

## Toward a New Secondary Mortgage Market

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### Executive Summary

There is a simple and sensible way to finally achieve comprehensive housing finance reform in our country. The approach we propose in this paper is to amend the charters of Ginnie Mae, Fannie Mae and Freddie Mac, and the Federal Housing Finance Agency (FHFA).

Simply amending these charters can accomplish a wide swath of the objectives that have eluded legislators and policymakers since the conservatorship of Fannie Mae and Freddie Mac began in 2008. Each of the charter changes we propose can stand on its own right as sound policy. Collectively, they allow us to take important steps toward a more robust, dynamic, and secure market for mortgage credit risk.

All of this can be achieved while not materially affecting borrower interest rates, since we leverage a well-known and widely accepted government-backed security that the market already understands, as well as risk transfer mechanisms that the market has accepted since 2013. The transition to this reform can be accomplished smoothly, leaving a housing system that is efficient, open to competition and innovation, and ensures a stable supply of mortgage financing.

Our proposal would end the conservatorships, reconstitute Fannie Mae and Freddie Mac as lender-owned mutuals, and build on the credit risk transfer (CRT) initiative to create a private market for mortgage credit risk while preserving a government-guaranteed rates market for mortgage-backed securities. Other firms could compete with Fannie and Freddie in the business of aggregating loans and gathering together the private capital that takes on housing risk ahead of the backstop government guarantee. We seek to make these changes while preserving as much as possible how lenders, servicers, and others operate today so as to keep what works, avoid disruption to current business practices, and limit risk in transition.

The framework outlined in this paper features the following key provisions:

### ***Fannie Mae and Freddie Mac***

- Passed through receivership and reconstituted as entities mutually owned by their seller-servicers.
- Have two principal business functions in the single-family mortgage market:
  - Provide credit enhancement. As they have been for the past few years, the companies would syndicate mortgage credit risk through a variety of credit risk transfer structures, thereby contributing to a broad and deep market for mortgage credit risk that disperses, rather than concentrates, risk and ensures ongoing market analysis of credit risk.
  - Maintain a cash window for small and mid-sized lenders to sell mortgages for cash and aggregate these loans for securitization and credit risk syndication.
- No longer have the attributes of their old government-sponsored enterprise (GSE) charters, nor would they maintain an investment portfolio or operate in a protected duopoly.

### ***Ginnie Mae***

- Taken out of the Department of Housing and Urban Development (HUD) and made a stand-alone government corporation like the FDIC, with authority over its own budget, hiring, and compensation.
- Authorized to accept private-sector credit enhancement from entities licensed by the FHFA.
- Provide a full-faith-and-credit wrap on mortgage-backed securities (MBS) issued by Ginnie Mae-approved issuers where the loan pools are credit-enhanced either by a government program (such as FHA or VA) or by FHFA-approved credit enhancers that arrange for the required amounts of private capital to take on housing credit risk ahead of the government guarantee.

### ***FHFA***

- Continues to regulate the housing finance system, including securitization and the quantity and quality of private capital standing in front of the government guarantee, as noted below.
- Oversees the winding down of the conservatorships, including oversight of the outstanding Fannie and Freddie securities backed by the Treasury support agreements.
- Authorized to set standards for private credit enhancement of loan pools and would license and examine entities providing such credit enhancement.
- Ensures standardization across the housing finance ecosystem with regard to data, data reporting, etc. to ensure a transparent and liquid market.
- Establishes and operates a Mortgage Insurance Fund (MIF) funded by industry assessments to backstop the credit enhancement market.

## **Introduction**

Housing matters for so many reasons—economic ones, yes, but also because it is a basic human need, the place where families and lives are built. And housing for most people in America is the most expensive item in their monthly budget, whether they rent or own. Therefore, how housing is financed—or even if financing is available—is of critical importance to everyone. From the standpoint of the overall economy, investment in housing and consumption of associated products and services represent a key contributor to GDP. For financial markets, problems in the housing finance system were at the center of the recent financial crisis. Getting this right matters.

The housing finance system and whatever changes we make to it must ensure the ongoing availability of credit to support the management of rental housing and the financing of home purchases for those ready to take that step.

The U.S. housing market was at the epicenter of the 2008 global financial crisis, of course. And since then Congress has allocated hundreds of billions of dollars to keep the secondary mortgage market solvent. Yet the emergency and supposedly temporary state of government ownership of one-fifth of the economy<sup>1</sup> has yet to be addressed by Congress.

The importance of housing to our economy has contributed to the challenges of market structure reform. The infrastructure providing finance to support housing showed fundamental flaws during the financial crisis and it remains in an unstable state—conservatorship—eight years later. The constant politicization of housing finance has left us at a policy impasse despite broad areas of agreement on what needs to be done.

This is in large part because the structure that undergirds today's housing finance market is complex. And so, eight years after the financial crisis, with the government explicitly backing the credit risk on the vast majority of mortgages issued, and the Federal Reserve serving as the largest holder of agency mortgage-backed securities, the entire system relies heavily on the public sector to function.

In the first paper in our series on housing finance reform, we made the case for why reform is needed and set forth its objectives. As we noted, the trick is to solve the policy problems that must be addressed while building efficiently off what already works.

In this paper, we will outline a detailed path that navigates such a course. This structure would replace the failed duopolistic GSE system with one of competitive private insurers, a vibrant market for mortgage credit risk, ownership structures that require lenders to have some skin in the game, and appropriate government standard-setting and oversight to ensure a deep and liquid MBS market.

Since 2008, several legislative attempts have been made to end the conservatorships of the GSEs—Fannie Mae and Freddie Mac. Most of these bills were generally designed to usher in a market-based system while providing a utility and regulatory role for the government in ensuring equitable access to the system for as many Americans as possible. Such proposals also have generally allowed the government to provide a transparent catastrophic backstop, thus minimizing the need for emergency congressional action during a crisis and allowing the government to charge upfront for the tail risk that many understand it already owns.

Much of the DNA of these past bills remains in what we propose. But we aim to achieve these objectives of legislation via a more streamlined path.

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<sup>1</sup> Examples of the federal government's ownership or direct support of the housing finance system include taxpayers' direct support of the Federal Housing Administration (FHA), the Treasury support agreements backstopping Fannie Mae and Freddie Mac, the Home Affordable Modification Program (HAMP), and the Federal Reserve's nearly \$2 trillion portfolio of mortgage-backed securities.

Perhaps the main concern around most reform proposals has been viability. The many moving parts of past proposals have led legislators and stakeholders to become trapped on a single question: Will this work? That was the main concern at play in discussions in the Senate in 2014, for example, and it remains a hallmark of most reform debates today.

To help mitigate this concern, we take as a starting point that reform must sufficiently leverage the aspects of our housing system that we know already function well. But it must do this while taking steps toward a model that rids us of the pre-crisis system that allowed profits to private GSE shareholders in good times but required an emergency taxpayer bailout during a time of extreme stress. We also need to move past a system that leans entirely on a single regulatory agency in Washington to make underwriting and mortgage pricing decisions while asking taxpayers to shoulder most of the risk.

Our plan solves these multifaceted challenges by relying heavily on the existing infrastructure, thereby easing the transition and ensuring the new structure will have much of the look and feel of the existing market. Our proposal leverages what the market already knows and understands.

There is no leap of faith in what we propose. There is, instead, a steady walk toward a better market structure.

How so? We propose to simply amend the charters that form the foundation of our secondary mortgage market system: the GSE charters, the Ginnie Mae charter, and the FHFA charter.

The amendments we propose would simultaneously improve the system and solve many of the policy problems of the past structure. They would promote competition for mortgage risk, align incentives throughout the mortgage ecosystem, level the playing field across large and small loan originators, and ultimately could stimulate credit availability.

## Policy Challenges We Aim to Solve

Reform, no matter how much focus it gives to ensuring simplicity and a smooth transition, should solve a few key policy challenges. There is often a trade-off between the magnitude of what can be solved and the amount of risk in transition—a trade-off we believe we optimize in our simple proposal. Still, one must ensure that certain key objectives have been met.

