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Before the House Financial Services Committee Subcommittee on Housing and Insurance

"Sustainable Housing Finance Part III: Private Sector Perspectives on Housing Finance Reform"

November 7, 2017

What to do with Fannie Mae and Freddie Mac? This question has plagued policymakers since the mortgage behemoths were placed into government conservatorship during the financial crisis almost a decade ago. Various legislative efforts to restructure the government-sponsored enterprises and significantly scale back government support and taxpayer backing have failed. Yet no one is happy with Fannie and Freddie in this limbo. This testimony considers the critical criteria that must be meet for housing finance reform to succeed and how the principal proposals to reform the system stack up relative to these criteria.

Defining successful reform

The success of any housing finance reform depends on its ability to satisfy six essential criteria, including ending too-big-to-fail, fully protecting taxpayers, providing equal access to the system for underserved communities and lenders of all sizes, maintaining affordable mortgage rates for borrowers under all market conditions, promoting competition, and easing the transition from the current system to the future system.

The future housing finance system must end the reliance on too-big-to-fail financial institutions. Fannie and Freddie were too-big-to-fail, and the cost to taxpayers of forestalling their failure during the financial crisis was considerable. In the future system, no private institutions should be indispensable to a healthy, well-functioning secondary mortgage market, or be able to dominate the market by controlling its infrastructure or taking a significant share of the system's credit risk.

Taxpayers must be fully protected from suffering any losses in the future system. This requires that there is substantial private capital in the system, sufficient to withstand losses in all but the most catastrophic economic scenarios. The federal government should stand behind the system, backstopping it against these dark scenarios, but mortgage borrowers should pay taxpayers for the cost of this backstop. Taxpayers should also have the ability to claw back from borrowers any costs they incur in backstopping the system.

Maintaining broad access to mortgage credit for those in a position to become sustainable homeowners is one of the most important and widely supported objectives of housing finance reform. For this to mean anything, though, not only must borrowers be able to find a lender willing to make them a loan, they must be able to find one willing to make them a loan on terms that they can afford.

Equal access for lenders of all sizes is also necessary to ensure sufficient competition in the future system.

The future system must not result in significantly higher mortgage rates while still providing the necessary capital buffer to protect taxpayers and the appropriate access for underserved borrowers. The system must also be flexible enough to ease the impact on mortgage rates and credit availability during tough economic times when private sources of capital will either be unwilling to provide capital or require such a high return that it would cause rates to spike. This requires a catastrophic government backstop.

Competition in the future system is necessary to ensure that mortgage borrowers are offered innovative loan products with attractive terms and interest rates. This includes promoting competition in the primary lending market, the markets for taking credit risk, and the secondary market. It is also critical that competition in the system is not based on inappropriate underwriting standards, which will result in unsustainable lending and an unstable system.

Finally, the transition from the current system to a future one must occur with as little disruption, uncertainty and risk as possible, building upon steps already under way. This includes Fannie and Freddie's current work to build a common securitization platform, or CSP, and the GSEs' current risk-transfer efforts. It is critical to move in an incremental fashion because the deep structural reform called for will require significant change to a complex and critically important system. The process of transition should be approached with an appropriate level of humility and flexibility in the face of the difficulty and importance of the challenge.

Reform proposals

A wide range of proposals have been put forward to reform the housing finance system since Fannie and Freddie were put into conservatorship during the financial crisis. They differ in many ways, but most fundamentally with regard to what to do with Fannie and Freddie, the role of the government in the future system, and the reliance on the current secondary market infrastructure. The most notable proposals, rank ordered from least to most viable when considering economic and current political factors, include a system with no government backstop, recapitalization and reprivatization of Fannie and Freddie, an expanded Ginnie Mae issuer-based system, a government corporation, and a multiple guarantor system. Each of these proposals is described briefly, and their advantages and shortcomings assessed in the context of the six critical criteria for reform.

No government backstop

Arguably the most disruptive GSE reform proposal would be to put Fannie and Freddie into receivership and sell off their assets. Outside of the FHA, there would be no government support to the housing finance system—the system would be privatized. This is the future system envisaged by legislation that passed the House Financial Services Committee in 2013, known as the PATH Act.[i]

The principal advantage of a privatized system lies in its stronger incentives for prudent mortgage lending. Mortgage originators, issuers, rating agencies and investors would understand that if things go badly and defaults rise, they will suffer the consequences. Of course the incentive depends on how strongly investors believe that the government will not intervene, even in bad times. Moreover, the collapse of the private label securities market during the recent housing bust demonstrated that imprudent risk-taking can occur in a private market, even where enormous losses are possible.

