returns to leverage the discipline of private capital while limiting the profit motive.

A Secondary System for the Future

The GSEs of 2019 are not the GSEs of 2005. Today, Fannie Mae and Freddie Mac have a stronger regulator in the FHFA with public oversight in Congress. The FHFA has proposed a risk-based capital rule and directs adequate pricing based on stress tests and a market rate cost of capital, but further refining of this would likely be necessary. The GSEs are currently restricted in the products they can purchase, the size of their retained portfolios, and their ability to lobby. The entities intermediate most of the interest rate and credit risk on the mortgages they guarantee to the private sector. This process has begun to de-risk the GSEs, bringing private capital and the discipline of markets to guarantee pricing and mortgage rates for consumers.

The GSEs' operations are reformed, but their ownership structure and oversight remain to be determined.

This proposal would re-charter the GSEs as Systemically Important Mortgage Market Utilities (SIMMUs), similar to Systemically Important Financial Market Utilities (SIFMUs). After being established in the Dodd-Frank legislation, the Financial Stability Oversight Council (FSOC) in the U.S. Department of Treasury) designated private market entities as SIFMUs because, "*a failure or a disruption to the functioning of an FMU could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system*."[1]

This precisely describes the view of the potential harm from unregulated GSEs. As SIFMU status comes with enhanced oversight by the FSOC, an enhanced FHFA would oversee the SIMMUs. The FHFA's oversight of the SIMMUs would be tailored to their unique mission of mortgage market liquidity and advancing access to affordable home financing to credit-worthy borrowers across the country.

This well-tested structure supports the public missions of liquidity and broad access through its board and its enhanced oversight. Explained in more detail below, shareholder equity generates the discipline to use resources efficiently to maintain regulated returns that vary in accordance with the quality of infrastructure investments. *It is worth noting that the FHFA's white paper on GSE reform called for "shareholder-owned secondary market entities (SMEs) operating as utilities with regulated, overall rates of return and appropriate capital requirements."*[2]

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[1] Depository Trust and Clearing Corporation, "Systematically Important Financial Market Utilities," available at http://www.dtcc.com/about/managing-risk/sifmu.

[2] National Council of State Housing Agencies, "Federal Housing Finance Agency Perspectives on Housing Finance Reform," January 16, 2018.

Shareholder Participation and the Public Mission in a Regulated Utility

Shareholder participation provides two important advantages: it places private equity ahead of taxpayers and incentivizes private owners with operational control to conserve resources and maintain performance-based regulated returns on equity. The public mission of the SIMMU should supersede the competitive motivations and benefits of shareholders with private capital at risk. This is consistent with the legal construct of a Beneficial Corporation[3], which allows a public purpose to be explicitly included as a shareholder objective and enables the board to consider the GSE's mission in their role of representing the best interests of shareholders. Nonetheless, transparency, a regulator to set returns, and mission focus are required.

Duties, Capital (Cyclicality) and Governance

As with all regulated utilities, these firms would be closely regulated by the FHFA. Decisions on pricing, returns on equity, infrastructure, products, and other business activities would require prior approval by the regulator. The entities would report to Congress on the strength of the business and performance against their public mission on a regular basis, but they would not be able to lobby and would fund their operations outside the government appropriations process through fees as the GSEs.

The regulated utilities would continue the mission of maintaining liquid and fair markets for residential mortgages by setting standards and continuing to intermediate most of their risk to the private capital markets—interest rate and prepayment risk through the To-Be-Announced (TBA) market and credit risk through existing credit risk transfer (CRT) and related credit risk programs. MBS would carry an explicit, paid-for, catastrophic guarantee provided by the U.S. government to enhance liquidity and support the TBA and CRT markets and long-term financing in turn.

The entities would retain enough risk to align incentives and enough capital to protect taxpayers from losses in all but the most extreme circumstances. This capital requirement reflects their role as insurance utilities and includes product, counter-party, and balance sheet risks, along with their countercyclical obligations. The utilities would transfer programmatic levels (a substantial majority as determined by their regulator) of credit risk to private capital.

For sustainability, the entities would have claims-paying ability to comfortably survive a 2007 type crisis; *about* 5 percent from guarantee fees, capital, and risk transfer. This level is consistent with the FHFA's recent proposed capital rule and current guarantee fees, with other reform proposals, and with the price of risk implied by the CRT markets. Under extreme stress, the U.S. Treasury backstop would provide liquidity to ensure the guarantors could continue operating and, crucially, to maintain confidence in the mortgage debt markets.