In our previous paper, we identified three aspects of the secondary mortgage market as it works today that should be preserved:

1. A liquid MBS market, including:
  - a. The To-Be-Announced (TBA) market
  - b. Standardization of mortgage data, servicing rules, and MBS security structure and disclosure
2. Nationwide, uninterrupted access to the secondary mortgage market
3. Competing outlets connecting the primary market to the secondary market

We also identified five broad objectives for reform, citing aspects of the current system that must be fixed or replaced:

1. Eliminate emergency bailouts
2. Build some degree of consensus on a modernized affordability and accessibility paradigm

3. Bring market signals, private capital, competition, and innovation back to the market, but with standards and guardrails
4. Eliminate hidden or implied guarantees and all vestiges of the crony capitalism that characterize Fannie and Freddie's charters
5. Align incentives as much as possible throughout the system

## The Government's Role in Guaranteeing Mortgage Credit

Before proceeding, it is worth taking a moment to look at the government's role in the mortgage credit system.

The fundamental question of housing finance reform is the role of the government, (i.e. taxpayers), in bearing mortgage credit risk. Considering this role means assessing whether accomplishing the objectives set forth above requires the government to ensure or backstop investors in the event of mortgage defaults.

Today, the government directly supports the majority of mortgage credit risk in the market through mortgage-guarantee programs such as FHA and VA and through taxpayer backing of Fannie Mae and Freddie Mac. While virtually all policymakers agree that this is far too much taxpayer involvement, none of the legislative proposals of the past few years have advocated complete elimination of federal support.

For example, none of the proposals advocated eliminating the FHA and VA loan-guarantee programs. Moreover, the Corker-Warner and Johnson-Crapo bills in the Senate would have replaced the current taxpayer support of Fannie Mae and Freddie Mac with a new government corporation that would explicitly provide catastrophic insurance of MBS in the event that private capital proved inadequate. The House bills, one sponsored by Republican Rep. Scott Garrett of New Jersey and another by Democratic Rep. John Delaney of Maryland and others, would have utilized Ginnie Mae to provide some level of government guarantee, albeit each in a different way, and Garrett's PATH Act only when market conditions warranted.

Like many reform advocates, we concluded that the vast majority of mortgage credit risk inherent in the conforming, conventional mortgage market—the market segment served by Fannie Mae and Freddie Mac—can and should be borne by the private sector. There is ample capital able and willing to underwrite, price, and manage mortgage credit risk provided the market operates with transparency and clarity regarding the rules, including the rules surrounding borrower defaults. Hence, there is a crucial role for the government in establishing and enforcing such rules.

Importantly, we believe the residual credit risk, sometimes called the catastrophic risk, should ultimately be the responsibility of the private housing finance sector as well, with the government providing only temporal support during an economic crisis so as to smooth out losses that ultimately remain the market's responsibility. Still, a government role in some form is probably key.

We came to this policy conclusion for four reasons:

1. The credit risk transfer market initiated several years ago demonstrates the capacity and interest of market participants in this credit market. Yet from our experience and interaction

with numerous market participants, we concluded that the vast majority of them believe the \$10 trillion single-family market is incapable of absorbing all the embedded credit risk in this market, largely because of the difficulty in pricing and reserving for the very infrequent and catastrophic credit events in housing.

2. A government guarantee of MBS that replaces the Fannie-Freddie market segment would cleanly separate the market for mortgage credit risk from the funding market for mortgages (known as the rate market), which undertakes the interest rate risk in mortgage lending. Only a government backstop guarantee perfectly bifurcates those markets. Removing credit risk from the rate market using a government guarantee has the substantial benefit of widening the pool of eligible investors in the rate market, thus lowering mortgage interest rates. With the private sector bearing all the credit and interest rate risk, the subsidy would be small, thereby reducing the market-distorting effects of the current built-in subsidies.
3. Such a guarantee would also preserve the TBA market as it functions today, removing a key element of uncertainty in the reform debate.
4. A catastrophic guarantee acts as an automatic stabilizer, enhancing market stability and housing finance liquidity during an economic crisis.

The pre-conservatorship Fannie and Freddie market concentrated \$5 trillion of mortgage credit risk on two balance sheets—Fannie and Freddie’s—while investors in their MBS saw through the Fannie and Freddie corporate credit guarantees to the taxpayers standing behind them. For years, this was widely described as the implicit guarantee inherent in the Fannie-Freddie model. Yet the government officially denied such support would be given and thus never received compensation for the economic benefit it provided Fannie and Freddie shareholders. The reality of this implied guarantee, however, was made manifest in 2008.

In conservatorship, the taxpayer guarantee is explicit through the Treasury support agreements that allow Fannie and Freddie to continue to operate despite their failure during the crisis. The existence of this guarantee has allowed the enterprises to continue to function, and because of it the Federal Reserve has been able to purchase the MBS issued by the enterprises, in an effort to lower borrowing costs for homeowners.

But over the past few years, at their conservator’s direction, both Fannie and Freddie have begun selling off mortgage credit risk to private investors, building a small but growing private-capital buffer in front of the taxpayer. We believe these credit risk transfer transactions have been important steps in clearing a path toward a robust market for mortgage credit risk, which is something our financial system badly needs.<sup>2</sup>

Our reform proposal continues toward an end state with a deep and liquid market for mortgage credit risk. In fact, the hallmark of our proposal is the creation of a vibrant credit market managed by regulated credit-enhancement entities, most of which would operate as mortgage guarantors and reinsurers. We propose establishing a backstop Mortgage Insurance Fund managed by the government as a catastrophic risk pool funded by the participants in (that is, beneficiaries of) the housing finance system.

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<sup>2</sup> For additional background on the steps taken to date and those still needed to fully develop a market for mortgage credit risk, see Edward J. DeMarco, “(Re-)Creating a Market for Mortgage Credit Risk,” October 28, 2015; <http://www.milkeninstitute.org/publications/view/748>.

Fees would be levied on the industry to prefund the MIF, and any later use of taxpayer money to add to the fund would be repaid by industry assessments. This is similar to how the deposit insurance funds operated by the FDIC protect insured depositors today.

Up to this point, our proposal is similar to numerous legislative, industry, and think tank proposals that have circulated in recent years. But it parts ways with many of them by relying on an existing federal corporation—the Government National Mortgage Association (Ginnie Mae)—rather than creating one or more new federal entities to accomplish its goals.<sup>3</sup>

Ginnie Mae is a government corporation within the Department of Housing and Urban Development. It does exactly what we just described, except it does it for mortgages whose credit risk is guaranteed by FHA, VA, or other federal programs, not by private capital. We believe that using Ginnie Mae's platform and world-recognized nameplate as a U.S. government backstop guarantor of MBS, but with private capital in front, provides an easy transition that accomplishes the goals described above. Getting there will require amending Ginnie's charter, the charters of Fannie and Freddie, and the FHFA charter, but it does not require creating any new federal program, corporation, or agency. Moreover, many of the participants in the housing finance system envisioned in our proposal already exist; there is no need to rely on entry by unknown future firms. Such entry and competition is supported (even encouraged) in our model, to the benefit of both taxpayers, through increased safety and reduced systemic risk, and future homeowners, through lower mortgage costs.

In the remainder of this paper, we outline how we propose amending these three sets of charters to create a smooth path to a new secondary mortgage market that allows access for all lenders and a reliable and stable supply of capital to fund mortgages across the country.

## **Step One: Amendments to the GSE Charters**

We begin by asking: What is to become of these two entities, Fannie Mae and Freddie Mac, which currently operate on government life support but largely keep the conventional mortgage market functioning? After all, the life support was put in place in recognition of the importance of not upsetting the roughly \$5 trillion segment of the mortgage market served by these two enormous enterprises. Transition to a new system must account for the current operations of these two companies and the many lenders and mortgage servicers that rely on them.