A privatized system would also protect taxpayers by restricting the government's ability to provide implicit subsidies to the mortgage and housing markets. The FHA would still be a potential source of subsidy, but this would be explicit. There is thus less risk that capital would be misallocated toward housing and away from more productive activities.

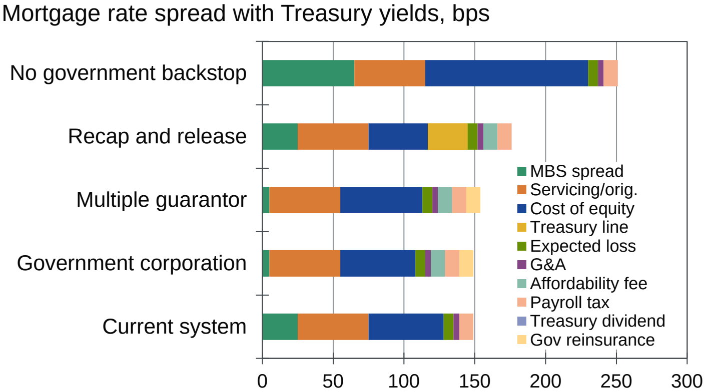
The systemic risks borne by taxpayers should also be reduced, at least in theory. In a truly competitive private market, Fannie and Freddie's roles would presumably be filled by smaller institutions that would not threaten the system if they fail. However, given scale economies in mortgage lending and servicing and historical precedent, it is very possible that the market would become more concentrated, with greater too-big-to-fail risks.

Complete privatization is much more plausible in theory than it would be in practice. Private capital is not limitless, and there are plausible catastrophic scenarios, similar to the Great Recession, that would completely wipe it out. At that point, the government would have little choice but to intervene, or the system would collapse. Regardless of what policymakers say, global investors will almost surely continue to believe the U.S. government would step in if housing foundered. This was amply demonstrated in the financial panic when the government rescued Fannie and Freddie, after saying for years that it would not do so. After Congress' approval of the Troubled Asset Relief Program and the bank bailouts, investors believe Washington will inevitably act if the broader financial system is in danger.

The potential advantages of privatization would also be overwhelmed by disadvantages in the form of much higher mortgage rates and a much less stable source of mortgage funding across the economy's ups and downs. The 30-year fixed-rate mortgage, the bedrock of mortgage lending since the Great Depression, would also be significantly diminished. Under the kind of system envisaged in the PATH, providing the system with enough capital to withstand a mortgage default loss rate of 5%—about the system's current capitalization level—would drive mortgage rates nearly 90 basis points higher than they currently are (see Chart 1).

Chart 1: Housing Finance Reform Impact on Mortgage Rates

Mortgage rate spread with Treasury yields, bps



Source: Moody's Analytics

Recap and release

Perhaps the least disruptive approach to GSE reform would be for the GSEs to be simply recapitalized and then reprivatized.[ii] Since Fannie and Freddie were remarkably profitable prior to the crisis, and have consistently been in the black in recent years, the logic for this proposal is that we can simply return to the system that prevailed prior to the crisis, albeit one that is more highly capitalized and regulated and that has an explicit government guarantee that is paid for by borrowers.

There are a number of concerns with the wisdom of releasing the GSE duopoly back into the private market. Most significant, the secondary market would be reliant on two too-big-to-fail financial institutions. They would continue to handle the securitization in this part of the secondary market and ultimately be responsible for all of its credit risk. Given our reliance on them, everyone in the market would know that they would be bailed out if they ever stumbled. Their shareholders would thus continue to be incented to take excessive risk to chase greater profits, knowing that if their bets did not pay off, the taxpayer would step in to cover them. And that, of course, is precisely what happened pre-crisis. Coming out of the crisis, there was thus almost universal agreement that we should reduce our reliance on this duopoly and shift more risk into a competitive private market.

The economics of recap and release are also problematic. There is no going back to the world pre-crisis, since economic conditions and the regulatory environment have changed in ways that would significantly affect how Fannie and Freddie would function as reprivatized institutions. First, upon being released they would assuredly be designated as systemically important financial institutions, or SIFIs. Once deemed by regulators as too-big-to-fail without threatening to undermine the entire financial system, SIFIs must hold enough capital to withstand very stressful scenarios and remain going concerns. For the GSEs, this could require very high levels of capitalization, resulting in meaningfully higher mortgage rates.

