

A Pragmatic Plan for Housing Finance Reform

by

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A Pragmatic Path Forward

This paper proposes a pragmatic reform of the housing finance system that ensures access to mortgages for creditworthy borrowers under all economic conditions, protects taxpayers from uncompensated housing risk, and increases the role of the private sector in allocating capital to the housing market.

The paper sets out a vision for the new system, a transition path away from the current conservatorship of Fannie Mae and Freddie Mac, and the policy actions necessary to arrive at the new system. Although some steps on the path require congressional authorization, many can be taken by administrative action once executive-branch policymakers embrace the vision and regulatory agencies bring it to life.

The authors of this paper come to the problem of housing finance reform from different perspectives. We have served in both Democratic and Republican administrations. One of us advises private firms, while the others work in think tanks and academia. But our collective experience tells us that, despite the ideological battles that frame choices about housing finance policy, the imperative of macroeconomic stability, the reality of gradual institutional change and global investor acceptance of that change, and political pragmatism all lead toward a sensible plan such as the one we propose.

The proposal aims to achieve several goals. One is a stable system that is resilient to financial and economic crises and mitigates the impact of those that might occur. The future housing finance system should provide a mechanism for policymakers to respond to economic and financial market developments. In good times, when private capital is ample, private markets would provide a broad range of mortgage products with a limited government backstop. During times of severe economic stress, when private investors are unwilling to bear much risk, the government's market share would naturally expand. Indeed, though the previous housing system had serious flaws, government involvement meant that mortgage financing remained available during the financial crisis even while other parts of credit markets experienced considerable strains. Although costly and poorly conceived in the

previous system, the government backstop eased the severity of the Great Recession that followed the subprime market collapse.

The future system should also provide access to desirable mortgage products such as long-term, fixed-rate loans for creditworthy borrowers who can support mortgages absent events such as death, disability, divorce or unemployment. And it should promote affordable single-family and rental housing, with dedicated and sustainable funding to finance innovation that expands access to mortgage credit.

The government's role in the housing finance system must be explicit and transparent. Premiums to cover the government's risk and any subsidies should be on-budget.

The government's outsized role in housing finance should shrink as private capital returns to the market. Our proposal envisions a housing finance system in which private market participants with their own capital at risk take primary responsibility for allocating capital between housing and other activities. Our proposal features an open system that allows entry and innovation in origination, securitization and insurance consistent with a level regulatory playing field. The housing finance system under our proposal would have room for financial institutions of all sizes.

A pragmatic housing finance system that achieves these goals includes three types of private firms: mortgage originators and servicers, who make loans and collect payments from homeowners; issuers of mortgage-backed securities, who use a new common government-run securitization platform; and MBS insurers, who bear credit risk for mortgage securities and arrange for this risk to be shared with other private investors. The government plays three roles in the system: establishing the securitization platform, insuring against catastrophic failure of the housing and mortgage markets,

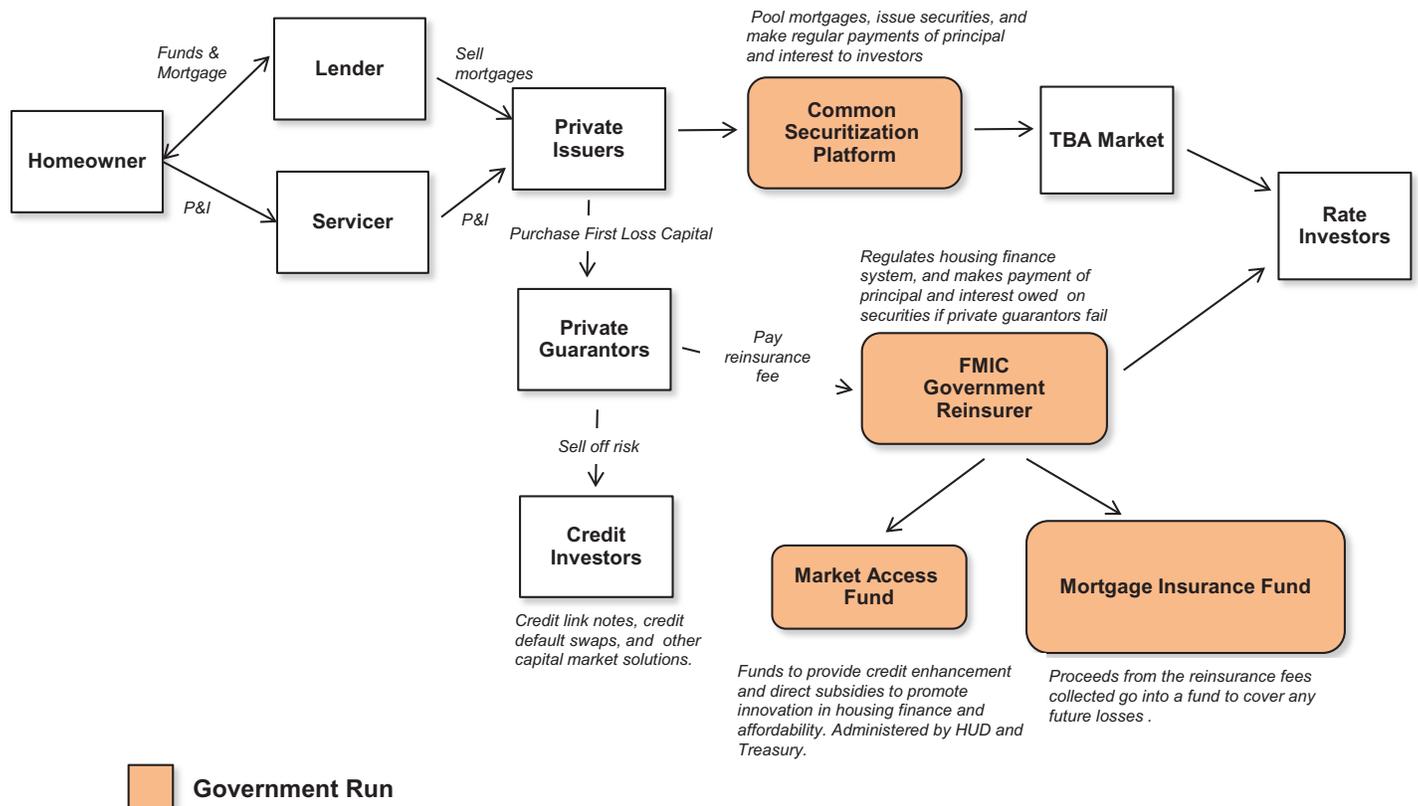
and regulating the housing finance system (see Chart 1).

Mortgage originators and servicers and MBS issuers exist in the current housing finance system, although the stress of the housing collapse significantly realigned and consolidated these participants. MBS insurers would be private, monoline firms, backed neither explicitly nor implicitly by the federal government. MBS insurers would be subject to federal regulation, much as insured depository institutions are today. MBS insurers would purchase secondary (catastrophic) insurance from the government for a guarantee fee (g-fee). The government backstop would ensure that MBS investors are paid when MBS insurers are insolvent, but the MBS insurers themselves could fail. A key role of the housing finance regulator would be to make sure there is adequate capital at risk ahead of the government guarantee.

The federal government would play an important role in the future housing finance system through a government-run mortgage securitization facility. This would leverage current efforts by the Federal Housing Finance Agency to develop a single securitization platform for Fannie Mae and Freddie Mac securities. The securitization facility would be used for all non-Ginnie Mae government-guaranteed securities and, although not required, could be used for nonguaranteed securities. A common securitization facility would result in greater standardization, benefit from significant economies of scale, and provide a more liquid market for MBS, to the benefit of both investors and homeowners. A common security platform would likewise make it easier to modify loans if needed during future housing downturns, and allow for a "to-be-announced" trading market that remains liquid and makes it easier for originators to offer rate-lock commitments. Loans that use the securitization facility would be covered

Chart 1

Future Mortgage Finance System



by a uniform servicing standard, encouraging prudent underwriting and aligning investor and borrower interests.

The system would have a new, independent federal government overseer called the Federal Mortgage Insurance Corporation (FMIC)—a name chosen intentionally to mimic the Federal Deposit Insurance Corporation. The current FHFA would be folded into the FMIC, but this new regulator would have considerably broader responsibilities, notably including oversight of MBS insurers and the securitization platform. The FMIC would determine which securities are eligible for the government guarantee, set standards for mortgages included in such securities, and determine capital, liquidity and other prudential requirements for MBS insurers. The regulator would ensure that appropri-

ate private capital was at risk ahead of the government guarantee.

