Federal Housing Finance Agency Perspectives on Housing Finance Reform

January 16, 2018

An Ongoing Conservatorship is Not Sustainable and Needs to End

The current form of government support for the housing finance system is unsustainable. Under the status quo, taxpayers bear the risk of future losses by Fannie Mae or Freddie Mac while their operations are managed through a government conservatorship that has lasted almost a decade. A more narrowly tailored government role can support broadly shared housing policy goals while protecting taxpayers from the risk of another bailout.

Objectives for a Post-Conservatorship Housing Finance System

A future housing finance system should:

- Preserve the 30-year fixed-rate, prepayable mortgage;
- End taxpayer bailouts for failing firms;
- Maintain liquidity in the housing finance market;
- Attract significant amounts of private capital to the center of the housing finance system through both robust equity capital requirements and credit risk transfer (CRT) participation;
- Provide for a single government-guaranteed mortgage-backed security that will improve the liquidity of the to-be-announced (TBA) market and promote a fair and competitive funding market for Secondary Market Entities (SMEs);
- Ensure access to affordable mortgages for creditworthy borrowers, sustainable rental options for families across income levels, and a focus on serving rural and other underserved markets;
- Provide a level playing field for institutions of all sizes to access the secondary market;
- Include tools for the regulator to anticipate and mitigate downturns in the housing market, including setting appropriate capital and liquidity requirements for SMEs, having prompt, corrective action authority for SMEs that are weak or troubled, and having authority to adjust CRT requirements as needed; and
- Provide a stable transition path that protects the housing finance market and the broader economy from potential disruptions and ensures that the new housing finance system operates as intended.

Implementing a Post-Conservatorship Housing Finance System

To achieve these objectives for a post-conservatorship housing finance system, the following suggestions and perspectives are considered responsible, balanced, viable and important to consider:

Establish shareholder-owned SMEs operating as utilities with regulated, overall rates of return and appropriate capital requirements: SMEs should be private, shareholder-owned institutions chartered by the regulator to issue government-guaranteed mortgage-backed securities.

- **Support innovation and competition:** In order to support sustained innovation and competition for the benefit of lenders and borrowers, there should be at least two SMEs to operate in the market. The regulator should charter SMEs, and the two existing GSEs should be reincorporated as private, shareholder-owned corporations with a regulated rate of return that would enter the market as the first two SMEs in order to help ensure an orderly transition to a new system. Any additional SMEs chartered by the regulator should likewise have a regulated rate of return and have the economies of scale necessary to provide liquidity to the national housing finance market and the standardization required for the TBA and CRT markets.

- **Prevent a race to the bottom:** While at least two SMEs would ensure that the housing finance market benefits from multiple approaches to serving the market, having too many SMEs operating in the market could increase the potential for a race to the bottom in underwriting standards in pursuit of market share or the emergence of just one surviving SME. A regulated, overall rate of return would limit incentives to unduly relax underwriting standards in exchange for higher pricing. As discussed further below, a single security would remove the incentive for SMEs to compete for market share to create a dominant security. Requiring a national footprint will minimize the risk of SMEs competing to cherry-pick the strongest markets, products, or borrowers thereby leaving others underserved, and will contribute to uniform pricing across the country.

- **Prohibit SME investments unrelated to core credit guarantee business:** SMEs should only serve a credit enhancement role for conforming mortgages and should be prohibited from adding risk to the system by taking advantage of subsidized financing for the purpose of enhancing returns. The SMEs' retained portfolios should be limited to eligible assets related to their core credit guarantee businesses (see more detail below).
- **SME pricing and regulated rate of return:** The regulator should have the authority to set a regulated, overall rate of return that permits each SME to earn a "fair return" for its shareholders. This rate of return should be sufficient to attract and retain shareholders while also supporting broad liquidity in the single-family and multifamily housing finance market with affordable mortgage rates. While having an overall regulated rate of

return, SMEs could set different rates of return for different products including, as today, having a lower rate of return on purchases serving low- and moderate-income borrowers and certain underserved markets. Regulating the rate of return while providing SMEs with flexibility in setting pricing for different products would reduce the risk that SMEs engage in overly risky behavior or monopolistic pricing and ensure that SMEs have the ability to serve a national market, including underserved borrowers and rural and other underserved markets.