Yet we strongly believe that a new system must open the door to competitive forces and to a mortgage market that is more holistically responsible for the performance of the loans originated. Ensuring that lenders had skin in the game (that is, had their own capital at risk in their lending decisions) was a key objective of the Dodd-Frank financial regulatory reform bill, but it has been effectively eviscerated by

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<sup>3</sup> We are not the first ones to propose using Ginnie Mae as the centerpiece of housing finance reform. Others who have proposed a central role for Ginnie Mae include the Delaney-Carney-Himes bill (<https://delaney.house.gov/news/press-releases/delaney-carney-himes-file-housing-finance-reform-legislation-to-protect-30-year>); Robert Couch and Joe Murin (<http://www.housingwire.com/articles/14005-former-ginnie-mae-execs-submit-gse-reform-plans>); Gary Acosta, Joe Murin and Gary Park (<http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/gary-acosta-jim-park-and-joe-murin-future-gses-ginnie-mae-20-solution>); and Andy Davidson ([https://www.ad-co.com/analytics\\_docs/GSERoundtableSummary\\_2015.pdf](https://www.ad-co.com/analytics_docs/GSERoundtableSummary_2015.pdf)).

decisions taken by the various regulators. We change this. Achieving these policy objectives puts us on a path toward a more stable housing market.

With these goals in mind, we set to analyzing how the crucial functions the GSEs perform can be preserved while the system moves toward sounder footing through reforms.

To begin, we propose that the new system preserve a place for the entities reconstituted from Fannie and Freddie but that the reconstituted entities lose the special privileges of their GSE charters (including their protected status as the gatekeepers of all mortgage credit risk). The reconstituted firms would have to compete and survive in a marketplace open to disruption and competitive forces. We also believe that their lenders should have oversight of their operations and skin in the game to protect against losses.

In this section, we outline the charter changes that would allow Fannie and Freddie to continue performing many of the business functions they have performed for decades, but without many of the special privileges that took them off course. We also seek to eliminate the conflicting mandates to serve shareholders as publicly traded companies, serve lenders as the only two outlets for securitization, and serve the public interest through their congressional charters.

The GSEs, in our view, should become credit risk syndicators that take on credit risk from their lenders, sell it to investors through credit risk transfer, and help drive the market to innovate and evolve. And the lenders that utilize these enterprises should have a stake in their management and performance. And we believe that no matter what we do with Fannie and Freddie, they should NOT be the entire market for mortgage credit risk in this country. They should operate in a competitive marketplace. And, of course, they will need capital beyond CRT to operate safely.

Getting there involves, one, changing Fannie and Freddie's ownership structure; two, requiring the use of risk transfer; and three, leveraging an already-built government security to allow new entrants into the market.

### **Mutualization**

If we are keeping Fannie and Freddie, albeit in a new market where they must compete (more on this in the next section), someone needs to own them. Someone needs to provide entity-level capital to ensure their operations.

A critical failing of the pre-2008 setup was that, because they were publicly traded companies, the GSEs—despite having a mandate to lead and serve the primary mortgage market—had an overriding fiduciary duty to their shareholders to maximize their ability to make money.

Mutualization, an ownership structure that allows the GSEs to be capitalized and owned collectively by their seller-servicers, avoids the challenges of other ownership models.

This is not a new idea. There are some very helpful precedents that demonstrate the viability and benefits of this model. In fact, it is the ownership model employed by the Federal Home Loan Banks

(FHLBs). In the FHLB structure, members purchase shares and have collective oversight of the FHLBs. The onus to keep the enterprises solvent is on those who use them—the originators.

The mutual ownership model is common in the insurance industry as well, including among such giants as State Farm and New York Life.

Credit unions, too, are mutual, and the U.S. has a long history of mutual savings and loans.

One of the world’s largest investment companies, Vanguard, is a mutual, as is a new and innovative municipal bond insurer, Build America Mutual, formed in 2012.

There is much to borrow from this model, and we believe the ownership structure aligns incentives in a way that can minimize the desire to “chase market share,” as the GSEs did in the mid-2000s.

By transforming Fannie and Freddie from GSEs into mutually owned and operated insurers, lenders that are familiar with selling loans to Fannie and Freddie will have the choice to continue to do so. But to align incentives properly, these lenders will become the owners of the mutual.

Moreover, the charters would not be exclusive. Lenders could be members at either, both, or neither mutual.

The mutual ownership structure aligns incentives on credit risk, meaning that both the loan originators and the credit enhancers have direct exposure to credit risk and each will want to carefully monitor market conditions generally and the quality of loan production across the members of the mutuals. Importantly, the mutual approach achieves what Dodd-Frank sought to accomplish—skin in the game for lenders and securitizers—but failed to achieve because of the way the regulations were written.

This type of structure achieves one very important policy goal: alignment of incentives throughout the system. If this alignment had been in place before the crisis, the incentive to simply sell all risk to the GSEs without care for loan quality—as in accuracy of underwriting—would not have been so prevalent. And when we talk about underwriting quality here, this is our primary focus. It is not just credit score or loan-to-value (LTV) ratio, but accuracy of documentation and the avoidance of carelessness with the underwriting process.

When the originators themselves have a stake in the performance of Fannie and Freddie, the incentive to ensure high-quality underwriting can be maintained. The FHFA would have strong regulatory oversight to make sure of this, as it does now with both the GSEs and the Home Loan Banks. The collective pressure of an industry with a stake in the performance of the loans it originates is also helpful.

Another benefit of the mutual structure is that it rewards the lender-owners for producing good-quality mortgages. In technical terms, the lenders can “monetize” the value of producing performing mortgages. This may prove especially beneficial to community lenders as compared with the old model. In the old model, Fannie and Freddie shareholders captured the economic benefit of good lending, whereas lenders had no economic incentive to be better underwriters than the next guy. Community lenders often argued that they knew their lending markets better than the national players but the GSE

secondary market did not reward them for that. In fact, community lenders typically received less for their mortgages when selling them to Fannie and Freddie because the national players were rewarded for volume. A mutual ownership structure helps to shift this dynamic.

Going a step further, if community lenders conclude that the Fannie and Freddie mutuals are not serving their needs, and in particular are not monitoring and responding to poor underwriting by other members of the mutual, they can form a new mutual. And so a small lender-only mutual would allow them to benefit from the quality of loans they produce while not having to worry about achieving sufficient scale for liquidity, since the Ginnie program does that for them.

Another benefit to mutualization of Fannie and Freddie, in addition to bringing in a steady and dedicated source of capital from lenders, is the institution of a cultural change at the enterprises, in particular, the managerial focus. No longer would the enterprises see their primary mission as maximizing returns for common shareholders. The owners of the reconstituted Fannie and Freddie would want—need, actually—them to be steady, responsible, and reliable sources of credit enhancement.

Again, this is nothing new. Indeed, it has a back-to-the-future element to it since Freddie Mac was first formed as a mutual in 1970 and remained so until the late 1980s. Even Fannie Mae used to require its seller-servicers to invest in Fannie Mae shares.

Following our approach, the services Fannie and Freddie provide today would continue to be available to lenders. And the work they have done in the past few years to develop credit risk transfers would continue, so that the mutuals would not warehouse mortgage credit risk as in the old model but instead would syndicate it across private-capital market investors.

As for governance and ownership rules, we propose starting with the ownership rules of the FHLBs. Essentially, each seller-servicer for the newly created mutuals would purchase shares in the mutual commensurate to the amount of loans they deliver, but to prevent any one large lender from dominating managerial decisions, *no lender would have voting rights that exceed the average ownership share size*. There would be a cap on voting rights that levels the playing field. Again, this has worked for the FHLBs and certainly can for the new Fannie and Freddie and any approved new entrants.<sup>4</sup>

## Capital

To get to a set of well-capitalized enterprises, we propose that the newly mutualized Fannie and Freddie have capital that comes in two forms.

First, they would be required to do credit risk transfer on a substantial portion of their originations, as they are doing today. A reasonable target for the amount of first-loss risk that they would have to shed could be the first 300 to 500 basis points of loss on roughly 80 percent to 90 percent of annual

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<sup>4</sup> The details of the governance structure and the development of a transition timeline are beyond the scope of this paper. We expect that the FHFA would initiate a process for licensing or chartering credit-enhancement mutuals, including the reconstituted Fannie and Freddie, before the conservatorships are ended. We also expect that issues involving the initial seed capital and allocation of that capital would be resolved before the conservatorships ended in order to ensure there is no gap in service.

production.<sup>5</sup> Once again, this is essentially what the GSEs are doing today, so the impact on rates would be practically nonexistent.