The FMIC would establish an insurance fund to cover losses on guaranteed MBS. While the new system was being put in place, this Mortgage Insurance Fund (MIF) would be built up using a portion of the g-fees charged by Fannie Mae and Freddie Mac. Once established, the fund would be maintained with g-fees paid by MBS insurers. The FMIC would adjust g-fees to strengthen the fund if needed to cover future losses.

The FMIC would coordinate with bank regulators, the Securities and Exchange Commission, and the Consumer Financial Protection Bureau to reconcile the new housing finance system with emerging regulations governing the private mortgage securities

market and mortgage-related activities of depository institutions and others.

A transition from the current housing finance system to the new system would take years and raise many issues. A balance would have to be struck between meeting the needs of creditworthy borrowers and ensuring adequate reserves for the next period of financial and economic stress. The transition would involve establishing a common platform to issue mortgage securities; trials of new mechanisms to attract private capital to take a first-loss position; separating the securitization and insurance functions now both performed by Fannie and Freddie, so that the noncatastrophic insurance function is transferred to well-capitalized private institutions; creating and pricing government catastrophic reinsurance to stand behind privately capi-

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talized insurers; and setting up a regulatory authority to establish parameters for MBS eligible for the government backstop.

Fannie Mae and Freddie Mac would not be part of the future housing finance system. Their investment portfolios would be wound down, their securitization activities spun out into the new platform, and their guarantee functions sold to privately funded MBS insurers. Any remaining assets would be sold. Taxpayers would be repaid (to the extent possible) for their past support of Fannie and Freddie.

The effort would be massive, but it is vitally necessary to meet America's housing needs, to protect taxpayers against a repeat of the costly Fannie and Freddie bailout, and to ensure that housing again helps sustain economic growth and job creation.

Those who seek to limit government's hand in the market will find that our plan allows private capital to return and play the dominant role in the new system. Indeed, in the transition away from the conservatorship of Fannie and Freddie, the government will step back as private capital comes into the first-loss position. This process will test the extent to which private investors can

provide a full range of mortgage products under disparate economic conditions. Bringing more private capital into the housing finance system would also test whether such a system can sustainably expand access to well-designed mortgage loans beyond those offered under the current system.

At the same time, those who seek to increase opportunity for creditworthy borrowers will find in our plan a sustainable mechanism for doing so. With so many communities devastated by the foreclosure crisis and so many family balance sheets impaired by the dislocation of the last five years, private markets alone may prove reluctant to serve all those able to manage prudent mortgages made on sustainable terms. Pendulums tend to swing too far, and credit has arguably grown too tight. Our plan provides transparent on-budget mechanisms and funding to support access to affordable housing, for both owners and renters.

The proposal in this paper would help bridge the ideological divide that stymies reform, leaves a crippled housing finance system in limbo, and exposes taxpayers to huge losses should there be another

housing downturn. If policymakers can embrace the core tenets of this proposal, most of the technical details can be determined by administrative and regulatory authorities within broad parameters set by policymakers.

Decisions made about the future of the mortgage finance system will affect U.S. homeowners and the broader economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy. In this area, inaction also represents a decision, since leaving Fannie Mae and Freddie Mac in conservatorship means the effective nationalization of the U.S. housing finance system. Such a course would penalize American families looking to buy homes and leave taxpayers exposed to excessive housing risk. Housing finance reform is a vital priority for public policy. As we discuss in this paper, it is a policy area in which common ground can be found. It is time to begin this reform.

What Kind of Housing Finance System?

Nearly five years after the government put Fannie Mae and Freddie Mac into conservatorship, nine of every 10 new mortgage loans are still backed by the federal government, either through those two entities or through Ginnie Mae, which relies on mortgage insurance from other government agencies—the Federal Housing Administration, Veterans Affairs, and the Department of Agriculture's Rural Housing Services Administration. Most of the remaining new loans are held on the balance sheets of the nation's largest depository institutions. (Throughout this paper, for convenience we will use FHA to refer to loan-level insurance provided by FHA, VA or USDA on loans bundled into securities guaranteed by Ginnie Mae.)

With Fannie and Freddie operating in conservatorship, the federal government is taking on credit risk for the securities these firms issue—currently three-fourths of all new mortgage securities—and thus assumes more risk than is desirable or necessary for a well-functioning housing market (see Chart 2). Although taxpayer risk is inherent in the FHA's mission to broaden access to mortgage financing, the FHA's current role insur-

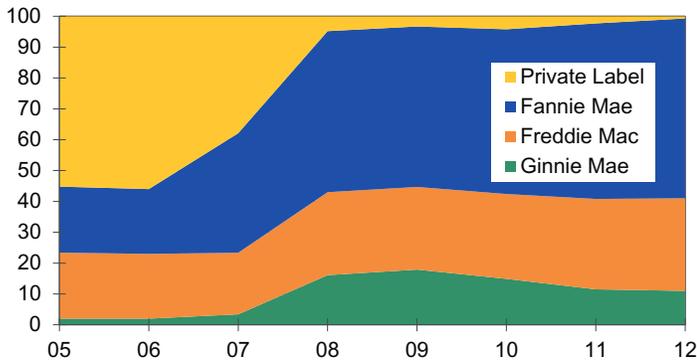
ing the other one-fourth of mortgage securities puts a notable strain on an agency not well equipped to manage risk on this scale.

The government assumed this outside role in the mortgage market when the collapse of the housing bubble caused investors to lose confidence in privately backed mortgage securities, and led originators to sharply reduce lending. Though rapid change in the housing finance system would disrupt the

mortgage market and harm the economy, the status quo leaves taxpayers at considerable risk, and mutes private incentives for efficient capital allocation. At the same time, under the current system, many potential homeowners with moderate incomes or imperfect credit records are left without access to financing, or find FHA-backed loans their only option. As confidence is restored, the government's role must shrink, and a

Chart 2
Government Lending Still Dominates

% of \$ mortgage-backed securities issued



Sources: HUD, Fannie Mae, Freddie Mac, Moody's Analytics

wider range of prudent lending options must be available.

Many ideas have been advanced to reform housing finance. At one end of the spectrum are proposals to largely nationalize the system. Fannie's and Freddie's functions would be taken over by the government, and along with the FHA the two entities would continue to guarantee most of the nation's mortgage loans. This system differs little from the status quo.

At the other end are proposals to fully privatize the system. Fannie and Freddie would be disassembled and sold to private investors. Although the FHA would continue to insure some loans, its scope would be strictly limited, leaving the agency with only a small share of the mortgage market. Under a privatized system, most loans would be provided by private lenders and funded by investors without explicit backing from the government.

Nationalization and privatization each have advantages, but also serious disadvantages. Nationalization would place the government behind virtually all mortgages, exposing taxpayers to far more risk than necessary for a liquid and efficient market. A nationalized system would also likely stifle innovation, ultimately reducing mortgage choices.

On the other hand, privatization likely would reduce access to mortgage credit, leaving many homeowners unable to obtain the fixed-rate mortgage loans favored by

American families. Worse, privatization would leave taxpayers on the hook even if the system had no explicit government guarantee. Recent experience strengthens our conviction that policymakers would feel obligated to stabilize the housing finance market during times of turmoil. Moreover, without an upfront acknowl-

edgement of government's limited guarantee, taxpayers would not be compensated for the risk they inevitably would bear. In other words, a notionally private system unintentionally would recreate the implicit guarantee of the housing finance system that existed before the recent housing collapse, when taxpayers took on risk without compensation through Fannie Mae and Freddie Mac.

A middle ground exists between nationalization and privatization. A hybrid housing finance system would combine a secondary federal backstop with private capital in a first-loss position ahead of the government guarantee. A hybrid system could take many forms, but the most attractive would retain several roles for the federal government. These include insuring the system against catastrophe, standardizing securitization, regulating the system for safety and soundness, protecting consumers and investors, ensuring nondiscrimination, and providing explicit subsidies and aids to access that policymakers deem appropriate.

Private market participants would provide the bulk of the system's capital and would originate and own the underlying mortgages and securities. The government would insure mortgage securities only for catastrophic losses that exhausted private capital. The government would collect insurance premiums and hold them in reserve to cover losses, much as the FDIC insures bank deposits. Catastrophic insurance would keep mortgage credit available during times when markets

are strained, while the substantial private capital at risk would protect taxpayers and encourage prudent behavior by investors.