The regulator would determine how much new equity must be raised if suspending dividends is not enough to recapitalize in stress losses, and, more generally, the amount of equity, regulated return, and other factors during normal operations. The regulator in conjunction with the U.S. Treasury would determine when the U.S. Treasury support is triggered and how long such liquidity payments would be

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[3] http://benefitcorp.net/businesses/why-become-benefit-corp

needed. When the mortgage market re-stabilizes, the regulator would direct the utilities to issue new shares to recapitalize, diluting existing shareholders.

To support prudent underwriting standards and to focus the resources of the federal franchises, the entities would only guarantee mortgages that comply with the Qualified Mortgage (QM) standard of the Ability-to-Repay Rule (ATR) and other standards as deemed fit by the regulator. Mortgages guaranteed by the entities that include less than 20 percent borrower equity would continue to require credit enhancement to substitute for the homeowner's stake. Likewise, the entities would continue to enforce capital and operational standards for servicers and credit counterparties that protect taxpayers while achieving the public mission. The entities would be responsible for providing clear rules regarding warranties made by counterparties and for related repurchases.

Private and public actors need to be able to monitor the work of the utilities; hence, origination and performance data on the entire portfolios should be freely available, along with information on the performance of the utilities themselves and their servicing and private risk-taking counterparties. Such transparency should allay some common concerns about utilities with regulated returns, such as mission creep and opaqueness. The entities would compete on service levels for business from their customers in the primary and secondary markets, rather than exploiting their capital arbitrage or watering down standards for extra profits.

Finally, the entities would provide and maintain a national infrastructure for securitization and credit risk sharing with private markets. Along with the regulator and board, the entities would determine the nature of their liquidity, new products, and non-performing loan portfolio, access for small lenders, and clear and fair pricing to lenders of all sizes and structures. They would be required to maintain a national presence at all times and to support 30-year fixed rate mortgages.

Broad Access to Mortgage Finance

The new utilities would continue to have an obligation to advance prudent access to homeownership financing, including to:

1. Purchase a representative mix of the potential conforming market.
2. Target a lower rate of return for qualified mortgages that result in lower rates for these mortgages for social ends.
3. Make long-term significant investments in fundamental data and research as well as programs and infrastructure to expand access to mortgage finance.
   i) For example, this could include but is not limited to improving the digital footprint of 'credit-invisibles' or future credit innovations through improved consumer credit reporting requirements, using non-traditional credit data, and investing in improved integration and reporting of credit data.
   ii) As directed by the regulator, allocate a share of budget to first-time homebuyer programs and infrastructure for targeted populations.
4. Support the affirmative obligations as directed in the *Housing and Economic Recovery Act of 2008* (HERA), including the Enterprise housing goals, Duty to Serve mandates, and dedicated funding to the Capital Magnet Fund and Housing Trust Funds.

Government programs may support a similar mission, but without reliance on private capital. Proposals that would eliminate or shrink the GSEs would reduce liquidity in the market and cause government programs to expand risk to tax payers.

Both efficiency and equity goals are accomplished through the SIMMUs—financial market utilities that receive regulated returns and execute the government's mission for housing finance.

Finalizing Secondary Reform, the Last Vestige of the Great Recession, and Transitioning to the Future

The first directive for transition of any systemically important financial markets is no disruption. Mortgage markets are functioning smoothly now and there can be no interruption in the daily availability of mortgages or in the continuous functioning of the $5 trillion conventional mortgage debt market. Therefore, the final model and transition process must be telegraphed to the market to assure stability and liquidity.

Advantages of this proposal are that it builds on the two existing Enterprises and their valuable infrastructure, retaining the many reforms made to date, and takes advantage of mechanics laid out in HERA. Congressional action would be needed to re-charter Fannie Mae and Freddie Mac into Federally-chartered, SIMMUs. Congress will need to:

- Affirm the public mission.
- Affirm the explicit government role as catastrophic insurer.
- Delineate the ownership, governance, and regulatory structure of the new SIMMUs.
- Establish a timetable to implement the new regulatory structure, issue stock, and establish governance.
- Concurrently, expand the FHFA's powers to oversee all GSE operations as a utility regulator.

Once Congress has ratified the new arrangement, the Enterprises would be placed in limited-life regulated entity (LLRE) status for their transition to Systemically Important Mortgage Market Utilities (SIMMUs). All assets and obligations of the GSEs would transfer. These LLREs as specified under HERA would give the FHFA and SIMMUs time to manage the transition.

This proposal is agnostic on the outcome of the lawsuit by current shareholders against the government, and this transition structure should not interfere with that process of determination, which would be resolved prior to the entities being placed in the LLREs.