Credit risk transfer can serve as the primary source of “capital” in a reformed Fannie and Freddie and among new entrants. The reconstituted enterprises would be given, under FHFA authority, the ability to choose the types and structures of these CRT transactions, leveraging what works best, and would be required to report regularly to the FHFA on the structures being used. But they would be syndicators of risk, not massive takers and holders of mortgage credit risk.<sup>6</sup>

Still, even with CRT, someone needs to own entity-level capital, which would provide a secondary capital support after the credit risk transfer. The entity-level capital supplied by the member-owners of the mutual forms the basis of this. It allows the mutual to continue to operate in a solvent way even if credit losses exceed those absorbed by CRT structures. This is how many other mutuals operate.

If CRT amounts to roughly 400 basis points of capital, or 4 percent, we believe the owners of the mutual should be required to put up somewhere around 2 percent of additional enterprise capital in the companies. If losses were to mount—exceeding the capacity of CRT and the ownership shares, putting solvency at risk—the owners would be required, under FHFA direction, to add more capital to keep the mutual functioning and solvent. One way to avoid pro-cyclicality with this type of structure would be for the industry to overcapitalize the mutual in times of economic and lending growth, so that in times of stress the capital base could shrink a bit while staying above 2 percent.

Finally, as we will discuss in a later section, a Mortgage Insurance Fund, paid for by the industry, would backstop the system in a time of extreme stress.

### **Cash Windows**

An important role played by Fannie and Freddie today is their ability to purchase loans for cash from smaller lenders and then securitize these loans into an MBS themselves. In our proposal, the new mutualized enterprises will have cash windows where they can continue to purchase, for cash, loans from these small lenders.

One criticism we have of the cash window is that at times it may not perform as much quality assurance of the underwriting as it should. This is still a concern we have. However, when this process is carried out under a mutual ownership arrangement, the lender-owners will have an incentive to ensure that the quality-control mechanisms in place are robust. In fact, we would expect the mutual to have a robust, lender-level reporting system so that the member-owners would see and appropriately respond to lenders selling poorly performing loans to the mutual. Though it’s beyond the scope of this paper to outline, there are several ways in which the incentive alignment can be tightened further by creating a

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<sup>5</sup> We put this range, and a target of 90 percent, as opposed to a hard first-loss amount on 100 percent of production so that credit risk transfer can flex and bow as credit markets fluctuate during the normal course of each year’s market cycles. By allowing a bit of flexibility, the mutuals can be responsive to the market’s dynamics and smooth in any changes in credit market interest rates.

<sup>6</sup> The mutual can decide—indeed, may be wise to decide—to require individual lenders to invest in the CRT structure of any pool to which they contribute loans.

form of risk retention where lenders retain some specific credit exposure to the loans they sell to the mutual.

Finally, we propose that the new mutualized enterprises be not only a source of credit enhancement, but that on loans they purchase for cash—and only on loans they purchase for cash—they be allowed to be the issuer of a government-backed MBS.

This is an important point. For the largest lenders, the reconstituted mutuals would operate more like mortgage insurers, guaranteeing the principal and interest payments to the MBS holder, but they would not be the issuer of the security (more on this in the next section, in our explanation of the Ginnie Mae program). This change substantially lessens their role in the market, but it would affect only their largest seller-servicers, because we would not change how they operate the cash windows for their smaller lending partners. That is because the enterprises would be permitted to be aggregators and issuers of a government-backed security *for loans they purchase from smaller and mid-sized lenders for cash*.

In order to make sure that no large lenders tried to arbitrage this execution option, we would propose that these rules come with a stipulation that no lender can represent more than 5 percent of either enterprise's cash window volume. So, by definition, the cash window would be for smaller and mid-sized lenders almost exclusively. Larger lenders would need to be the issuers of their own securities, thus giving them more of an incentive to underwrite high-quality production and be directly responsible for that production.

This would give smaller and mid-sized lenders three choices in how they access the MBS market. One, they could issue securities themselves (which many already are doing through the Ginnie II program, as Ginnie Mae allows single-loan pools and has roughly 400 issuers already). Second, small lenders could sell loans for cash to either new mutual, and the mutual would issue the MBS on their behalf. Third, small lenders could create their own new mutual or could sell their loans to any of the existing 400-plus Ginnie Mae issuers (again, as already happens today).

It would be sensible to assume that other new entrants that emerge to compete with the reconstituted Fannie and Freddie—which we will discuss in the next section—would want, and should have, the same capability to purchase loans for cash and issue a government-backed security.

## **Step Two: Amendments to the Ginnie Mae Charter**

### ***Ginnie Mae Refresher***

Ginnie Mae, the Government National Mortgage Association, is one of the most important yet least understood pillars of today's housing finance system. This section provides a brief review of how the agency functions.

Ginnie Mae traces its roots to the establishment of the Federal Housing Administration in 1934 and the Federal National Mortgage Association (Fannie Mae) in 1938. Congress established Ginnie Mae as a government corporation within the Department of Housing and Urban Development in 1968 by splitting Fannie Mae into two entities: Ginnie Mae and a "privatized" Fannie Mae. Ginnie Mae's role was to

guarantee mortgage-backed securities composed of mortgages insured or guaranteed by federal entities such as the FHA and VA. In fact, Ginnie Mae issued the first mortgage-backed security (MBS).

Today the total outstanding amount of Ginnie-guaranteed MBS is \$1.7 trillion. Without much fanfare, Ginnie recently surpassed Freddie Mac in terms of total MBS outstanding and is now second only to Fannie Mae, which has \$2.8 trillion outstanding. In 2016, according to some estimates, Ginnie Mae may surpass even Fannie. In short, the Ginnie Mae program is growing fast.

Moreover, Ginnie Mae MBS trades at a premium to both Fannie and Freddie MBS in the market, meaning the price for Ginnie-backed bonds is higher and therefore the yield of these bonds is lower. This can translate into a lower mortgage rate for the homebuyer. This premium in Ginnie MBS stems from the global acceptance of the security, including by central banks from Tokyo to the European Union, and, most importantly, the fact that Ginnie Mae MBS provides a full-faith-and-credit government guarantee that is well known by the investor community.

One thing that is different about Ginnie vis-a-vis Fannie and Freddie, apart from the fact that the platform already has a government wrap, is that Ginnie Mae is *not the issuer* of the MBS when a Ginnie security is created. The seller of the loans—the originator—is the issuer of a Ginnie security. The issuer actually purchases insurance from Ginnie Mae, which protects the Ginnie MBS investor in case of issuer default.

An issuer can be anyone approved by Ginnie Mae, and *today there are more than 400 approved Ginnie issuers*. Compare this with estimates that the GSEs have roughly 100 institutions that securitize MBS through them (all others using the cash window). The Ginnie Mae program is substantially more small-lender-friendly than those of the GSEs.

Ginnie issuers range from community banks to the largest megabanks and also include nonbanks of all sizes. The volume of loans issued also varies greatly by issuer, from some that may issue a pool containing just a single loan (note: Ginnie’s platform can handle single-loan securities) to large nonbank lenders such as Quicken, or megabanks such as Wells Fargo and Chase that may issue pools with thousands of loans in a given month.<sup>7</sup>

To issue a Ginnie Mae MBS, the originator needs to do three things: obtain credit enhancement—essentially a form of mortgage insurance—from an approved source; maintain capital and liquidity standards for issuers set by Ginnie Mae; and retain responsibility for loan servicing. The Ginnie charter is very short and straightforward. Amending it as we propose would be relatively easy.