Second, the GSEs would likely owe the government for the taxpayers' financial support. Back in 2008, Treasury saved the institutions from imminent collapse with an injection of substantial capital and a line of credit. Under the terms of their agreement with Treasury (Senior Preferred Stock Purchase Agreements, or PSPAs), the GSEs are required to pay Treasury a dividend in return for its investment and a commitment fee in return for their line of credit. The dividend was initially set to equal 10% of Treasury's investment per year, but as Treasury grew concerned that one or both of the institutions would be unable to pay the 10%, forcing them to borrow against their finite line of credit, the parties changed the dividend to equal all of the institutions' annual profits.

Under the PSPAs, the enterprises are also required to pay a commitment fee equal to the market value of the line of credit at the time, but the fee was suspended before it was even determined, out of concern for its impact on the still-precarious institutions. The fee was then suspended indefinitely when the dividend was converted to a profits sweep, because the institutions would have no profits from which to draw the revenue needed to pay the fee.

Depending on how the ongoing obligations to the government are determined, mortgage rates under the recap and release proposal would be 50 to 100 basis points higher than in the current system, and likely much higher for higher credit risk underserved borrowers (see Chart 1).

Expanded Ginnie-issuer system

A more recent GSE reform proposal would turn Fannie and Freddie into mutual institutions—owned by the nation's lenders—that would be a source of credit enhancement in the current Ginnie-issuer system.[iii] The reconstituted Fannie and Freddie would provide this credit enhancement alongside the FHA, VA and USDA, and potentially other sources of private capital. Fannie and Freddie's common securitization platform would become unnecessary, but they would continue to transfer risk to other private investors through their credit risk transfer processes. As in the current Ginnie-issuer system, the securities would be backed by Ginnie Mae, which would be spun out of HUD into a new government corporation. Ginnie would continue to guarantee the timely payment of principal and interest on the securities.

Too-big-to-fail risk in this system would be addressed by converting Fannie and Freddie into lender-owned mutual institutions, which should constrain any inclination for them to take on excessive risk, as lenders can be expected to be careful in the management of an infrastructure on which they will be so reliant for their own survival. Moreover, by opening the Ginnie-issuer system to other approved sources of credit enhancement, this presumably would reduce the reliance on a limited set of government-run entities to provide mortgage insurance, and allow for greater disruption and innovation in the secondary mortgage market from new competitors. It should also result in a wider dispersion of credit risk, reducing the systemic risk of the entire financial system.

Expanding the current Ginnie-issuer system takes advantage of the current strong demand by global investors for Ginnie securities. These securities have the full faith and credit of the U.S. and are deemed by investors to be nearly as risk-free as Treasury securities. This is critical to keeping mortgage rates down in the future system given the added fees that will be necessary in most future systems, including a fee for the government's explicit catastrophic reinsurance, and an affordability fee for funding activities to support access to the system for underserved communities. These costs will be offset by the lower yields on Ginnie securities.[iv]

A shortcoming of the proposed expanded Ginnie-issuer system is the transition costs of moving to it from the current system. Stakeholders in the current GSE-based system, including lenders, servicers, private mortgage insurers, and others will have a difficult time accepting the new system. This reticence is likely in part caused by their recent experiences with the current Ginnie-issuer system, which could be addressed by converting Ginnie into a government corporation that is able to fund itself and is independent from HUD, but more broadly there is a worry that Ginnie is simply not up to the enormous demands that would be placed on it in this proposed system.

There is also a reasonable concern that lenders may not get true sale accounting in the new system if the credit enhancement comes from sources other than the government via the FHA, VA and USDA. True sale is necessary for lenders to get the mortgage originate off their balance sheets. This is an accounting question, but a critical one, and may create a significant amount of complexity in including other sources of capital into the expanded Ginnie-issuer system.

Finally, small lenders will likely be nervous about getting equal access in this proposed system. If large lenders are permitted to provide credit enhancement to get the Ginnie-guarantee, even via their role in the Fannie and Freddie mutual institutions, small lenders will rightly worry they will not have access to that guarantee on the same favorable terms.