The SIMMUs would continue to maintain and develop the infrastructure of the conventional mortgage market, and the regulator would oversee the issuance of required stock analogous to an Initial Public Offering (IPO). It is estimated that $100-$200 billion (2 to 3 percent) of equity capital would be needed to back the SIMMUs, supplementing the existing guarantee fees and risk sharing structures for a 4 to 5 percent claims paying ability. Discussions with market experts in raising capital indicate this could be achieved in a few offerings over several years. Once recapitalized, a new board would be seated and the FHFA would determine the risk-based insurance fee that shareholders will begin paying for the U.S. Treasury backstop.

Thus, in as little as two years, the new SIMMUs could emerge well-capitalized and with a stronger regulator and clearer public mission to support a liquid and fair national market for mortgages—one that is disciplined by the interests of private shareholders and regulated returns.

Fully-Loaded Guarantee Fees? We are Already There.

Pricing of the guarantee fee is critical to accomplish the mission and to attract private investors, but raises a number of important questions. What is the right guarantee fee that fairly prices risk and protects taxpayers? How much should the utilities charge to raise and maintain equity and sell risk into the market? Will the market be disrupted in achieving a market rate?

For an extended period before the financial crisis, the GSEs had 0.45 percent statutory capital for credit risk and 2.50 percent for portfolio assets, charged about 20 basis points (bps) guarantee fees, and generated high returns on their highly-levered balance sheet. During the crisis the GSEs cost the taxpayers nearly $200 billion, which was subsequently paid back, or about 4 percent of $5 trillion notional balance mortgages, a loss nearly ten times their required capital. Since then, about $2.5 trillion of notional balance CRT has been issued, transferring risk and providing extensive discovery on the price of risk and implied capital required for GSE credit risk. From 2011 to 2014, guarantee fees were raised in a series of steps to roughly 55 bps. This amount is consistent with credit risk and a return on capital in the market and with pricing under a regulated utility as proposed.[4]

For the past several years, the GSEs have been charging 50 to 60 bps guarantee fees, and the table on the following page shows a rough calculation of the components. This proposal uses conservative estimates and comes to about the same fee level effectively using market prices for debt and equity. In the current system, about 15 bps are residually available to cover the risk that taxpayers bear.

Protecting taxpayers to a 97[5] percent confidence level could require about 4 percent to 5 percent[6] claims paying resources. Current CRT sizing of 3.5 percent provides the equivalent of about 2.5 percent equity to combine with 2.5 percent equity capital. Similar to deposit insurance fees, risk-based catastrophic protection purchased from the U.S. Treasury would protect taxpayers from virtually any outcome.

In the height of the financial crisis, subprime and corporate spreads widened by hundreds of basis points. CRT spreads might widen that much in a future crisis, though they probably would be more stable provided there is confidence in the continued functioning of the GSEs with the U.S. Treasury behind them. Investors in subsequent CRT issuance during a crisis would not be exposed to losses on older books of business, but they might nevertheless pull back. Consequently, equity investors are crucial to guarantee fee stability in uncertain times. Nonetheless, GSE risk transfer cost should be limited by the option to issue additional equity at the 10 percent regulated return. In a repeat of the 2007 financial crisis, the *Stress Example* shows that credit costs might rise about 40 bps.[7]

However, in order to support their countercyclical mission and buttressed by their deeper capital position and diversified outlets, the entities would not have to raise guarantee fees in lock step with CRT or capital costs. This would hold for any system having a reliable federal backstop. Under a fully-private

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[4] Richard Cooperstein, "A Capital Standard for the GSEs," The Pipeline, AD&Co, #149 May 2017.
[5] A more severe case than experienced during the subprime crisis and great recession.
[6] The 4 percent to 5 percent claims paying resources is likely high and conservative for these purposes.
[7] These results are consistent with the $200 billion charged to taxpayers on the $5 trillion market in the previous crisis. Also see the Urban Institute's comment on the FHFA's Proposed Capital Framework (see table 11 https://www.urban.org/sites/default/files/publication/99433/analysis_of_fhfa_proposal_on_enterprise_capital_1.pdf)

structure, results would likely to be far worse, with no guarantee that the mortgage market would continue to function, recalling the collapse of the subprime and Alt-A markets.