A hybrid system would foster the return of mortgage securitization without government guarantees, so that private label MBS would co-exist along with guaranteed MBS. As more private capital was required to be at risk in front of the government guarantee, non-guaranteed securitization would become a larger part of the housing finance market than is the case today, including some securities eligible for the guarantee that choose to go without government backing. A system with both guaranteed and non-guaranteed mortgage securities would provide a diverse source of funding, with competition creating incentives for innovation. In times of stress when private capital hesitates to take on risk, the government could reduce the levels of required first-loss private capital if needed to ensure the availability of liquidity for mortgage lending.

Under a hybrid system, desirable mortgage products would be available to qualified homeowners in all market conditions. The stabilizing impact of a government guarantee was demonstrated during the recent financial crisis, when federal support for Fannie Mae and Freddie Mac kept conforming mortgages available even as other credit markets experienced severe strains and private-label mortgage securitization all but vanished. The government guarantee would ensure that homeowners could obtain long-term, fixed-rate mortgage products that might otherwise not be widely available, while strict regulation including requirements for considerable private capital would help curb the housing market's worst bubble-bust tendencies.

At the same time, a hybrid system would address the salient failing of conservatorship, in which an absence of private capital leaves taxpayers exposed to potentially vast losses should there be a new housing downturn. A system in which there was a meaningful share of nonguaranteed mortgages would further remedy the current problem of potential homebuyers who do not qualify for conforming or government-insured mortgages, even as private investors are reluctant

to offer them loans outside the government-guaranteed framework.

The new system would require regulatory oversight to ensure that government-backed loans were of high quality, that appropriate premiums were charged for the government's catastrophic insurance, and that adequate amounts of high-quality private capital stood ahead of the government in case of loss. With these protections for taxpayers, mortgage rates would be higher than they were before the housing crisis (that is, spreads over risk-

free Treasury securities would be higher), but only because the previous system was undercapitalized (see Sidebar: *Mortgage Rates in Nationalized, Privatized, and Hybrid Systems*).

As with any government guarantee, it will be difficult to set a level for the insurance premium that adequately compensates taxpayers for the risk of backstopping the system. However, even if one takes the view that the government inevitably charges too little for its insurance, any price would be more appropriate than implicit insur-

ance given for free in a system that remains private only until the next crisis. A hybrid system would include a new guarantee on mortgage-backed securities. But these securities are already guaranteed through the conservatorship of Fannie Mae and Freddie Mac. Under our proposed hybrid system, the government guarantee on MBS would be paid for, and taxpayer exposure to risk reduced by placing an increasing amount of private capital at risk first. That is, we would formalize the government guarantee in order to shrink it.

Mortgage Rates in Nationalized, Privatized and Hybrid Systems

Mortgage rates will be higher in the future than they were prior to the housing crash, as the pre-crash housing finance system was clearly undercapitalized. How much higher mortgage rates will ultimately be depends on the structure of the future housing finance system.

Prior to the housing crash, Fannie and Freddie charged a 20 basis point guarantee fee to compensate for the mortgage losses that were expected to result from a 10 percent decline in house prices. However, this was insufficient to withstand the Great Recession, in which house prices fell by closer to 25 percent. Fannie and Freddie had insufficient capital and were put into conservatorship, ultimately needing taxpayer aid close to \$200 billion.

If Fannie and Freddie were nationalized and required to charge a g-fee sufficient to withstand losses consistent with a 25 percent decline in house prices, they would need to charge more than 40 basis points to serve even the homeowners they serve today—those with 30-year fixed-rate mortgages with an 80 percent loan-to-value ratio and 750 FICO scores (see Table 1). This is more than double what Fannie and Freddie charged before the crisis, but less than the 50 basis points the GSEs currently charge. (It is assumed that the government requires a risk free return of 4 percent on the capital it provides to the mortgage finance system.)

In a fully privatized system, mortgage rates would be almost 100 basis points higher than in a nationalized system, assuming the system requires enough capital to withstand mortgage losses consistent with a 25 percent decline in house prices.

This assessment depends on three important assumptions. First, it assumes that financial institutions providing capital to a privatized mortgage system will require a 30 percent return on equity. This is greater than the 15 percent ROE that the private mortgage insurance industry (PMI) has typically obtained during times of normal market conditions with a government backstop, but less than the 30 percent-plus return that unsecured credit card issuers have traditionally sought. Investors providing capital

to a fully privatized system will need a higher return to compensate for greater risks when the government does not have their proverbial backs. Even if the ROE required by financial institutions in a privatized system were 15 percent – the same as the PMI industry in normal times – then privatized mortgage rates would be 75 basis points higher than in a nationalized system.

A second assumption is that investors in a privatized market would assess a liquidity risk premium of 10 basis points. A private system will likely feature a greater variety of securities than would a nationalized system, resulting in a smaller, shallower market. The benefit of a deeper market is evident in the interest-rate spread between jumbo and agency-backed mortgage securities, which has ranged from 10 to 30 basis points in normal periods. In times of stress, the spread has been much greater. If a private securities market were to gain traction and displace the current agency market with standardized securities, this liquidity premium would presumably decline, but even under the best of circumstances, it would not disappear.

A third assumption is that investors in a privatized market would require a financial market risk premium of 25 basis points. Investors will want some compensation for the additional risks of investing without a government backstop. Just how much compensation is difficult to determine, but it is instructive that the TED spread—the difference between three-month Libor and Treasury bill yields—surged from 25 basis points just prior to the financial crisis to a peak of almost 400 basis points at the height of the financial panic, when investors were seriously questioning whether the government would support the financial system. After the TARP and other government interventions, the TED spread came full circle, reflecting the widespread belief that the government would not allow major financial institutions to fail.

Mortgage rates in a hybrid system would be approximately 10 basis points higher than in a nationalized system but nearly

Mortgage Rates in Nationalized, Privatized and Hybrid Systems (Cont.)

90 basis points lower than in a privatized system. This assumes that private financial institutions in the hybrid system require a 15 percent return on equity, are required to hold capital consistent with a 25 percent decline in house prices, and that the government picks up mortgage losses only after all private capital is exhausted. (Mortgage rates are not especially sensitive to the assumption regarding the required ROE of private financial institutions in a hybrid system. A system with more capital will be safer,

which should lead investors to demand a lower yield on capital.) At this level of capitalization, mortgage rates would be just over 30 basis points higher than they were prior to the financial crisis, when the mortgage finance system was capitalized to withstand only a 10 percent decline in house prices.

Under almost any assumptions, mortgage rates in a hybrid versus privatized system are lower by a large enough amount to have a meaningful impact on the housing market and homeownership.

Table 1: Guarantee Fees In a Hybrid System Under Different House Price Assumptions

Basis Points

Stressed Peak-to-Trough House Price Decline	Hybrid			Difference Between:			
	Private	Government	Total	Privatized	Nationalized	Hybrid-Nationalized	Hybrid-Privatized
-10	19	0	19	57	13	6	-38
-20	37	7	44	108	31	13	-64
-25	36	15	51	137	41	10	-87
-30	35	22	58	166	51	6	-109
-40	35	34	69	208	68	2	-139

Key Assumptions:

In the Hybrid system, private capital requires a 15% ROE and government receives a 4% return

In the Privatized system, private capital requires a 30% ROE and government receives a 4% return, and there is a 10 basis point liquidity risk premium and a 25 bp financial market risk premium

Source: Moody's Analytics

Goals of Pragmatic Housing Finance Reform

The housing finance system proposed in this paper aims to make the government's role in housing explicit and limited, but effective in achieving public policy goals. The goals include:

Stability. The future housing finance system must be resilient to crises. Financial market panics and the failure of private financial institutions should not cut off the flow of mortgage loans. Households and investors must be confident that they can finance and refinance properties, and buy and sell securities under a range of economic conditions.

Liquidity. The system must be sufficiently deep, standardized and transparent to attract a wide range of global investors and to operate efficiently. The system must be able to provide desirable mortgage products such as long-term, fixed-rate loans to creditworthy borrowers under all market conditions.

Access and equity. The system must allow all creditworthy borrowers a chance to obtain mortgage loans they can repay under normal life circumstances. Entities operating in the secondary market must serve all

qualified mortgage applicants without regard to race, color, national origin, religion, sex, familial status, or disability, and must enable the primary market to meet its obligations under the Community Reinvestment Act and related statutes.

Support for affordable housing. The system must provide support to expand access to affordable mortgage financing and for affordable rental housing, explicitly and on-budget, either via credit subsidy or direct support. Our proposal includes a stable revenue source for these activities. We view the strengthening of these activities as an essential element of reform.