The first requirement for issuing a Ginnie security—the purchase of credit enhancement for the loans securitized into a Ginnie MBS—must adhere to the rules of the Ginnie Mae charter. Today’s charter approves three main forms of credit enhancement provided by government agencies.<sup>8</sup> These agencies

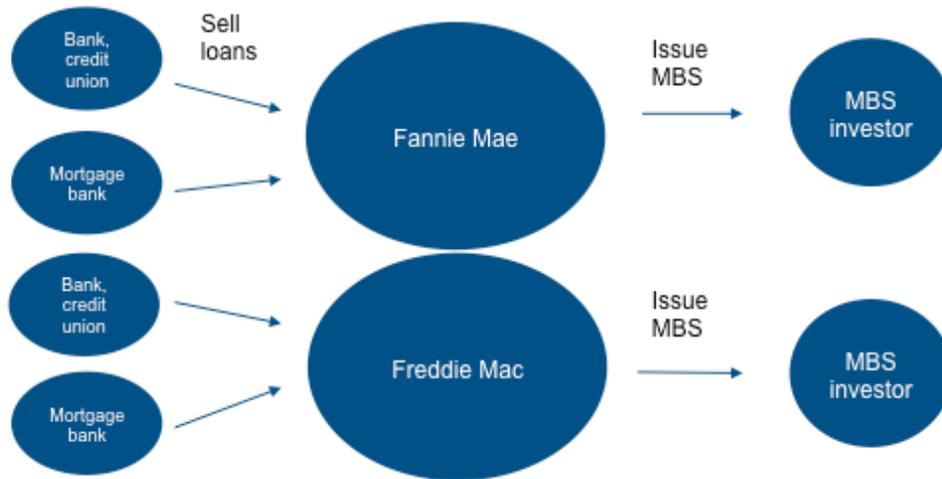
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<sup>7</sup> <http://www.nationalmortgagenews.com/news/secondary/nonbank-lenders-usurp-banks-as-ginnie-mbs-leaders-1051188-1.html>.

<sup>8</sup> [http://www.ginniemae.gov/about\\_us/what\\_we\\_do/Documents/statutes.pdf](http://www.ginniemae.gov/about_us/what_we_do/Documents/statutes.pdf).

are: FHA insurance, VA insurance, and USDA insurance. Having obtained the credit enhancement, the issuer then purchases MBS issuer insurance from Ginnie Mae.

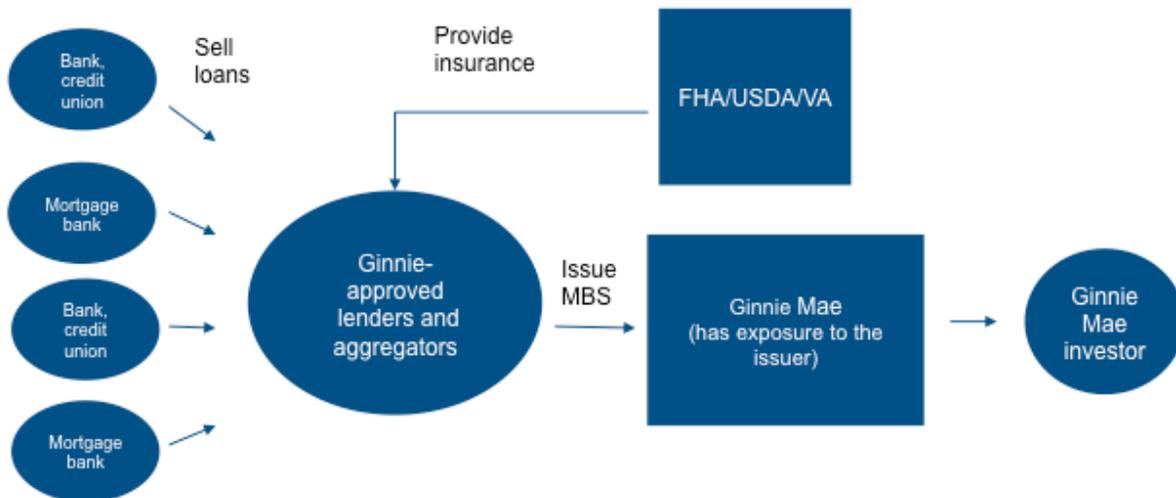
## Fannie/Freddie system today



### Key features of this system

- Fannie and Freddie retain credit risk; they distribute much of it via credit risk transfer (CRT). Historically, they kept all of it.
- Fannie and Freddie’s mortgage-backed securities (MBS) investors do not worry about credit risk. In the past this was due to implied guarantee; today it is due to preferred stock purchase agreements.

## Ginnie system today



### Key features of this system

- Ginnie has exposure to the issuer (and indirectly to the guarantors).
- FHA/USDA/VA provide loan-level credit enhancement on Ginnie pools.
- Ginnie Mae MBS investor gets full-faith-and-credit MBS.

## Credit Enhancement

It is the purchase of credit enhancement that we focus on for reform, while also focusing on changes to Ginnie Mae's charter that would allow it to have greater authority, flexibility, and resources to fulfill its mission of issuer oversight.

Credit enhancement is any form of credit protection that pays a defined amount to the lender or investor in the event of a borrower default. Credit enhancement is essentially just insurance provided against credit losses from borrower defaults. There are many ways to credit-enhance a mortgage or pool of mortgages.

Fannie and Freddie today, through their guarantee of loans that go into their MBS, are the world's largest credit enhancers. The FHA, at more than \$1 trillion in size, is enormous as well. *The core of our proposal is to amend the Ginnie charter to allow new private entrants to come into this market for credit enhancement and compete.*

By allowing new entrants besides the FHA to take on this risk as credit enhancers ahead of Ginnie, we can leverage the Ginnie MBS multi-issuer platform while creating a vibrant private market for mortgage credit risk.

Like other forms of insurance, credit enhancement spreads risk. In a pool of 100 loans, for example, default models can project that two are likely to default, but we don't know which two they will be. Models and historical data also tell us which ones are more (or less) likely to default; that is, which loans are more (or less) risky than others in the pool.

For the purposes of the remainder of this paper, we see two forms of credit enhancement being used to capitalize the credit enhancers in the system.

First, we would allow the reconstituted Fannie and Freddie to be credit enhancers under a new ownership structure, as discussed earlier in this paper. But we would let them do so in a competitive environment where other new entrants—once approved and regulated by the FHFA—are allowed as well. In general one can think of these firms and the reconstituted Fannie and Freddie as “guarantors” or even “mortgage insurers.” Yet we are careful with the word “insurance” for two reasons: One, these would not be state-chartered insurance companies, and two, they would be responsible for the entire risk of the outstanding unpaid principal balance of each loan they guarantee. This is different than traditional mortgage insurance, which insures only a portion of the loan balance. Also, it is conceivable that the private credit enhancement we propose would work with less than 100 percent of the possible credit risk being transferred. For that to work, however, the residual credit risk, which would remain with the MBS issuer, would need to be sufficiently remote to avoid the loans being consolidated back on the books of the issuer.<sup>9</sup>

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<sup>9</sup> With 100 percent of the risk transferred, the catastrophic risk ends up with the Mortgage Insurance Fund described later in this paper. With less than 100 percent risk transfer, the catastrophic risk would be distributed across all the issuers. In either event, since we would require all issuers to have skin in the game with regard to credit enhancement via their ownership interest in the credit enhancer, the issuers retain meaningful responsibility for the credit quality of the loans they securitize.

Second, both the new Fannie and Freddie and any new entrants would be required to transfer credit risk to the market, making them part conduits of mortgage credit risk and part holders of mortgage credit risk. This is largely the operational structure of the GSEs today, as they have slowly been transforming themselves into credit syndicators via the credit risk transfer programs initiated by the FHFA in 2012. This, too, is a form of credit enhancement, and we would advocate that the new system build off this work and these programs.

### *Leveraging Ginnie for Reform*

One step that policymakers can and should take, either on its own or as part of comprehensive reform, is to give Ginnie Mae greater control over its budget and resources. As already noted, the primary risk Ginnie faces is that one of its issuers will be unable to make good on remittance of scheduled principal and interest payments. Typically, a Ginnie issuer will rely on the credit insurance offered by the FHA or another federal program to ensure that it can make bondholders whole in the event of borrower defaults. But until the loan modification process or the foreclosure is completed, the issuer must advance payments to investors each month.