Government corporation

Another approach to GSE reform would combine Fannie and Freddie into a single government corporation. The corporation would handle all of the operations that the GSEs perform today, while transferring most non-catastrophic credit risk into the private market and providing an explicit federal guarantee on mortgage-backed securities that is paid for by borrowers.[v]

By putting the infrastructure that mortgage market participants depend on into a government corporation, and spreading the lion's share of the credit risk across a diverse range of private sector actors, including the capital markets, reinsurers, private mortgage insurers, lenders, and other private entities, this system would end the reliance of the housing finance system on a few too-big-to-fail financial institutions.

It would also ensure broad access for underserved communities and smaller lenders. The government corporation would be required to meet duty-to-serve and affordability goals defined by the FHFA, the same as Fannie and Freddie must do today. As with the GSEs, to help meet these obligations, the corporation will set its guarantee fees in a manner that cross-subsidizes underserved borrowers who are creditworthy but may not be able to afford a mortgage loan otherwise. Community banks and small lenders will also have access to the system in the way they have it today, by using the cash window through the corporation.

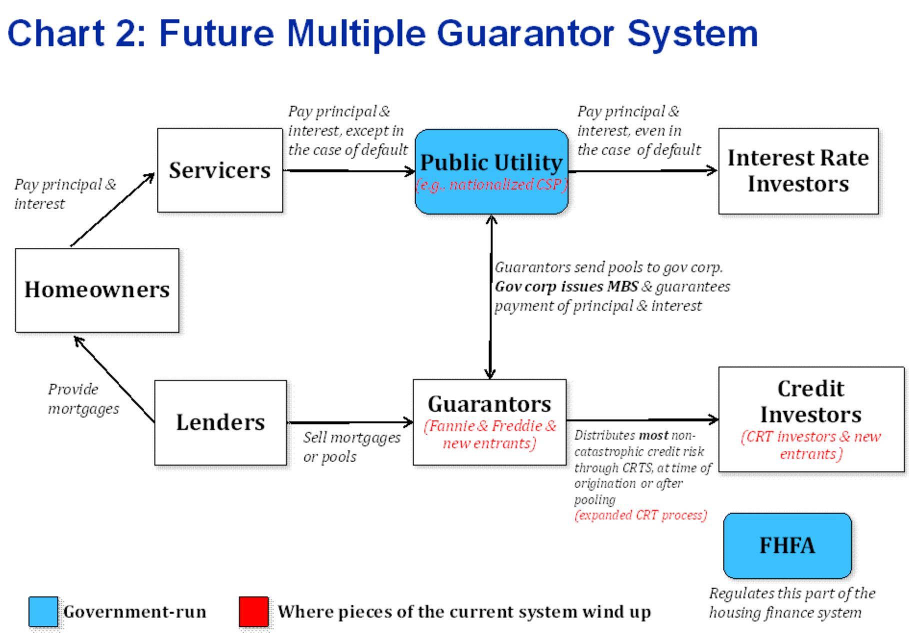
The government corporation would be insulated behind enough capital to guard against economic stresses, and since there are no too-big-to-fail institutions in this system, the amount of capital required to support the system would be lower than in other systems dependent on too-big-to-fail institutions. Less required capital means lower costs and thus lower mortgage rates. Indeed, the corporation will be able to maintain current mortgage rates, despite the added fees for the government's catastrophic backstop and funding access to the system for underserved communities.

Finally, under this proposal the transition from the current to future system will occur with little disruption as it builds upon steps already under way. Fannie and Freddie would continue to build their common securitization platform, and the current effort to synchronize some of the processes at the enterprises would gradually be extended to all of them, from purchasing mortgages to securitizing them and overseeing their servicing. The GSEs' current risk-transfer efforts would also gradually be expanded from an effort to share some non-catastrophic risk with the private market, to one in which they share much of the non-catastrophic risk.

This reform proposal has some potential shortcomings, including that it may be overly reliant on sources of capital that will become more costly during times of financial market and economic stress. The system may also get bogged down in a government bureaucracy, although a government corporation has considerably more flexibility and autonomy on rule-making, employee compensation, and other key areas than a government agency. The system also eliminates competition in the secondary market, although by putting the infrastructure of the market into a government corporation rather than a privately owned too-big-to-fail institution or two, this opens up more competition in the primary market and creates an entire new market for credit risk in the secondary market.