Taxpayer protection. The government's role in the housing system must be explicit and transparent, with private capital at risk ahead of taxpayers. Government acceptance of risk without private first-loss capital should be limited to times of crisis

when other policy measures such as by the Federal Reserve are not sufficient to support the housing market and the broad economy. Premiums to cover the government's risk should be on-budget, and subsidies to ensure the system meets other public purposes should be funded from dedicated fees on the system. The current outsized government role should recede as private capital returns to the system.

Private incentives, competition and innovation. Private market participants with their own capital at risk should be primarily responsible for allocating resources between housing and other activities. An open housing finance system would allow entry and innovation by new participants, both in securitization and in origination, consistent with a level regulatory playing field. The system must be open on an equitable basis to financial institutions of all sizes.

How Would a Pragmatic Housing Finance System Work?

A pragmatic housing finance system would include three types of private firms: mortgage originators and servicers, issuers of mortgage-backed securities, and mortgage and MBS insurers who would bear mortgage credit risk. The government would play three roles: establishing the securitization platform on which guaranteed MBS (other than Ginnie Mae securities) would trade and nonguaranteed MBS could trade, providing a catastrophic guarantee to MBS insurers for a guarantee fee, and regulating the housing finance system.

Mortgage Originators

Various private financial institutions make mortgage loans, either holding them on balance sheets or selling them to other lenders and MBS issuers. Originators and servicers can include both depositories and other financial institutions. This part of the housing finance system has experienced significant restructuring, consolidation and regulatory change in the wake of the housing bust. Mortgage originators and servicers may also be MBS issuers.

MBS Issuers

MBS issuers create and issue mortgage-backed securities, which may or may not qualify for the government guarantee, and sell them to global investors. Guaranteed MBS would have first-loss credit insurance purchased by the MBS issuer from a privately capitalized, federally regulated MBS insurer. This would ensure that private capital takes risk ahead of the government. MBS insurers may also sell some of this risk to other private investors through a variety of mechanisms.

Guaranteed MBS would be sold via a common government-run securitization platform, on which nonguaranteed MBS could also be sold, at the issuer's option, although any securities sold via the platform would have to abide by a standard pooling and servicing agreement. In addition, MBS that qualify for the government guarantee may be issued without the guarantee; an MBS issuer might prefer to provide its own guarantee and avoid the fee for the government backstop.

MBS issuers may or may not have originated the loans in their securities, and may or may not hold servicing rights to those mortgages. MBS issuers will be required to

purchase mortgage loans from all qualified originators, including small depository and other financial institutions, on equal terms. Small depository and other financial institutions that originate mortgage loans may decide to become or form MBS issuers in order to gain efficient access to MBS insurers and the government guarantee. The combination of competition among mortgage insurers for the business of smaller lenders and regulatory oversight would ensure that the housing finance system is open to market participants of all sizes, including community banks and credit unions.

MBS Insurers

MBS insurers would be monoline private firms not backed, either explicitly or implicitly, by the federal government. MBS insurers would be federally regulated by a new housing finance regulator—the Federal Mortgage Insurance Corporation.

MBS insurers would purchase catastrophic reinsurance from the government for the benefit of MBS investors, with the MBS insurers paying a g-fee to the government for this insurance. The government's backstop would cover only guaranteed MBS; the MBS insurers themselves would in no way be supported by the government and could fail.

A number of different sources of private capital would thus bear the bulk of the credit risk in housing, taking losses ahead of the government and protecting taxpayers. These sources of capital would be completely extinguished before the government paid a claim against an insured MBS. At the level of individual mortgages, private capital sources would include homeowners' down payments and the capital of any private mortgage insurers attached to the loan. At the level of the mortgage-backed security,

capital sources would include, but not be limited to, the capital of the MBS issuer, if any risk retention is required; the capital of the MBS insurer; and the capital put at risk by global investors who take on housing risk from MBS insurers. This risk transfer could take place in a variety of ways, including through non-guaranteed tranches of guaranteed MBS (tranches of securities that would explicitly not be guaranteed by MBS issuers, MBS insurers, or the government) and credit default swaps (see Sidebar: *An Example of Risk-Sharing: Using Credit Default Swaps*). There could also be other models under which private market participants took on housing risk ahead of the government. The FMIC would be tasked with ensuring that appropriate private capital is in place ahead of the government guarantee.

MBS insurers would not be permitted to hold portfolios of mortgages or mortgage securities for investment. Small portfolios would be permitted for specific purposes such as pulling loans out of securities for loan modification and warehousing restructured loans before resecuritization, and for other loss mitigation and REO disposition purposes. The future mortgage finance system should have five to 10 MBS insurers. Five MBS insurers would ensure that the system is competitive and free from too-big-to-fail risk. Competition among MBS insurers would reduce interest rates on MBS and thus mortgage interest rates paid by homeowners. More than 10 MBS insurers could result in prohibitively high transaction costs. This is important for smaller MBS issuers grappling with the complexity of dealing with many MBS insurers and their different contracts, data exchange processes, and accounting and underwriting systems. MBS insurers would replace Fannie and Freddie, although

An Example of Risk-Sharing: Using Credit Default Swaps

There are numerous ways MBS insurers can share mortgage credit risk with global capital markets. One illustrative example of a risk-sharing mechanism is to use a financial instrument known as a credit default swap or CDS. Use of a CDS would allow an MBS insurer to lay off some credit risk to other private investors.

Under a CDS, a private investor would sell an insurance contract to the MBS insurer on a particular portfolio of mortgages (see Chart 3). The MBS insurer would pay a premium to the investor every month, for example 0.05 percent of the outstanding balance. If borrowers pay their mortgages as expected with a default rate below a prescribed threshold or deductible—say 2 percent—then the private investor would keep the charged premiums without any additional transfer of funds. These premiums would be the investor's return (positive, in this instance) for taking on housing credit risk. If instead many borrowers default on their mortgages and the losses on the insured portfolio exceeded the threshold, then the investor would be required to make a payment to the MBS insurer to cover the additional losses up to some maximum level—say 5 percent. The MBS insurer would then be responsible for any loss incurred above and beyond this upper bound. In this latter circumstance with mortgage defaults, the private investors receives a negative return because the investor is required to make good on the insurance contract.

The CDS arrangement described above is not new. Investors have purchased CDSs on sovereign and corporate bonds since the early 1990s. They were also issued in the private label MBS market during the early 2000s and did provide investors in these securities with a level of protection for a number of years.

However, the rapid plunge in house prices exposed serious flaws in this system that were hidden while house prices were rising and losses on mortgage portfolios were low. The most obvious structural flaw stems from the fact that buyers and sellers of CDSs had different incentives leading to moral hazard. Mortgage originators, for example, reduced their efforts to enforce underwriting standards given that another party was accountable in case a loan defaulted.

Counterparty risk was an even larger issue. Buyers of loss protection did so under the belief that the party

providing the coverage would actually have the funds available to pay claims. Some due diligence was done, but without a central clearinghouse it was impossible for investors to verify the solvency of their counterparties during times of stress. Even a large, highly diversified company such as AIG looked like a rock-solid counterparty in the early 2000s. However, it was wholly unprepared to pay out claims simultaneously on all of the insurance it had underwritten on MBS once losses started to pile up in 2008.

For all of the pain it caused, the Great Recession has identified the operational and legal issues associated with CDSs. Steps have been taken to address them, though few would agree that the system has been fully corrected. Additional rules and requirements still need to be developed to minimize risks, especially for more complex transactions and institutions. These will take more time for lawmakers and regulators to fully specify and codify into law.

In the interim, however, now would be an ideal time to test the market appetite for simple CDS structures. New mortgage originations are of exceptionally high quality and have predictable performance. Counterparty balance sheets have also been cleansed, making it much easier for the GSEs and regulators to monitor the ability of market participants to take on housing credit risk. By starting to purchase coverage on small portions of their portfolios, MBS insurers could build out the infrastructure needed to efficiently transact CDS. Once the system is in place, it could be scaled up and enhanced to provide additional liquidity and transparency to an otherwise opaque market.

