Reforming the Housing Enterprises

Sustaining Homeownership and Protecting Taxpayers

American
Bankers
Association®

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. rules and regulatory practices affecting residential mortgage finance:

a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; and
f) make regulation efficient, effective, and appropriately tailored.

The American Bankers Association[1] offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **During the period that the secondary market housing enterprises (GSEs) remain in conservatorship, the Federal Housing Finance Agency, Treasury and other responsible agencies should maintain regulatory policies and direction to GSE management designed to reduce taxpayer risk and develop business activities and structures that are conducive to transition to successor secondary mortgage market institutions.**
- **Such directed actions include development of products to transfer credit risk exposure to private investors, development of more efficacious mortgage securitization platforms, significant reduction or elimination of direct GSE investment in mortgage portfolios, and other initiatives to build market solutions likely to support robust and lower risk mortgage markets after the conservatorships are ended.**
- **Congressional action is needed to end the conservatorships and determine the degree of direct taxpayer support of mortgage markets, and the terms under which that support will be provided. Very likely a portion of the government's terms for engagement will codify certain practices put in place by regulators during the period of conservatorship. A common set of principles for reform should guide regulatory oversight during conservatorship, and subsequent actions by Congress to end the conservatorships and establish the structure and statutory requirements for successor institutions in the secondary marketplace for residential mortgages. Those principles are articulated in nine components in this White Paper.**

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.

The Past as Prologue

In nearly a decade since they were placed into conservatorship, policy makers in Congress have been unable to resolve the fate of Fannie Mae and Freddie Mac and chart a sustainable course for the future of the government's involvement in the mortgage market. During that time, however, progress has been made through limited but significant regulatory changes mandated by the Federal Housing Finance Agency, the most notable of which has been the development of credit risk transfer mechanisms. Additionally, while differences remain, there is growing broad consensus among most in the industry around certain key principles. Even with growing consensus on the outlines of reform, there remain many paths leading to a final destination. What is the desired end point? How do we get there? Who pays and how much? Ultimately those will be choices that Congress will have to make. We offer the following background and principles to guide policymakers in the Administration, in the regulatory agencies and on Capitol Hill as these important decisions are made.

Background

Prior to conservatorship, Fannie Mae and Freddie Mac existed as hybrid companies, in a duopolistic system. They had private shareholders who profited from risks taken with the implied guarantee of the federal government.

Early in the conservatorship, Fannie Mae and Freddie Mac were unable to pay the 10 percent required interest rate on over $180 billion injected by U.S. taxpayers to prevent their collapse. As a result, the two were de facto nationalized with profits, if any, being swept to the U.S. Treasury. Under this arrangement, the interest payments on government bailout funds has been waived. The GSEs operate with little and shrinking capital and are, under terms of the conservatorship, expected to go to zero capital by 2018.

Since returning to a positive cash flow in recent years, the terms of the conservatorship as amended have remained in place. Though funds swept to Treasury have been substantial, the amount falls substantially short of the taxpayers' direct investment plus the waived interest obligations on that investment. The terms of the conservatorship do not provide for a cutoff of payments (or for the debt incurred to be considered repaid) and do not allow for the GSEs to retain earnings to build capital.

Some have suggested that the GSEs simply be recapitalized and released back to the private market, with limited changes to their charters, noting that reforms to the entire mortgage market have addressed many of the problems that lead to the financial crisis and the insolvency of the GSEs.

We reject that approach, as it would return us to the untenable situation of public risk-taking to the benefit of private investors. Even with reforms in place it would encourage future abuses and undue risks to U.S. taxpayers.

Other proposals, most notably legislation considered by the Senate Banking Committee in the last Congress, envisioned a complete restructuring of the secondary mortgage market system.

Those legislative approaches ultimately were not able to gain approval at least in part over concerns that they were too complex and untested, and that the transition from the current system to a new one envisioned in the legislation would be too disruptive to the housing finance system.

Still, the legislative efforts undertaken by the Senate were helpful in focusing attention on the key services provided by the GSEs in the past, and in delineating how some of those services could be separated into component parts, and reassigned in a new system to reduce risk and create opportunity for greater competition.

Consensus is forming around the view that a limited and controlled government involvement in the secondary mortgage market is needed to ensure the availability of stable, affordable long term financing for mortgage finance. Americans have relied on the long term fixed rate mortgage for affordable mortgage finance for 70 years. Fannie Mae and Freddie Mac have facilitated access to this product by providing access to the capital markets for primary market lenders. Absent aggregation and securitization provided through the To Be Announced (TBA) market, access to long-term, lower rate funding would be far more difficult to come by for most primary lenders. The government guarantee provided to mortgage backed securities issued by the GSEs makes them attractive to the capital markets ensuring liquidity.