Historically, when banks and thrifts dominated Ginnie Mae issuance, Ginnie Mae's risk was largely based on an issuer losing access to liquidity or running out of capital due to unrelated events (such as losses on its other banking activities). Today, however, with complex and costly loss-mitigation requirements, lengthy foreclosure timelines, and the rise of nonbank servicers that do not have access to banks' traditional funding sources (such as deposits, FHLB advances, and the Federal Reserve), the risk of an issuer liquidity crisis is something Ginnie has become more focused on. Ginnie Mae still charges its issuers 6 basis points in rate for this insurance, which, on a \$1.7 trillion MBS base, generates \$1 billion per year.

However, with Ginnie operating as part of HUD, these funds are deposited at Treasury and then directed elsewhere via the appropriations process. Ginnie, for example, has been unable to spend \$4 million on additional oversight resources requested to examine the nonbank issuers using its platform. Ginnie has been seeking, even if not as part of broader reform, the authority to spend a small fraction of the money it brings in on a process for more robust oversight and stress testing of its issuers. But because it does not control its own revenues, it cannot spend these resources, even though they are meager relative to the funds Ginnie generates for the Treasury. At a minimum, this dynamic needs to change.

When coupled with the power of using the Ginnie platform as a bridge to a new housing market structure, however, a few changes to Ginnie can be enormously significant.

The first steps we propose—which come with the support of past Ginnie Mae presidents<sup>10</sup>—is to amend the Ginnie Mae charter to bring it out of HUD and allow it to set its own budget outside of the appropriations process. Operating a multitrillion-dollar financial guarantee and securitization business requires financial sophistication, and Ginnie Mae should be treated like the bank regulatory agencies in terms of employee hiring and compensation rules.

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<sup>10</sup> <http://www.scotsmanguide.com/News/2016/05/Ginnie-Mae-should-be-separated-from-HUD--former-Ginnie-president-says/>.

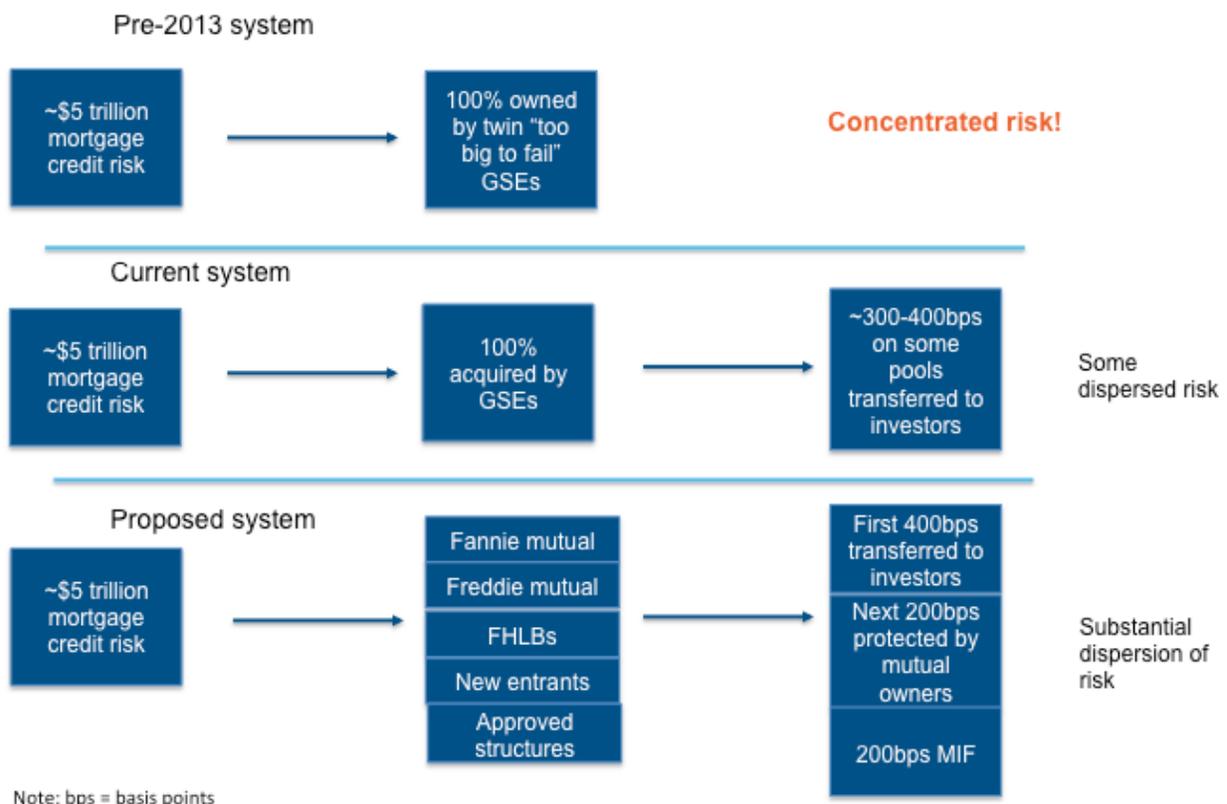
Once Ginnie is given enhanced budget autonomy from outside of HUD, it is a relatively easy step to allow it to be the platform that creates a bridge to a new and more competitive, dynamic mortgage credit system.

### New Credit Enhancers

Assuming Ginnie Mae as the platform and the source of the government guarantee in creating a rates instrument for the mortgage market, how does this model deal with credit risk? Today, loans in Ginnie pools receive credit enhancement from one of several government guarantee programs (chiefly FHA and VA). We propose that an additional source of credit enhancement be permitted: private credit enhancement provided by a licensed credit enhancer that raises private capital to support each individual pool and that has additional entity-level capital dedicated to backstop the credit guarantee.

This is what all reform proposals have sought: dispersing \$5 trillion of mortgage credit risk that traditionally has been entirely concentrated on the balance sheets of Fannie Mae and Freddie Mac.

## History of mortgage credit risk



This figure shows the before, current, and after view of what we are trying to achieve. Before 2013, Fannie and Freddie retained all the credit risk on all the mortgages they bought or securitized, beyond any loan-level mortgage insurance on low-down-payment mortgages. As we learned in 2008, this was a perfect recipe for systemic risk.

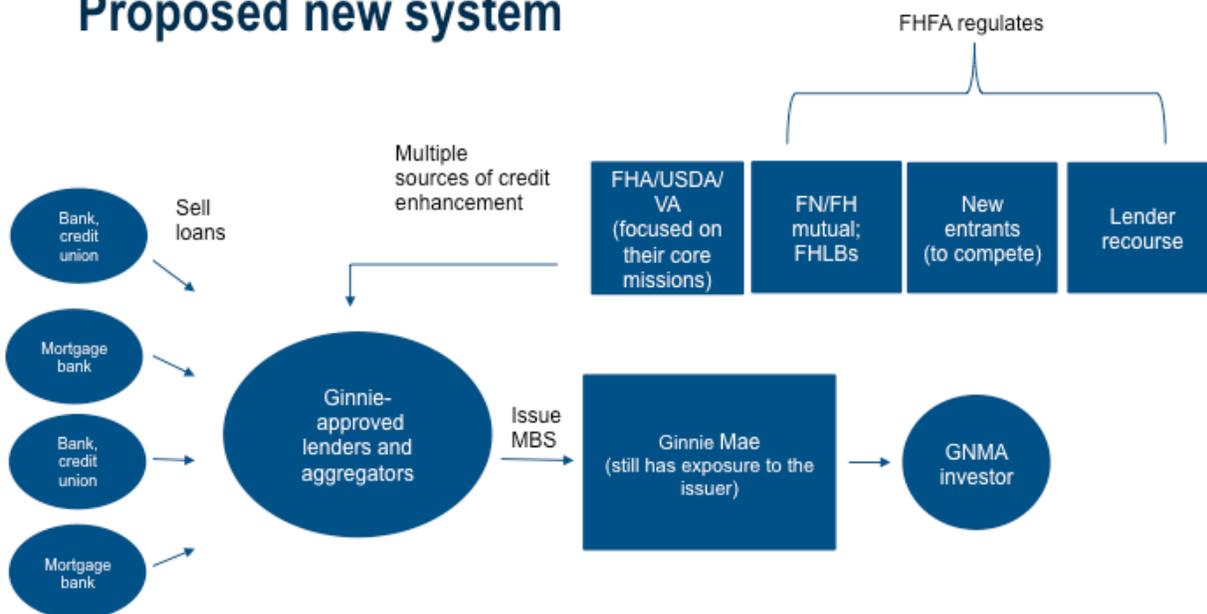
Beginning in 2013, Fannie and Freddie’s conservator (one of this paper’s co-authors) directed them to begin selling a portion of this risk exposure to private investors. Using a variety of transaction types, Fannie and Freddie have been selling off an increasing amount of this exposure. (A technical term for this is that Fannie and Freddie have been syndicating the risk, that is, buying it all up and then distributing [syndicating] a large portion of it to other investors.)