Chart 3
Simplified Credit Default Swap Mechanics

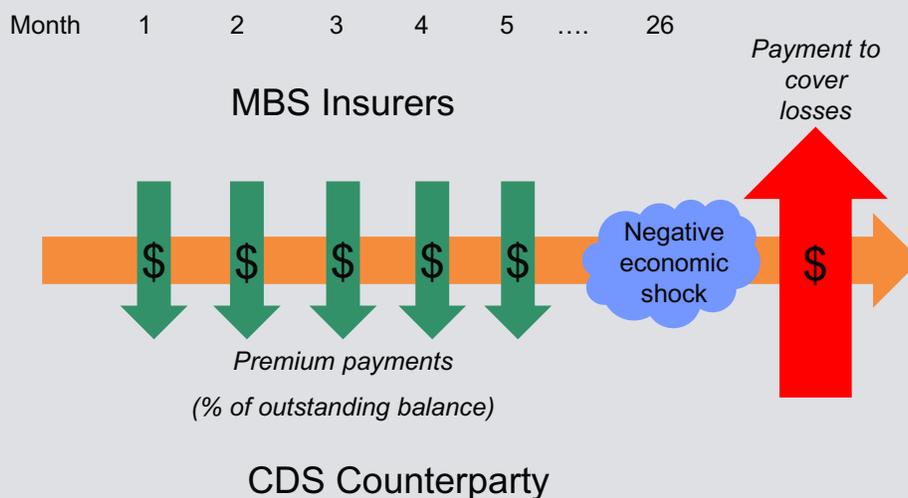
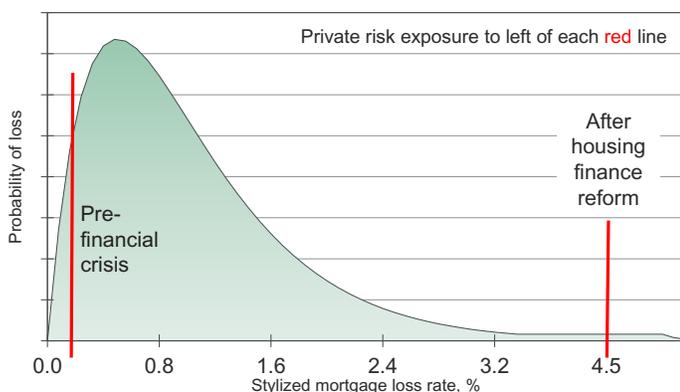


Chart 4
Where is the Government's Attachment Point?



Source: Moody's Analytics

some of the two government-sponsored enterprises' assets would be sold to private investors and could form the basis for MBS insurers. (Other GSE assets such as the common securitization platform the two firms are developing would likely stay with the government).

The organization and governance of MBS insurers would be determined by the private investors who establish them. To promote the entry of new sources of private capital into the housing finance system, MBS insurers would not be permitted to affiliate with depository institutions, with the exception that the FMIC would permit the formation of one MBS insurer by a consortium of community banks in order to ensure their access to the housing finance system. Judging by the equity recently raised by the private mortgage insurance industry, potential investors in MBS insurers include mutual funds and wealth management firms. However, if the FMIC found that insufficient private capital was available to ensure adequate competition among MBS insurers, the regulator would have the authority to allow depository institutions to affiliate with MBS insurers.

The FMIC would set capital and liquidity requirements and other standards for MBS insurers. The regulator would establish the amount of private capital required in front of the government's catastrophic guarantee and determine what sources of private capital were appropriate, and whether the private institutions holding credit risk were capable of meeting their obligations under

to set g-fees adequate to allow the fund to withstand a severe housing and economic downturn similar to that of the Great Recession. Regular stress-testing and other risk management techniques would be used to set the g-fees, whose level would depend on the amount and structure of the first-loss private capital available. The greater the amount of first-loss private capital and the higher its quality, the lower the necessary g-fees. Along the lines of the FDIC, the FMIC would be required to increase g-fees if the MIF, after expected claims, is projected to fall below a minimum level. The FMIC set g-fees to keep the MIF solvent.

Finding the right level for the g-fee will be difficult, but as housing finance reform progresses the FMIC can use various techniques to better price the guarantee. For example, it is conceivable that in the future the government would not guarantee all MBS that qualify for its backstop, enabling the FMIC to use an auction mechanism to inform the price of government insurance.

In a future financial crisis, the Treasury secretary and the chairman of the Federal Reserve could decide, after consultation with the president, to give the FMIC authority to adjust the extent of risk-sharing between the federal government and MBS insurers (the attachment point) to ensure the liquidity of the MBS market and the availability of mortgage credit (see Chart 4). Policymakers would thus have a mechanism to reduce the amount of private capital required ahead of the government guarantee, providing increased support for

stressed housing and economic scenarios. The FMIC would also ensure that MBS insurers made insurance available to all MBS issuers on an equitable basis.

Guarantee fees would be held in a reserve fund—the Mortgage Insurance Fund—similar to the FDIC's Deposit Insurance Fund. The FMIC would be instructed

housing and the overall economy. This process mimics the systemic risk exception for the FDIC, and is meant to be used in similar circumstances. It would not be used for normal countercyclical macroeconomic adjustments, which would remain the responsibility of the Federal Reserve.

Securitization Facility

A single government-run mortgage securitization facility would be used for all government-guaranteed securities and, although not required, could also be used for nonguaranteed securities. A common securitization facility would produce greater standardization and a more liquid market, make loan modification efforts easier in future downturns, and give MBS issuers operating flexibility at a low cost. It would also allow for a robust "to-be-announced" trading market. The securitization facility would be overseen by the FMIC.

The securitization facility would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities. For a fee, the securitization facility would provide a range of services, including:

- » Mortgage loan note tracking.
- » Master servicing, which involves asset and cash management; standardized interfaces to servicers, guarantors and aggregators; servicing metrics; data validation; and reporting.
- » Data collection, validation, and dissemination of loan-, pool- and bond-level data to improve integrity, transparency and efficiency in the securitization market.
- » Bond administration, including standardized investor and third-party disclosures, bond processing, principal and interest distributions, securities monitoring, portfolio reporting, and trustee services.

Mortgage loans included in securities that use the common securitization facility (including all mortgages that benefit from the government guarantee plus some nonguaranteed loans) would be covered by a uniform pooling and servicing agreement and uniform servicing standards that encourage prudent underwriting and align investor and borrower interests. This would encourage the adoption of similar standards for other mortgages.

A Pragmatic Plan for Housing Finance Reform

The securitization platform would permit the creation of multilender securities that would have access to the government guarantee. A multilender securities program would allow many originators to sell their mortgages into one security. In return for the mortgages the originators receive a pro rata share of the security (based on loan balances). The pooling requirements are largely the same as for the typical single originator securities. These securities are good for delivery into the TBA market. As a result, originators can easily convert the securities to cash even before the security is formed. This would be particularly important to community banks and other smaller mortgage originators (see Sidebar: *Preserving Community Bank Access Through a Multilender Securitization Program*).

Federal Mortgage Insurance Corporation

This new, independent government agency, similar to the FDIC, would oversee the housing finance system and cover losses on guaranteed MBS. The current FHFA would be folded into the FMIC, but the new regulator would have considerably broader

responsibilities, overseeing the government-run securitization platform and MBS insurers. The regulator would coordinate with other government agencies that oversee financial firms with housing-related businesses, including bank regulators, the Consumer Financial Protection Bureau, and the Securities and Exchange Commission.

The FMIC would oversee the Mortgage Insurance Fund. While the new housing finance system is being put into place, the MIF would be built up using a portion of the guarantee fees charged by Fannie Mae and Freddie Mac. Once established, the MIF would be maintained by guarantee fees charged to MBS insurers for the catastrophic government reinsurance.

Just as the FDIC funds itself with a levy on the deposit insurance fund, the FMIC would cover its expenses through a levy on the MIF. To encourage administrative efficiency, the FMIC would be required to publicly disclose the impact of its expenses on mortgage interest rates.

More explicitly, the FMIC would:

- » Set standards for single- and multifamily loans in government-guaranteed MBS

to ensure strong underlying mortgage loan quality. It would be important that loans underlying MBS that receive the government guarantee be considered qualified mortgages and qualified residential mortgages.

- » Set standards for and supervise servicers of guaranteed mortgages, in coordination with other regulators. Servicers of MBS that are not guaranteed and not part of MBS traded on the government platform would not be required to follow the same uniform servicing agreement, but would be subject to federal oversight by the CFPB and other regulators.
- » Ensure that sufficient high-quality private capital is at risk before the government guarantee. The FMIC would approve mechanisms by which private capital would be brought in ahead of the government guarantee, and would set standards and supervise MBS insurers that provide capital to the housing finance system.
- » In coordination with other regulators, in particular the SEC, regulate MBS in both guaranteed and nonguaran-

Preserving Community Bank Access Through a Multilender Securitization Program

In the current housing finance system, community banks often sell their conventional loans to Fannie Mae and Freddie Mac either through a cash window where they receive cash in exchange for their mortgages or through a multilender program where they receive a pro rata share of a MBS. To generate the cash for the cash window the GSEs either issue debt (historically the Fannie Mae program) or issue securities backed by multiple small originators (historically the Freddie Mac program).