Congress has an essential role in providing the certainty necessary to ensure long-term stability of the housing finance system. Just as the federal debt market provides the bellwether that makes all private debt markets more efficient and liquid, an explicit, fully priced, fully paid-for federal guarantee for a targeted portion of the mortgage market will be a catalyst for broader market growth and development. Congress should not defer action any longer. Nine years of conservatorship is more than enough.

Fortunately, a common set of principles suggests much of what regulators have done, and what Congress should do next. The architecture of how a targeted and sustainable federal guarantee is delivered is open to debate, and we will not advocate here for any specific model or form. Instead, we set forth the key principles that should guide the regulators, and that Congress must employ in making choices about the ultimate path toward mortgage market reform. These principles are also the measures by which the success of Congress and the regulators will be judged.

ABA PRINCIPLES

1. **The GSEs must be strictly confined to a secondary market role of providing stability and liquidity to the primary mortgage market for low and moderate income borrowers and must be strongly regulated, thoroughly examined and subject to immediate corrective action for any violation.**

A reformed system must ensure that the GSEs or their successors stay focused purely on advancing stable, affordable and readily available secondary market access to the primary market. Shareholder returns or other investment goals cannot be allowed to drive their behavior. While a certain level of competition is desirable to ensure innovation and responsiveness to the market, competition cannot be allowed to spin out of control and take the GSEs into other businesses or investment areas. For this reason it has been suggested that a public utility or member owned cooperative model may be a desirable evolution for the GSEs. We note only that while ownership structure is one way to limit their activities, strong regulation will also be necessary to keep them focused on their defined role, regardless of what ownership structure is ultimately chosen.

2. **In return for the GSE status and any benefits conveyed by that status, these entities must agree to support all segments of the primary market, as needed, in all economic environments and to provide equitable access to all primary market lenders.**

The GSEs or their successors, including any potential new competitors that may be chartered, will benefit from a defined market available only to them and with a government guarantee on the securities that are issued. To ensure that those benefits are available to all, GSEs must be required to provide access to all primary market lenders on an equitable basis.

3. **Access must also include preservation of the To Be Announced (TBA) market and service retained or sold options.**

The To Be Announced market, also known as the Cash Window, allows originators to sell loans on an individual basis to the GSEs. This option must be preserved to ensure access to the secondary market for lower volume lenders or those who choose for business purposes to sell individual loans. Similarly, to ensure that originators may continue to service loans consistent with their chosen business model, flexibility to sell loans servicing retained or servicing released must be preserved in any reformed system.

4. **Mortgage Backed Securities issued by the GSEs should carry an explicit, fully-priced and fully transparent guarantee from the federal government.**

The key benefit conveyed by the GSEs to the primary market is access to long term affordable liquidity for mortgage lending. To preserve that liquidity, the government guarantee is necessary, but taxpayers need to be fully compensated for the risks they bear in providing that guarantee. Fees necessary to support the guarantee must be charged, and must be transparent so that they reflect the true cost of the guarantee, and only that cost. Fees should not be assessed to offset other government spending or priorities. It may be desirable to establish a segregated insurance fund to cover potential losses in the event that the guarantee is tapped in a crisis. Further, to ensure equitable access, the fees must be assessed equally on all lenders on a cost averaging basis.

5. **The GSEs or their successors must be capitalized appropriately to the risks bourn and regulated to ensure that they remain so in all market conditions.**

Currently, Fannie Mae and Freddie Mac are operating under conservatorship, with little capital and with all profits being swept to the U.S. Treasury as compensation for the federal investment and risks bourn of behalf of taxpayers. It will be essential that going forward the GSEs or their successors have adequate capital to withstand market downturns, especially as they will be monoline businesses subject to regional and national downturns. Capital can come from a variety of sources, including indirectly from credit risk transfers, and injections of new capital from new member/owners/users of the GSEs or their successors (depending upon the model ultimately chosen by Congress).

6. **Regulation of the GSEs must include establishment of sound and fair underwriting standards for the loans they purchase, and must be based upon and coordinated with underwriting standards applicable to the primary market.**

Significant underwriting requirements imposed under the Dodd-Frank Act, most notably Ability to Repay (ATR) and Qualified Mortgage (QM) rules, while less than perfect, have significantly strengthened mortgage underwriting in the primary market. Going forward we believe it desirable that these primary market underwriting requirements serve as a basis that supports all secondary market activity, regardless of whether residential mortgages are sold to the GSEs or their successors or to private label purchasers. As a general matter, mortgages sold into the secondary market with government guarantees should meet QM standards, whereas private label securitizations will only require the less stringent ATR standard.