Multiple guarantors

The most viable proposal to reform the housing finance system is known as the multiple guarantor system (see Chart 2).[vi] Fannie and Freddie are turned into privately owned, heavily regulated, guarantor utilities that would compete with other similarly chartered guarantors. Various steps would be taken to facilitate entry into the secondary market by these new guarantors, and the new system would only begin when there was sufficient entry. Fannie and Freddie's common securitization platform would turn into a mutually owned private institution, with all of the guarantors having a stake in the platform. The guarantors would also be incented to offload credit risk to other private investors through the credit risk transfer processes. The securities issued by the CSP would receive an explicit government guarantee via Ginnie Mae, although Ginnie would have no oversight of this part of the system.



The multiple guarantor system should significantly curtail too-big-to-fail risk, as the guarantors should be much smaller than in a duopoly. Competition among the guarantors will also be maximized, which should lead to more innovation in the market and lower costs for borrowers. By turning Fannie and Freddie into utilities with heightened regulation, including rates of return, this would check any incentive to take on excessive risk. And it turns the CSP into a government corporation that issues the securities of Fannie, Freddie, and any other chartered guarantors and guarantees to investors the timely payment of principal and interest on their investments.

With the benefit of the explicit government guarantee, the multiple guarantor system can capitalize to an appropriately high level to protect taxpayers and still be able to keep mortgage rates where they are today, even after charging fees for the government's backstop and to help meets its mandate to provide broad access to underserved borrowers. The guarantors would also have a guarantor-level broad duty to serve all markets under all economic conditions. And to maintain small lender access to the system, the guarantors would be required to maintain a cash window to purchase loans from these lenders on equal terms with large lenders.

Vital to the success of a multiple guarantor system is entry by a sufficient number of guarantors to compete with the future Fannie and Freddie. While it is hard to know what is sufficient, if the private mortgage insurance industry is a guide, then it is reasonable to expect that five to seven strong guarantors are feasible and would make for a healthy market. Entry will be facilitated by the mutually owned CSP, the risk transfer process, and efforts by the system's regulator to help new entrants be cost competitive with the entrenched Fannie and Freddie. Fannie and Freddie's current guarantee book should also be separated from the future Fannie and Freddie guarantors, supported by the current PSPA, to reduce the amount of private capital that will need to be raised to stand up the new system and to reduce Fannie and Freddie's competitive advantage against new entrants. However, despite all these efforts, whether there will be sufficient entry into the new system will not be known for sure until the reform process is under way.

Another potential complication with the multiple guarantor system is ensuring appropriate access for underserved borrowers. Given a guarantor duty-to-serve, a fee to finance efforts to expand affordability, and strong regulatory oversight, a multiple guarantor system should be able to achieve the appropriate level of access, but this will be more complicated to ensure in a system with many guarantors, particularly compared with a system with a single government corporation or even a duopoly.

Conclusions

It is critically important for lawmakers to re-engage on the issue of housing finance reform. The unsustainability of the current system makes reform inevitable. There are numerous proposals to reform the system, each with its plusses and minuses, but the most viable from both an economic and political perspective is the multiple guarantor system. It is vastly preferable to the current system, shedding its problems but not its benefits in a way that minimizes the risk and uncertainty of transition. Whether one agrees with this view or instead prefers one of the other reform paths offered in this testimony, it is necessary to engage in the reform discussion in earnest now, in a moment of relative calm, rather than when another crisis forces our hand.

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[i] For a more detailed analysis of the PATH Act, see "Evaluating PATH," Mark Zandi, Moody's Analytics white paper, July 2013.

[ii] For a more detailed analysis of the recap and release GSE reform proposal, see "Privatizing Fannie and Freddie: Be Careful What You Ask For," Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute white paper, May 15, 2015.

[iii] The GSE reform proposal is described in more detail in "Toward a New Secondary Mortgage Market," Michael Bright and Ed DeMarco, Milken Institute, September 2016.

[iv] Unlike Fannie and Freddie's MBS, Ginnie Mae's MBS is explicitly backed by the full faith and credit of the U.S. government, and thus trade historically at a much lower yield than Fannie and Freddie MBS.

[v] The details of this reform proposal are available in "A More Promising Road to GSE Reform.", Parrott, Zandi, et al.

[vi] The most recent example of a proposed multiple guarantor system is provided in "GSE Reform Principles and Guardrails," Mortgage Bankers Association, January 2017.