	Current System			Proposed System			Stress Example		
	Capital	Cost	G Fee	Capital	Cost	G Fee	Capital	Cost	G Fee
Capital			0.29%	6.00%	6.50%	0.39%	6.00%	10.0%	0.60%
Equity				2.50%	10.0%	0.25%	3.00%	10.0%	0.30%
Debt [i]	1.00% [ii]	4.0%	0.04%	3.50%	4.00%	0.14%	3.00%	10.0%	0.30%
Overhead [iii]			0.08%			0.08%			0.08%
Expected losses [iv]			0.08%			0.08%			0.20%
Treasury Premium						0.05%			0.10%
TCCA [v]			0.10%						
Benefit of a Federal Guarantee [vi]						-0.05%			-0.05%
Total			0.55%			0.55%			0.93%

vii. Six percent nominal total of equity and debt combine for about 4-5% effective capital
viii. Based on roughly $50 B of CRT outstanding
ix. The 4 percent to 5 percent claims paying resources is likely high and conservative for these purposes.
x. Six percent nominal total of equity and debt combine for about 4-5% effective capital
xi. Based on roughly $50 B of CRT outstanding
xii. Regulators can use transparency and incentive-based returns for investors to maintain low overhead as discussed below. This estimate is higher than the 7bp listed by the FHFA in its 2014 request for input on guarantee fee pricing https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/GfeeRFI060514F.pdf.
xiii. Cumulative default rates on new GSE business are projected a bit over 1 percent with severity slightly under 40 percent. This leads to average cumulative losses under 50 bps over the life of typical loans and works out to a guarantee fee equivalent of roughly 8 bps with a multiple of six. Expected losses are increased 2.5 times in the stress event as an approximation.
xiv. This 10 bp fee is the Temporary Payroll Tax Cut Continuation Act of 2011 (TCCA) to fund an extension of the payroll tax cut and is set to expire in 2021. Assuming a two-year transition, the TCCA fee would end before the new system takes hold.
xv. This estimate is the low end of the impact of a federal guarantee. Estimates by Barclays (Barclays, Implications of Possible GSE Reform for the MBS and CRT Markets (July 14, 2017) put the benefit at 6 to 10bp, while Zandi, Parrot, Stegman, and Swagel have argued for a 20bp reduction in rates ("Access and Affordability in the New Housing Finance System"). Regulating returns ensures that the benefits are passed onto consumers.

Conclusion

This vision of a reformed secondary market for housing finance first recognizes the need for the reformed GSEs to carry out a public mission, the same need that led to their initial creation. Second, this proposal builds upon the transformed enterprises under conservatorship. Third, this proposal codifies a utility structure that is effective, resilient and fair, balancing the incentives of private operating companies with a public mission. It builds on what works today and creates a system that will serve the Nation for decades to come.

NAR'S VISION FOR HOUSING FINANCE REFORM:

The GSEs' Mission and Role in the Economy and Housing Market are Too Important for Poorly Crafted Reform

The National Association of REALTORS® has collaborated with Susan Wachter of the Wharton School at the University of Pennsylvania and Richard Cooperstein of Andrew Davidson and Company on new research exploring ideal restructuring of the secondary mortgage market. The overall effort is intended to promote a reliable and affordable source of mortgage capital for consumers.

THE VISION INCLUDES:

» Leveraging reforms and innovations implemented since the crisis while completing the process with instrumental updates for a fully functioning liquid market.

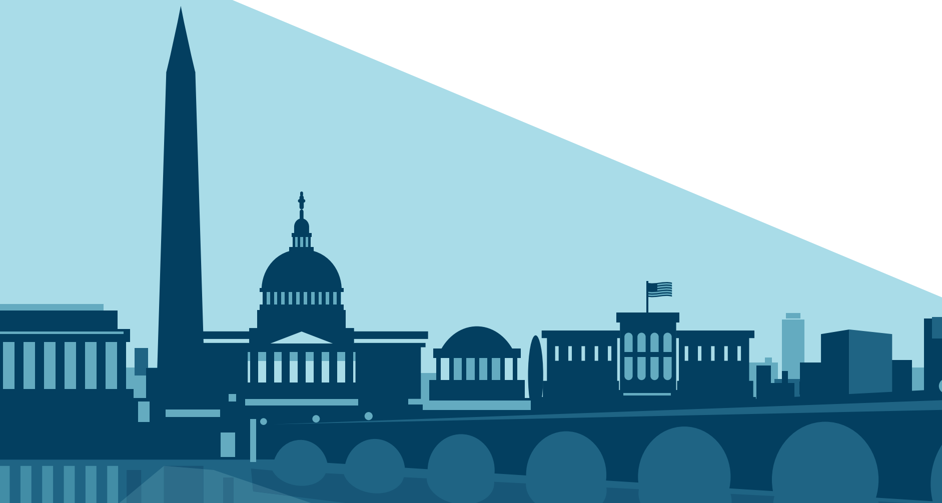
» Promoting competition in the secondary market through proven structures to correct market failures.

» Preserving the 30-year fixed rate mortgage and focusing the mission on liquid secondary markets for Middle America and underserved borrowers.

» Minimizing the cost to consumers in normal and stress periods while maximizing access for creditworthy borrowers.

» Protecting taxpayers by using private capital.

» Maintaining simplicity in the transition while avoiding market disruptions.



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