- **Strong capital and liquidity requirements set by the regulator:** The SMEs should be subject to capital and liquidity requirements, stress tests, and capital planning requirements as set through regulation. As is in place today, the regulator should be responsible for establishing: 1) a comprehensive risk-based capital standard ensuring that the SMEs could survive a severe housing stress like the recent financial crisis and continue to write new business; 2) a leverage ratio standard that is complementary to the risk-based capital standard; 3) annual stress test requirements; 4) required capital planning procedures; 5) temporary and/or additional capital requirements – such as a potential countercyclical buffer – as determined to be appropriate by the regulator; 6) liquidity requirements; and 7) thresholds to initiate prompt corrective action when SMEs become weak or troubled. This set of requirements would provide the regulator the necessary tools to regulate risks to the SMEs, including credit, market, and operational risk. As generally occurs with all prudential regulators, the level of capital and liquidity requirements are best left to the regulator's discretion as opposed to being prescribed in legislation. This approach would ensure that the requirements are calibrated with one another, account for the amount of credit risk transfer transactions conducted by the SMEs, can be adjusted as needed over time to avoid unintended consequences, and appropriately considers safety and soundness and costs to SMEs and ultimately borrowers.
- **Allow SMEs to support both single-family and multifamily markets:** SMEs should have the option of supporting housing finance market liquidity for both single-family and multifamily markets. Operating in both markets would ensure that SMEs have a complete view into the housing market and could adapt to any changes. Serving both markets would also likely make it easier for SMEs to attract private capital, as investors would diversify business line performance risk.
- **Compensation oversight by regulator:** It is important that SMEs are able to attract the necessary, highly skilled talent needed to run these institutions effectively while recognizing that executive compensation should not encourage undue risk taking. Thus, the regulator should have authority to disallow excessive compensation for SME executive officers. A regulated rate of return would provide an additional check against excessive executive compensation.

- **Corporate governance:** As publicly held corporations, SMEs would be subject to well established standards for corporate governance. This includes state corporate law governance standards, Securities and Exchange Commission requirements, and Financial Accounting Standards Board requirements.

Provide government guarantee on securities: The government should provide an explicit and paid-for catastrophic guarantee on mortgage-backed securities issued by regulated SMEs.

- **Establish a Mortgage Insurance Fund:** Fees for this explicit support should fund a mortgage insurance fund (MIF) that would cover catastrophic losses on mortgage-backed securities ahead of remote losses covered by the government guarantee. This approach would 1) ensure that the government is out of the business of rescuing failing institutions; 2) protect taxpayers because the MIF would only be available to cover catastrophic losses if an SME exhausted both the credit risk transfer coverage provided by private capital and SME capital levels set by regulation; and 3) ensure the continued viability of the TBA market so that borrowers and investors could continue to benefit from ongoing housing finance market liquidity during economic and housing market downturns.

Require credit risk transfer: SMEs should be obligated to disperse substantial credit risk to private investors through approved credit enhancement and credit risk transfer transactions when such transactions are economically sensible. The regulator should have the authority to determine the amount of capital relief that forms of credit risk transfer receive and should have countercyclical authorities to allow the SMEs to reduce their credit risk transfers when such transactions are not economically viable due to adverse economic, housing finance market, or credit risk transfer market conditions. Use of such authorities would allow the primary market to continue operating during significant economic downturns and periods of housing finance market or credit risk transfer market disruption and require the SMEs to return to standard CRT practices once the market disruption had ended.

Support a national footprint and countercyclical market coverage: As today, SMEs should have a mandate to promote access to mortgage credit throughout the nation, including rural and other historically underserved areas and borrowers. A national footprint is necessary in order to establish a stable national market that has uniform pricing and can withstand regional and nationwide downturns. Additionally, TBA investors in mortgage-backed securities (MBS) – as well as credit risk transfer investors – expect that MBS will be backed by geographically well-diversified pools of mortgages. Failure to have a national presence could therefore jeopardize the development of a single security and limit ongoing liquidity in the TBA market. A national market, coupled with safety and soundness regulation, should also ensure that underserved markets receive appropriate access to mortgage credit.

Establish affordability requirements: In recognition of having a government guarantee, SMEs should remain subject to affordability-oriented obligations designed to ensure that all taxpayers can share in the benefits of federal support for the housing finance market, either through support for access to credit for creditworthy borrowers or through support for affordable rental housing. The regulator should have authority to oversee these responsibilities. Any new approaches or authorities substituted for any or all existing authorities (authority to set housing goals, review and assess duty to serve plans, and fund the Housing Trust Fund and Capital Magnet Fund), should provide benefits at least comparable to these existing requirements.

Support common securitization infrastructure: Require the continued operation of the Common Securitization Platform (CSP) as a market utility that is mutually owned by SMEs and potentially other secondary market participants (similar to the Depository Trust and Clearing Corporation). Like other financial market utilities, the CSP should be an operating company, not an investment risk-taking financial firm. For SMEs, the CSP market utility would facilitate SME issuance of a single security backed by conforming loans wrapped with a government guarantee.