Both GSEs also run a multilender program that provides community banks with a share of a larger MBS backed by multiple lenders rather than cash. The community bank often will then sell the MBS through a dealer. In effect the cash window and the multilender program allow smaller banks access to the capital markets and turn loans into cash even if they only have a few loans to sell each month.

Ginnie Mae also runs a multilender program known as GNMA II. It has recently put out for comment a proposal to move the

market exclusively to this program in order to increase liquidity and hence lower mortgage rates.

In the future housing finance system it is important to preserve the direct access of small lenders to the capital markets. Moreover, given that in the housing finance system proposed in this paper the MBS issuers are separated from the MBS insurers, and the insurers are unlikely to have continuous access to the debt markets needed to support a cash window, care will need to be taken to preserve a multilender securities program.

A multilender platform has an additional benefit beyond ensuring that small institutions are not disadvantaged. Multilender securities promote competition and tend to be more liquid and trade better in the capital markets. It often is advantageous for large institutions to avail themselves of a multilender program rather than issuing a security under their own name. As part of standardizing pooling and promoting liquidity, the FMIC may even want to encourage the use of a multilender program by all market participants.

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teed portions of the market, focusing on transparency—including timely loan-level performance disclosure—as well as conflicts of interest and dealing with defaulted loans in a manner that aligns the interests of investors and borrowers.

- » Determine securitization requirements and oversee the single securitization platform. The regulator would ensure that a

“to-be-announced” market continues for guaranteed mortgages, coordinating with the SEC as needed.

- » Address issues of document custody, including reform of the Mortgage Electronic Registration System.
- » Supervise the unwinding of Fannie Mae's and Freddie Mac's existing portfolios and the two entities' ultimate sale or privatization.

Other regulators would be involved as well—the CFPB in consumer protection and the Federal Reserve, FDIC, OCC, NCUA and state regulators in safety and soundness for mortgage originators, servicers and MBS issuers. Federal and state regulators would be encouraged to collaborate on housing finance issues even if their regulatory jurisdiction covers only part of the system.

Ensuring Equitable Access and Affordability in a Pragmatic System

Housing finance reform must promote access to affordable owner-occupied and rental housing. The long-term, fixed-rate, fully amortizing mortgage has served borrowers well at many income levels and appears to be desired by most U.S. homeowners. At the same time, the destruction of homeowners' equity in the Great Recession and changing demographics suggest there is value in responsible experimentation and flexibility in future housing finance arrangements (see Chart 5).

This experimentation might prove challenging for the private housing finance system, in part because good ideas take time to prove, but once proven are easily replicated. Limited and potentially temporary forms of credit enhancement (for example, soft second mortgages at below-market rates, or loss reserves for a pool of loans testing alternative underwriting strategies to determine ability to repay) can enable the unsubsidized market to serve many more families capable of becoming and remaining homeowners.

Innovation is also needed to maintain a supply of unsubsidized affordable rental housing in small properties, those with up to fifty units. Such housing accounts for the bulk of unsubsidized rental units and a high percentage of all affordable units, but often needs refinancing, renovation and repair, yet has little access to capital. After market contractions, private credit providers tend to leave behind good credit risks. The inability of creditworthy borrowers to access credit exacerbates income and wealth disparities and impairs economic development in many communities.

The statutory program definitions under which the FHA and VA operate make innovation extremely difficult. To address these concerns, we would establish a Market Access Fund to provide explicit credit enhancement and direct subsidies. With the former GSE housing goals abolished, affordable housing activities would be supported instead by the MAF through a transparent mechanism and with dedicated funding.

The MAF would be financed by a 6 basis point assessment on all MBS, both guaranteed and nonguaranteed. Charging the fee on both guaranteed and nonguaranteed

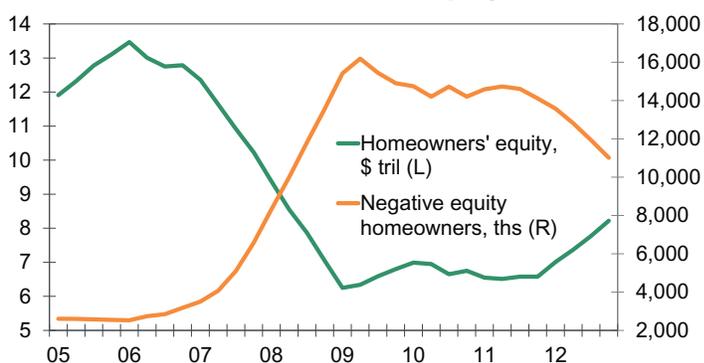
MBS eliminates the fee as a source of market bias while providing a stable and consistent source of funding for the MAF. The six basis point assessment is the same as Ginnie Mae's current servicing fee and would ultimately generate at least \$5 billion in annual revenue in

today's dollars. While a considerable new expenditure, this is much smaller than the \$100 billion annual cost of the mortgage interest deduction whose benefits largely go to higher-income families. It would take approximately 5 years from inception for the MAF to be fully funded.

The Market Access Fund would consist of four subsidiary funds:

1. R&D Fund: Provide grants and loans for research (including market research), development and pilot testing of innovations in pre-purchase preparation, product, underwriting and servicing that expand the market for sustainable homeownership and for unsubsidized affordable rental housing.
2. Credit Support Fund: Provide limited credit enhancement and other credit support for products that increase sustainable homeownership and affordable rental by supporting the testing, beyond pilot projects, of products that if successful have the potential to be scaled-up and eventually sustained by the private market.

Chart 5
Great Recession Leaves Millions of Homeowners With Little or No Homeowners' Equity



Sources: Federal Reserve, Moody's Analytics

3. Capital Magnet Fund: Provide funding for the Capital Magnet Fund (CMF), which enables CDFIs and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact. This Fund was authorized by Congress under the Housing and Economic Recovery Act of 2008 (HERA); the CMF was to have permanent, dedicated financing through a charge on Fannie Mae and Freddie Mac but has not been funded, other than one round of appropriated funding in FY2010.
4. National Housing Trust Funds: Provide funding for the National Housing Trust Funds (NHTF), which is a HUD-administered state block grant program designed primarily to increase and preserve the supply of rental housing for extremely low income families. The NHTF was authorized by HERA but has never received funding.

Potential uses of the subsidiary funds and their administration are shown in Table 1, and their funding levels are explained in the sidebar, *Explaining and Sizing the Market Access Fund*, on next the page.

Explaining and Sizing the Market Access Fund

Use	Examples	Administration
R&D Fund: Grants and loans for research, development and pilot testing of innovations in product, underwriting and servicing	<ul style="list-style-type: none"> » Low-downpayment mortgages that require a portion of every mortgage payment to be deposited in a reserve account to provide a cushion for repair, maintenance and economic stress » Equity protection mortgages and equity sharing mortgages » Financing for rehabilitation and energy retrofit of small rental properties » Experiments in sustainable housing counseling models 	Competitive award by HUD, with portion set aside for competitive award to state housing finance agencies; all MAF grants and loans are on budget; Awards may be used in conjunction with Credit Support Fund.
Credit Support Fund: Credit support that will constitute a portion of the capital required to back MBS eligible for the government catastrophic guarantee	<ul style="list-style-type: none"> » Mortgages underwritten by Automated Underwriting Systems (AUS) that include variables such as housing counseling » Bi-weekly payment mortgages » Financing for small rental properties including scattered site rentals » Financing for manufactured housing » Financing for assisted living housing » Financing for veteran housing (working with VA) » Financing for first time home buyers (working with FHA) 	Competitive award by HUD, with portion set aside for competitive award to state housing finance agencies; FMIC will determine extent to which MAF credit support can substitute for private capital; all MAF credit support is on-budget. Credit support may be used in conjunction with R&D Fund.
Capital Magnet Fund	Financing affordable housing for low-income families; one and only round has funded housing for very low income individuals and families, housing for seniors, conversion of investor-owned manufactured housing parks to owner cooperatives	Competitive award by the CDFI Fund to CDFIs and non-profit housing developers; must leverage at least \$10 for every \$1 granted; on-budget
National Housing Trust Fund	Production, preservation, rehab of rental housing for extremely low and very low income families	Formula award to states by HUD, based on need; on budget