In the new system we are proposing, this risk syndication would be broadened to cover all securitized loan pools and could be performed by a wide array of market participants, not just the reconstituted Fannie and Freddie. This opens the field to allow new participants into the credit-enhancement market for mortgages. We do not want Fannie and Freddie, even if reconstituted as mutuals, to be the only players in the marketplace.

In short, credit enhancement on Ginnie Mae MBS would come from a range of entities, all of which would use—as the GSEs do today—credit risk transfer market transactions in which the cash for potential loan losses is provided upfront and held in reserve to offset losses and help build a vibrant market for mortgage credit risk.

By opening the Ginnie charter to other approved entrants to provide credit enhancement, we can end today’s reliance on a limited set of government-run entities to provide this mortgage insurance. We can also greatly reduce systemic risk, because the \$5 trillion in mortgage credit risk that is today concentrated on Fannie Mae and Freddie Mac’s balance sheets would be more widely dispersed across the financial system, where it can be reviewed by countless investors and analysts and be priced and traded in transparent markets. Most importantly, within well-defined parameters that ensure equitable and national access to the system, we can allow for disruption and innovation in the secondary mortgage market from new competitors.

## Proposed new system



### Key features of this system

- Ginnie still has exposure to the issuer.
- Credit enhancement could be provided by FHA, VA, USDA, Fannie, or Freddie mutuals, FHLBs, new entrants (such as a new mutual). FHFA has regulatory oversight of all nongovernment participants.
- Ginnie Mae MBS investor still gets full-faith-and-credit MBS.

If policymakers use the Ginnie Mae platform, what we describe—ushering in a new market for mortgage credit risk—would not be very difficult to do mechanically. Ginnie already has in place a system that verifies that an issuer has obtained approved credit enhancement from one of the sources permitted in its current charter. By adding additional options to this query, it would verify the source of the credit enhancement, including from licensed nongovernment sources.

Say, for example and for simplicity's sake, that the Ginnie charter was amended to allow a credit enhancement obtained by a reconstituted Fannie Mae to count as an eligible credit enhancement. Ginnie could amend its system to establish a process to check with Fannie that loans being brought for Ginnie securitization had in fact obtained credit enhancement from Fannie. In this way, a loan credit-enhanced by Fannie could access a full-faith-and-credit-guaranteed MBS.

Alternatively, and more interestingly, assume that a new entrant had a viable idea to disrupt and improve how mortgage credit risk-taking and syndication could work. This is not entirely theoretical. In fact, some traditional mortgage insurers are evolving their business models to be innovative developers of credit risk syndication today. By allowing them to compete in this market, we can not only enhance customer service but can responsibly (e.g., subject to qualified mortgage [QM] rules) expand access to homeownership opportunities.

New entrants would simply apply to the FHFA to be an approved credit enhancer for loans issued off the Ginnie Mae platform. Once they were approved, Ginnie would add them to its process for checking for the existence of suitable credit enhancement.

Then, a Ginnie issuer putting together a pool of mortgages to be securitized through Ginnie could purchase credit enhancement from the newly approved entrant while simultaneously purchasing a Ginnie wrap on the MBS. By allowing new entrants, we would more broadly disperse credit risk and do so in a way that relies on private capital and allows for new competition. The issuer would still be responsible for ensuring timely payments to investors, as it is today.

In this type of transaction—that is, when an issuer obtains credit enhancement from a new entrant—there would be no involvement whatsoever from Fannie or Freddie. By definition, then, opening the Ginnie charter would reduce the size of Fannie, Freddie, and potentially the FHA.

### *How Would It Work, Mechanically?*

We propose that Congress amend the Ginnie charter to allow new providers of credit enhancement. To establish rules that provide market stability, we would require that Ginnie and the FHFA jointly approve any new form of credit enhancement and establish clear policy criteria for any new entrant to be approved.

On the latter—the outline of policy criteria necessary for any new entrant to be approved—we advocate that the Ginnie charter be amended to state the following:

New entrants may be approved as credit enhancers as part of a Ginnie Mae securitization so long as they:

- a. Can show a dedication to mortgage credit through the economic cycle, nationally, serving all markets
- b. Can offer an ownership structure, such as a mutual or co-op, that gives loan originators a meaningful level of ownership in the performance of loans they credit-enhance through a new entrant
- c. Can syndicate a substantial portion of their first-loss credit risk to the markets, as the GSEs are doing today
- d. Are well-capitalized and can pass stringent regulatory criteria to ensure capital and liquidity in severely stressed economic environments
- e. Improve access to credit for low-income borrowers
- f. Have management with extensive mortgage finance and mortgage credit risk management experience
- g. Can structure execution that achieves true sale accounting for the originator
- h. Can enhance execution options for small lenders and are prohibited from giving pricing for volume discounts to large lenders

By establishing these policy criteria in legislation (that is, by adding them to the Ginnie Mae charter) but allowing Ginnie and the FHFA to jointly approve nongovernment sources of credit enhancement, we would allow the market to replace taxpayer capital with private capital, be more dynamic, and evolve with shifting market dynamics, within these defined policy parameters.

### *What If a Ginnie Issuer Wanted to Credit-Enhance Its Own Production?*

One of the interesting possibilities with using the Ginnie Mae platform is that an issuer could, in theory, decide that it wanted to credit-enhance its own loans. We think this is a scenario that should be permitted.

For example, say a lender or an aggregator that was a Ginnie Mae issuer wanted to issue securities off the Ginnie platform, but instead of obtaining credit enhancement from a separate entity it wanted to structure and syndicate the credit risk itself. This is very much akin to some of the so-called front-end credit risk transfer deals the GSEs are doing today (e.g., PennyMac and Redwood). We think this should be allowed so long as the following requirements are met:

- a. The issuer would need to syndicate the same amount of risk as we are requiring the new Fannie and Freddie and any new entrants to shed: 300 to 500 basis points of first loss.
- b. The issuer would need to produce “representative sample” pools so that it could not do this on only one risk cohort of loans. This can also be thought of as “no cherry picking.” Again, there is precedent for this in some of the front-end CRT deals being done today.
- c. The issuer—and this is where we add a new dimension—would need to retain on its balance sheet a mezzanine ownership tranche in the pools, in order to retain the skin-in-the-game framework we propose for the mutuals. This would mean that a Ginnie issuer would sell a piece of, say, zero to 400 basis points of first loss but then retain on its balance sheet the next 200 basis points of loss to backstop the first-loss pieces. In this way the issuers still have an incentive to produce well-underwritten pools, because they share some of the loss risk. And we would achieve capital equivalency across all execution types.

It is unclear whether such a market would grow and evolve, but we would not rule out the possibility, and it could offer some substantial benefits to creating a wide and deep credit risk market. It may very well be that the market would be willing to purchase only the first 400 basis points of loss if the issuer (which is also the servicer) also held a portion of the first-loss risk so that the market trusted the firm's commitment to service the loans properly. This has been a dynamic that has plagued the attempts at revitalizing the private-label securities (PLS) market. But we would leave that to the originator and market participants to work out. So long as the capital is ahead of Ginnie, so much the better if the issuer holds a piece of first-loss risk.