- **Use by the industry:** All SMEs chartered by the regulator should be required to join the CSP market utility. Other secondary market participants (private-label mortgage-backed securities aggregators, etc.), should also be able to make use of the CSP by investing in the CSP or by paying a securitization fee. The CSP should leverage industry standard interfaces and software to provide greater ease of use by a variety of secondary market participants.
- **Oversight by the regulator:** To ensure the ongoing liquidity of the single security issued by the CSP market utility, the regulator should have appropriate oversight authority over the CSP to ensure a deep, liquid TBA market.
- **Fungibility with past securities:** The regulator should have the authority to require the CSP to implement a mechanism through which legacy agency MBS can be made fungible with new government-guaranteed securities in order to avoid bifurcating the market, to protect existing MBS investors, and to improve liquidity. The regulator should have the authority to allow the MIF to capture some of the increased value of newly wrapped legacy securities through imposition of a fee.

Provide a level playing field: SMEs should be obligated to offer competitive access to the secondary market through cash window purchases of mortgages so that lenders of all sizes can compete on a level playing field. SMEs should also be prevented from offering pricing discounts to lenders based on higher volumes.

Retain regulator's diversity and inclusion authority. The regulator should retain authority as currently provided over diversity and inclusion requirements.

Provide government guarantee to support activities related to core credit guarantee business: Supporting a robust and stable housing finance market will also require guaranteeing debt funding for a core set of well-defined, related secondary market activities. This is similar to the FDIC deposit insurance fund, which also guarantees core defined liabilities. The regulator should oversee and limit these eligible activities to the following:

- **Cash window and loan aggregation operations:** Cash window operations would allow smaller lenders to originate loans with the confidence that they will have reliable and competitively-priced access to the secondary market. Because loan aggregation for single-family and multifamily loans is a balance sheet-intensive process and most small institutions do not have capital markets business units, the cash window provides an essential secondary market outlet for smaller lenders. Absent a cash window, smaller lenders would need to rely on potential competitors to gain access to the secondary market and would likely have to give up their servicing rights in the process.
- **Loss mitigation efforts for delinquent loans:** To facilitate loss mitigation programs for loans that become delinquent, SMEs would need the ability to buy defaulted mortgages out of government-guaranteed securities and hold those loans on their balance sheet. These loss mitigation programs would reduce losses for credit risk investors and SMEs, and this would reduce the risk that an SME needs to access funds from the MIF. Loss mitigation efforts often include loan modifications that result in lower, sustainable monthly payments for distressed borrowers, while being economically beneficial for all credit risk investors. During a severe downturn, SME loss mitigation authority supports market stability and recovery.
- **Affordable loans serving underserved markets:** Limited and regulator-approved purchase of certain affordable mortgages that are not immediately able to be securitized and regulator-approved investments would allow SMEs to explore new ways of providing housing finance market liquidity for underserved housing markets. Such loan purchases or investments can be critical to meeting duty-to-serve obligations to support rural communities, manufactured housing and preservation of affordable housing.

In stable economic periods, the SMEs' portfolios should be small. In stressed economic periods, the portfolios would have the ability to grow as the SMEs purchase distressed loans out of securities. Portfolio balances would then decline again as a result of subsequent re-securitizations of re-performing loans, whole loan sales of non-performing or re-performing loans, or foreclosure.

Ensure an independent regulator: To protect taxpayers in providing a government guarantee, SMEs should be subject to supervision and regulation by a strong and independent prudential regulator with safety and soundness authorities comparable to those of FHFA and other federal financial regulators. Like other prudential regulators, the regulator should be funded by fees levied on the regulated SMEs and the CSP. The regulator should retain FHFA's existing authorities and add Bank Service Company Act-comparable authority to examine SME counterparties.

Provide a stable transition to a new housing finance system: It is critical to the stability of the housing market and the broader economy that transition efforts do not disrupt the housing finance system. As a result, changes to the housing finance system should reflect thoughtful consideration of the following factors: the complexity of potential changes to the housing finance system (and the time required in transition to avoid disruption), the likelihood of success of the changes, the benefits they will provide to the housing finance market and to borrowers, and the needed flexibility of the regulator to successfully implement the changes. The perspectives shared above attempt to balance these factors to ensure that there is both a stable transition to a new housing finance system and that the new housing finance system addresses the shortcomings of the existing model. Leveraging the extensive reforms made during conservatorship should reduce transition risk and support launching a new housing finance system.