For the primary market, loans originated and held in portfolio should automatically be granted QM status so long as they meet basic Ability to Repay requirements and do not run afoul of safety and soundness regulations. Such loans are inherently conservatively underwritten as portfolio lenders hold 100 percent of credit risk and thus will only make loans that have a high degree of ability to be repaid.

For the secondary market, the so-called QM Patch currently in place effectively allows Fannie Mae and Freddie Mac to confer Qualified Mortgage status to any loan they are willing to purchase. As a result, Fannie Mae and Freddie Mac define the nature and extent of risks to which taxpayers are exposed. This was a necessary but flawed mechanism to ensure that the new rules did not overly restrict mortgage credit when regulations in 2014 subdivided ATR mortgages into QM and non-QM categories, and was deemed to be manageable as long as the GSEs were in conservatorship. However, the QM Patch is designated to expire when conservatorship of the GSEs ends, creating the necessity and opportunity to revise the QM/ATR rules so that the GSEs or their successors are restricted to purchases of QM loans that have well-defined and fixed criteria, and that transition to a revised QM designation does not constrict credit availability. A well-defined QM requirement to "earn" a federal guarantee is essential to protect taxpayers, and will serve to guide non-QM mortgages to a private label secondary market without taxpayer exposure.

7. **Credit Risk Transfers required by FHFA should be continued and expanded. Credit risk transfer must be a real transfer of risk and must be economically viable for the GSEs and the lenders they serve.**

Several mechanisms for credit risk transfers have been one of the greatest innovations introduced to the GSE model in years. They have helped to bring private market participation back to the mortgage markets, and have made a real impact on reducing taxpayer exposure to GSE risks. They should become a permanent feature of secondary market financing. However, they must continue to be developed in ways that make economic sense for the GSEs, primary market lenders, and for the borrowers they serve. They must also truly transfer credit risk in a permanent fashion to ensure taxpayer protection. To that end, FHFA (or it successor) must vigorously regulate, examine and enforce credit risk transfer requirements.

8. **Any reform of the secondary mortgage market must consider the vital role played by the Federal Home Loan Banks and must in no way harm the traditional advance businesses of Federal Home Loan Banks or access to advances by their members.**

The Federal Home Loan Banks (FHLBs) have provided mortgage financing in the form of collateralized advances to their member/owners for over 80 years. They have performed as intended, ensuring liquidity even in times of market crisis. Their crisis performance is traceable in part to mutual ownership status and relatively high statutory capital requirements. Changes to Fannie and Freddie may impact the FHLBs, even if unintended or indirect, and the impacts must be considered and accounted for, and preferably avoided before they are undertaken. Additionally, the FHLBs may have the potential to play an expanded role in a revised GSE system, but any expanded role must be separately capitalized and regulated in such a manner that it does not put at risk the traditional advance business of the Banks.

9. **Affordable housing goals or efforts undertaken by the GSEs to expand the supply of affordable rental housing should be delivered through and driven by the primary market, and should be structured in the form of affordable housing funds available to provide subsidies for affordable projects.**

The bright line between the primary and secondary market in the single family housing finance area should also broadly apply to the affordable housing and multifamily market. Primary market lenders should be the originators of these loans supported by access to stable, long term liquidity from the GSEs. Only in complex originations where the primary market lacks capacity should the GSEs be involved in direct financing, and strong regulation and oversight should be employed to ensure that there is no “cherry picking” of deals by the GSEs from the primary market.

What is the desired end point?

There are many possible paths to GSE reform. The end point should be a reduced direct role of the federal government in mortgage finance. Today the government either owns or insures three of every five mortgage loans currently outstanding in the country. A more robust private market for housing finance should be fostered and encouraged with an ultimate goal of a much smaller direct governmental role, and with that role focused on ensuring market stability, access to the capital markets for all originators, and as a safety valve in the event of market failure. GSE guarantees should be focused on markets serving the needs of low and moderate income borrowers. A well-regulated private market should be the desired financing source for the bulk of higher income borrowers whose income and credit rating qualify them for conventional financing.

Conclusion

Access to affordable mortgage finance is one of the most important wealth building tools available to the American public. That tool is reliant upon a public/private partnership of private primary market lenders and controlled and limited government support to bring capital market access to mortgage borrowers. Access must be available to all primary lenders, it must be based on sound, clear and fair underwriting, and it must be backed by a guarantee that is targeted and limited to ensure both its sustainability and its safety so as not to continue to put taxpayers at undue risk. The American Bankers Association looks forward to working with policymakers to ensure that this tool is preserved for future generations.