1. R&D Fund: Approximately \$1.5 billion outlay. Examples of how the fund may be allocated:
 - » \$500 million for promoting savings and reserves so as to increase first time homeownership. A subsidy of \$10,000 per property to promote savings and reserves would support 50 thousand household per year.
 - » \$250 million for basic research and pilots around alternative AUS, equity sharing, rent to own, counseling, etc.
 - » \$750 million on products to support small property rentals, scattered site, assisted living, manufactured housing, etc. A \$5,000 outlay per unit would support 150,000 units per year. The number of households living in these types of underserved units is approximately 25+ million.
2. Credit Support Fund: Approximately \$3.0 billion in credit scoring (outlay will be variable)
 - » If the fund takes a first loss position (so credit scoring equals outlay equals economic subsidy), \$3 billion provides a 2% support (equivalent to about 50 bps per year over the life of a mortgage) on \$150 B of mortgages or approximately 1 million mortgages per year. This represents about 1 percent of the households. Most likely, only half the funds will be used in single family market and half to support rental units. Note that for a program to be scalable and have sufficient volume for a liquid security in the capital markets need about \$20 billion of tradable stock and production of \$0.5 billion per month. Assuming half the funds are used in the single family market about 4 products can be incubated per year. If the fund takes a mezzanine position (between private capital and government insurance fund), \$3 billion under current credit scoring could most likely be levered about 5 to 1. This represents roughly a one in 5 chance of a \$15 billion outlay of cash. Given the volatility in outlays, a reserve account would need to be established and administered by the FMIC.
3. Capital Magnet Fund: Approximately \$0.2 billion outlay (same as currently under HERA)
4. National Housing Trust Fund: Approximately \$0.3 billion outlay (same as currently under HERA)

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The MAF could be administered by either HUD or the FMIC and—there are pros and cons to either. HUD has considerable experience in both grant making and credit enhancement, and has a mission to serve low- and moderate-income households and communities. However, HUD has limited experience with the non-guaranteed housing finance market, and the difficulties FHA has had in innovating suggest that if the funds are in

HUD, they should be placed directly under the Secretary and given significant flexibility in administration. The FMIC will be knowledgeable about the non-guaranteed housing market. However, it will be a regulatory entity with a mission to significantly increase private capital in the system. Asking it also to make grants and, in particular, to allocate and evaluate credit enhancement—against FMIC-set capital standards—may compromise the FMIC's mis-

sion or result in sub-optimal allocation of the funds. The better location for the MAF would appear to be HUD, with the exception of the Capital Magnet Fund, which should remain with the CDFI Fund of the Treasury.

The MAF would be subject to regular review and evaluation of its activities and effectiveness, with a requirement for recommendations concerning its modification, improvement, and continuation.

Key Features of a Pragmatic Housing Finance System

Our proposed housing finance system has a number of important features worth highlighting:

- » **Diverse sources of mortgage funding.** The system would feature both government-guaranteed and nonguaranteed mortgages, including: balance sheet lending by financial institutions with no government guarantee; loans guaranteed or insured by the FHA, VA and USDA; mortgage-backed securities with a government guarantee; and private-label MBS not guaranteed by the government.
- » **Diverse set of participating institutions.** The system would provide access to the secondary capital market for an array of mortgage originators, large and small, national and community-based, so that innovation is encouraged and no institution exercises undue market power.
- » **Explicit secondary government guarantees priced to cover losses.** Government-provided catastrophic reinsurance would backstop the obligations of private MBS insurers to MBS investors, with the government stepping in only after private capital was exhausted. This private capital could come from a number of sources, including homeowner down payments, private mortgage insurance, nonguaranteed tranches of otherwise guaranteed MBS, credit default swaps, and MBS insurers, among others. The government

would sell the catastrophic insurance to MBS insurers at a price meant to cover taxpayers' losses.

- » **No investment portfolios and no too-big-to-fail risk.** MBS insurers would not hold large investment portfolios and would not invest in the MBS they guarantee. Their portfolio activities would be for specific and necessary ends such as to buy loans out of pools to facilitate mortgage restructuring, for loss mitigation, or REO disposition. The system would have enough of these insurers so that no one of them was too big to fail. The Federal Reserve would be able to buy and sell guaranteed MBS in its monetary policy role.
- » **The end of Fannie Mae and Freddie Mac.** The FHFA, the government-sponsored enterprises' current regulator, has already begun to reduce the GSEs' investment portfolios and is working to combine their securitization platforms into a new government-run utility that can serve the entire mortgage market. The enterprises' remaining assets eventually would be sold to private investors to help repay taxpayers for backing these institutions. These assets may help other firms enter the mortgage insurance market, but without the special privileges that Fannie and Freddie enjoyed.
- » **A continued role for the FHA.** The FHA would retain its historical role of provid-

ing mortgage financing for disadvantaged households, affordable rental housing, and liquidity in times of economic stress. The VA and USDA would also continue their unique roles. The mission of the FHA would be more explicitly defined, with its share of the single-family market expected to fall back to historical norms.

- » **Federal Home Loan Bank System reform considered separately.** Changes to the FHLB system are not included in this proposal, although such reforms should be considered in the future.
- » **Support for affordable housing without numerical goals.** Affordable housing objectives would be advanced through explicit government programs with dedicated funding, including the Market Access Fund. MBS insurers that purchase government guarantees will have obligations to serve all markets. However, the system would not establish upfront numerical targets such as the GSEs' housing goals.
- » **A capable and empowered regulator.** The Federal Mortgage Insurance Corporation would assume many current FHFA responsibilities and take on others in coordination with bank regulators, the SEC and the CFPB. The FMIC would protect against excesses such as those seen during the housing bubble, while respecting the roles of the government and the private sector.

Getting From Here to There: Transition Steps and Reform Time Line

The transition from the current largely nationalized housing finance system to the future system must meet five principal objectives:

- » *Protect the economic recovery.* Government support cannot be withdrawn too quickly without undermining the housing market and destabilizing the broader financial system.
- » *Repay taxpayers.* To the extent possible, taxpayers should be repaid for the financial support they provided to Fannie Mae and Freddie Mac. Given Fannie and Freddie's recent annual profits of around \$20 billion, taxpayers could be made whole by the end of this decade. Yet it is also possible that taxpayers might not be made entirely whole; if not, any ultimate losses would constitute the cost of the previous GSE-based housing finance system.
- » *Protect holders of legacy Fannie and Freddie MBS and debt securities.* The federal government now guarantees existing MBS and bond obligations of Fannie and Freddie through agreements between the Treasury Department and the two firms and must continue to do so through the reform period. Not doing so would undermine the full faith and credit of the United States, resulting in higher borrowing costs and exacerbating the nation's fiscal problems. Again, this represents a legacy of the past flawed system. While our proposal would avoid recreating the obligation to do so ever again, we cannot retroactively change expectations without damaging the nation's credibility in global credit markets—which would produce negative consequences well beyond housing policy.
- » *Ensure an increasing amount of private capital over time.* Private capital standing in front of the government, through the various forms discussed above, must be adequate to absorb mortgage losses resulting from all but the most severe financial crises and economic downturns. This is necessary to protect the government against losses and avoid future govern-

ment bailouts. In conservatorship, there is no private capital at the MBS level ahead of the government's guarantee. This should be changed over time.

- » *Mitigate too-big-to-fail risk.* Ensure that financial entities participating in the future mortgage finance system could fail without catastrophic economic consequences. The assets of Fannie Mae and Freddie Mac would be sold in whole or in part to private investors, and these new entities would face competition. Under the reform proposed here, Fannie and Freddie would no longer exist in their current forms.

The transition involves the following steps (see Chart 6):

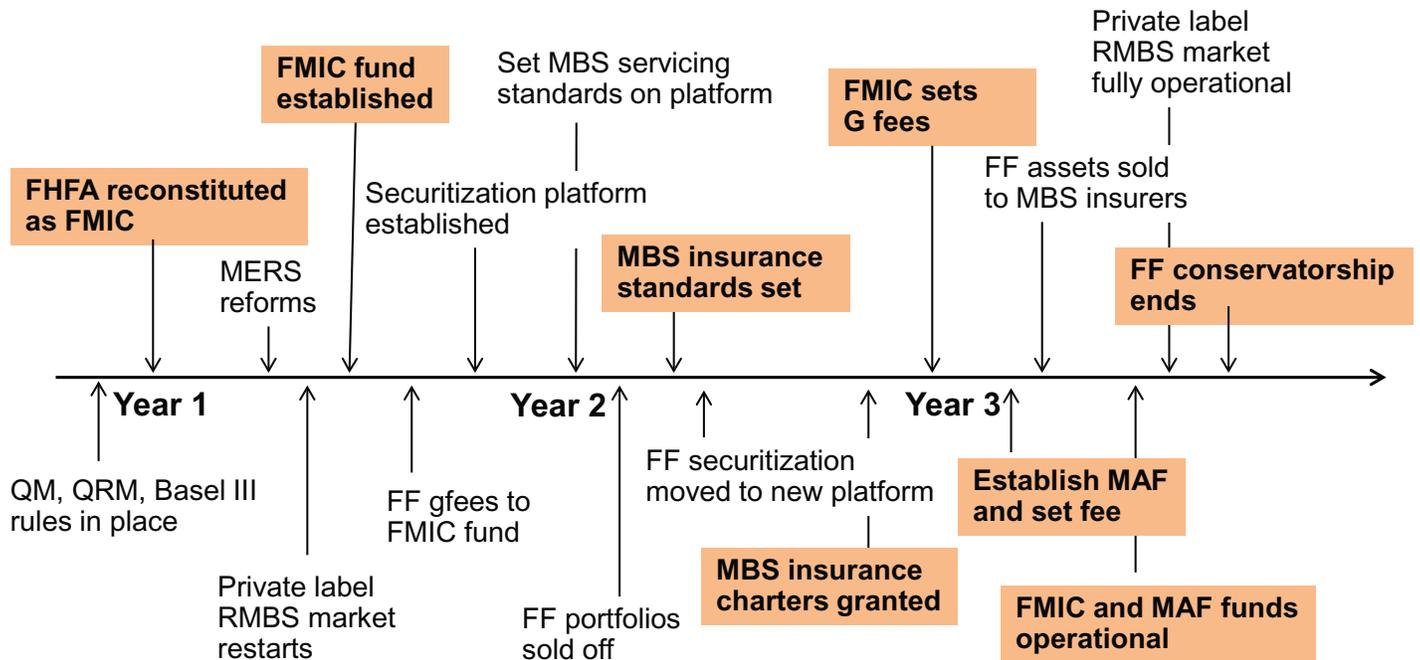
- » The Consumer Financial Protection Bureau recently defined QM loans, and bank regulators, the FHFA and HUD are set to soon define QRM loans. Basel III capital rules are also being devised. These rules and others such as those involving servicing and transparency are necessary before private capital will return and the housing finance system can begin its transition in earnest. These regulations could also significantly affect the extent of the government's backstop in the future housing finance system. It is important that loans comprising government-guaranteed MBS be QM and QRM.
- » Fannie Mae's and Freddie Mac's investment portfolios are steadily reduced as in the FHFA's strategic plan.
- » The government-run single securitization facility replaces Fannie's and Freddie's securitization platforms. Under the FHFA's direction, the two firms are now developing a common platform. The TBA market can function without interruption, as the SEC continues its exemption of Regulation AB for securities traded on the common securitization facility.
- » The Federal Mortgage Insurance Corporation is created, replacing the FHFA. Fannie's and Freddie's MBS are reinsured by the FMIC, fulfilling the government's

commitment to existing MBS investors and stabilizing the mortgage finance system during the transition.

- » The FMIC formalizes the government guarantee for MBS, establishes the MIF, determines appropriate guarantee fees, sets the appropriate amount of private capital needed to protect the government's guarantee, and promulgates other necessary regulations.
- » The FMIC determines standards for MBS insurers' capital adequacy and approves MBS insurers.
- » The FMIC implements reforms to the MERS mortgage registry.
- » A mechanism for collecting the Market Access Fund assessment on MBS is established. A governance structure is established for the Market Access Fund, and policies are developed to make awards from the fund, creating incentives for high-quality and sustainable affordable mortgage finance.
- » Fannie Mae's and Freddie Mac's remaining assets, including the mortgage guarantee businesses, are sold to private investors who qualify as private MBS insurers. The Treasury helps determine the sale method to maximize taxpayer returns and ensure that the market for MBS insurance is competitive.
- » Preconservatorship shareholders of Fannie and Freddie receive no value until the government is repaid in full. The objective of a competitive MBS insurance system is paramount. Although the government would likely maximize its recovery from selling Fannie and Freddie if those firms were allowed to again dominate the market, this would undermine the purpose of housing finance reform. The government would accept a smaller recovery on Fannie and Freddie to create a more competitive housing finance system.
- » The government's role in the housing finance system would be reduced over time as the required amount of first-loss private capital increases. This change in taxpayer exposure could be achieved in

Chart 6

Housing Finance Reform Timeline



Requires Congressional Authorization

several ways, including by varying the attachment point for losses borne by private capital (for example, lowering the size of a loan eligible for the government guarantee). In contrast with the current situation, in which there is no private capital ahead of taxpayers, the government guarantee on MBS would be formalized so that government exposure would shrink.

In the event of a future crisis, monetary policy remains the appropriate initial response. As seen in the recent crisis, the monetary policy toolkit has expanded to include quantitative easing involving Fed

purchases of guaranteed MBS, and this would remain available with housing finance reform. If the Fed's actions are not sufficient to stabilize the housing market, however, the government could provide greater support by reducing the amount of first-loss private capital required for MBS to qualify for the government guarantee. The new housing finance system would thus provide mechanisms for intervention in case of a future crisis.

» Private-label securitization would return as the government's role receded, with increased private capital and regulatory re-

form. The reduced government role would tend to increase the attractiveness of nonguaranteed MBS. Though market conditions would ultimately dictate market shares, we envision an eventual market share of around 50 percent for guaranteed MBS, 35 percent for nonguaranteed mortgages (including both private-label securitization and balance-sheet lending), and 15 percent for mortgages covered by government agencies such as the FHA. The government's share could shrink when capital was flowing freely and grow when capital was fleeing.

Conclusions

The U.S. housing crash produced the worst economic downturn since the 1930s. The housing finance system failed. Policymakers must reshape the system to clearly define the roles of government and the private sector, and ensure that taxpayers are compensated for the risk they assume. The system should be made less vulnerable to future financial panics and recessions, and more effective at providing affordable access to mortgage credit.

Legislation is needed to establish the framework for the future housing finance system. Without guidance from policymakers, the system will evolve in uncertain ways, leaving the government's role ill-defined and likely larger than desirable. Policymakers must also determine what to do about Fannie Mae and Freddie Mac. With this guidance in place, administrative actions can implement the transition.

Future policy decisions about the mortgage finance system will affect U.S.

homeowners and the broader economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy. A new housing finance system will further make it possible for more families to enjoy the benefits of homeownership.

About the Authors

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Ellen Seidman recently joined the Urban Institute as a senior fellow in housing finance research and policy. She has previously served in an array of positions related to housing finance issues, including as Director of the Office of Thrift Supervision and as Special Assistant to the President at the National Economic Council. Ms. Seidman also worked at the US Treasury Department and for Fannie Mae. She is on the board of a number of the nation's leading community development financial institutions and is a founder and Chair of the Board of the Center for Financial Services Innovation. She holds a bachelor's degree from Radcliffe College, a law degree from Georgetown University Law Center, and an MBA in finance and investments from George Washington University.

Phillip L. Swagel

Phillip L. Swagel is a professor at the School of Public Policy at the University of Maryland. He is also a visiting scholar at the American Enterprise Institute and a senior fellow at the Milken Institute. Mr. Swagel was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009. In that position, he served as a member of the TARP investment committee and advised Secretary Paulson on all aspects of economic policy. Mr. Swagel previously worked at the White House Council of Economic Advisers, the International Monetary Fund, and the Federal Reserve, and taught economics at Northwestern University, the University of Chicago Booth School of Business, and the McDonough School of Business at Georgetown University. He received a bachelor's degree in economics from Princeton University and a PhD in economics from Harvard University.

Sarah Rosen Wartell

Sarah Rosen Wartell became the third president of the Urban Institute in February 2012. A public policy executive and housing markets expert, Ms. Wartell was President Bill Clinton's deputy assistant for economic policy and the deputy director of his National Economic Council. In 2003, she co-founded the Center for American Progress, serving as its first chief operating officer and general counsel. Later, as executive vice president, she oversaw its policy teams and fellows. Her work has focused on the economy and housing finance, mortgage markets, and consumer protection. In 2012, she was named a "Woman of Influence" by HousingWire.

Ms. Wartell has an A.B. degree with honors in urban affairs from Princeton University's Woodrow Wilson School of Public and International Affairs and holds a J.D. degree from Yale Law School.

Mark M. Zandi

Mark M. Zandi is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis. Dr. Zandi earned his B.S. from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.

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