As long as these pools achieve all of the policy objectives behind the mutual—national and diverse loans, ability to serve low-income markets, skin in the game for the issuer, and collateralized credit risk transfer ahead of the Ginnie wrap—we believe it could be a helpful and additive part of the mix of options for lenders.

### *Community Banks, Thrifts, and Credit Unions*

A common concern in housing finance reform debates is that any system that is not based on Fannie and Freddie as they exist today would leave community banks, other small depository institutions such as savings and loans and credit unions, and even mid-sized lenders and nonbank lenders out in the cold. The framework we propose has many advantages for these smaller players.

A critical feature of the Ginnie Mae platform is that smaller issuers get the same pricing as larger issuers, thereby benefiting directly from the scale provided by large issuers. Relative to the Fannie-Freddie model, smaller players that do not want to be issuers themselves have hundreds of issuers to sell to, not just two.

In the framework proposed in this paper, smaller lenders would still have the Fannie and Freddie cash windows available, with the added benefit of being part-owners of these mutual. As mutuals, the reconstituted Fannie and Freddie would serve their member-owners with much improved incentive alignment relative to the old system.

Even with all of that, additional opportunities remain that would benefit smaller lenders. A community bank credit risk syndication actually exists today. It is the original Mortgage Partnership Finance (MPF) program of the FHLBs. That program syndicates credit risk among community banks while separately financing the long-term mortgages. Moreover, this example also points to another important competitor in the framework we propose: the Federal Home Loan Banks. The FHLBs are already Ginnie-approved issuers and the MPF and related programs have a built-in infrastructure to help community banks, savings and loans, and credit unions aggregate mortgages, syndicate credit risk, and access the secondary mortgage market (through Ginnie and Fannie and Freddie). We believe that the FHLBs are a logical competitive alternative to the mutualized Fannie and Freddie and to other credit enhancement options. They already have the mutual structure, community bank focus, and the mortgage market

expertise to build upon in providing a competitive alternative in the market structure we propose here.<sup>11</sup>

### *Why Ginnie and Not the FMIC/CSP?*

Those who have followed or participated in housing finance reform discussions the past several years know that in 2012, the FHFA (at the time led by one of this paper's co-authors) initiated a common securitization platform (CSP) to replace Fannie and Freddie's respective proprietary securitization systems. The CSP was folded into most subsequent reform proposals and is still being developed today. In the Johnson-Crapo bill and other proposals, the CSP was to be the securitization infrastructure on which MBS guaranteed by a new federal agency—the Federal Mortgage Insurance Corporation (FMIC)—would be issued.

While this remains a viable policy alternative, concurrent developments at Ginnie Mae, in our view, now provide a better alternative. At about the same time work on the CSP began, Ginnie Mae initiated an overhaul of its securitization platform. This work has produced an operating, multi-issuer single security wrapped by a federal guarantee—the same outcome as envisioned in these various legislative proposals for the CSP. Moreover, the technology is already tested, the pipes are working, and the loan-level disclosures envisioned when the CSP was announced are already a reality in the Ginnie model.

In addition, the Ginnie platform is already built to accept multiple forms of credit enhancement and can be adapted to add more. The CSP, on the other hand, has been focused on serving just Fannie and Freddie the past two years and is still more than a year from being fully operational just for those enterprises alone.

It is entirely possible, in fact likely, that the CSP could be used to enrich the current Ginnie Mae platform.<sup>12</sup> Thus, if Congress were to pursue using the Ginnie Mae framework as we are recommending, we believe it should direct Ginnie Mae and the FHFA to collaborate on a detailed due-diligence review of the CSP to determine its optimal use in this new framework, whether that means adapting it into the Ginnie platform or distributing some or all of its components to the new credit-enhancement mutuals, or some other path. In any event, since the CSP is a joint asset of the two conservatorships, every effort should be made to maximize the return on this investment for the benefit of the future secondary mortgage market.

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<sup>11</sup> The evolving composition of housing finance players suggests other policy questions involving the FHLBs, such as whether mortgage REITs or others should be offered membership in the system. The FHLBs were created more than 80 years ago to provide a source of liquidity for savings and loans, which at that time were the principal source of financing mortgages. Since then much has changed. Securitization that produces a mortgage credit market separate from the funding market, and the increasing dominance of nonbank loan originators, servicers, and holders of mortgage-related assets suggests some policy rethinking about the purpose and role of the FHLBs in the 21<sup>st</sup> century mortgage market. The FHLBs are a different type of government-sponsored enterprise than Fannie and Freddie but are GSEs nonetheless. Whether changes or expansion in their membership and purpose are warranted requires careful policy consideration and is not a step to take lightly. In any event, an important operational issue in housing finance reform, including with this framework, is the availability and stability of funding for warehousing mortgage production and for payment advances to MBS holders. We will explore that issue further in a later paper.

<sup>12</sup> For FHFA's most recent status report on the common securitization platform, see <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Details-Plans-and-Timelines-for-the-SS-and-CSP.aspx>.

Small lenders benefit from a Ginnie model in particular because of how the Ginnie pools work. Under Ginnie II, which is by far the dominant Ginnie program, all loans delivered in a given month for securitization in a Ginnie security are aggregated together and issued under the same alphanumeric code. Thus small lenders that are approved Ginnie issuers have access to the securitization market and benefit from the scale provided by other, larger issuers whose pools are all aggregated together by Ginnie each month. This is a benefit unique to the Ginnie Mae platform. It is designed to be a playing field equalizer.

While there still may be benefits to be drawn from the CSP development, the Ginnie platform is operational today. Moreover, it comes with a government catastrophic guarantee of the security already built in. Thus, there is no need to create and develop a new federal entity.

Finally, and importantly, the security is already highly liquid. We can build off a \$1.7 trillion government-backed Ginnie MBS market that is widely accepted across the globe.

## Common securitization platform vs. Ginnie Mae

	Ginnie Mae	CSP	Merged entity
Has a government wrap	YES	NO	YES
Can handle single-loan pools	YES	NO	YES
Has sufficient resources	NO	YES	YES
Is easily opened to new entrants	YES	?	YES

To summarize, we propose two main changes to the Ginnie Mae charter:

1. Move Ginnie Mae out of HUD and give it control of its finances
2. Allow credit enhancement approved by Ginnie and the FHFA that is outside FHA, VA, or USDA insurance

### Step Three: Amendments to the FHFA Charter

#### *Consolidated Housing Finance Regulator*

Crucial to the reforms we propose is a strong central regulator, which we believe should be the Federal Housing Finance Agency. The FHFA currently has oversight authority for the GSEs and the Federal Home Loan Banks. We propose giving it additional authority to approve new forms of credit enhancement and new entrants into the credit-enhancement market.

The FHFA would be tasked with overseeing the capital adequacy and other requirements imposed on all credit enhancers (including on the reconstituted Fannie and Freddie); all acceptable forms of credit enhancement; and any new credit-enhancer entrants. In particular, we envision the FHFA having express authority with regard to prudential oversight of any credit enhancers in the system, as these firms' very existence and business operations are entirely dependent on this national market that would run through Ginnie Mae. This oversight authority is already well within the FHFA's core competency.

By bringing all Ginnie credit enhancers under the FHFA regulatory umbrella, the FHFA can get a consolidated, bird's-eye view of nearly the entire housing market and ensure that it is safely and soundly fulfilling the needs of American homeowners. It would also lend its supervisory expertise to assist Ginnie Mae with Ginnie's key challenge today: how to set, monitor, and enforce prudential guidelines on Ginnie issuers, particularly nonbank issuers (since bank issuers are already supervised by a primary federal banking agency).

The amendments to the FHFA charter would not be onerous or long. They would simply need to add resources and personnel to oversee the approval of new entrants and new forms of credit enhancement. In many ways, this is simply an extension of the work the FHFA is doing now in exploring different types of credit risk transfer.

Ultimately, the reforms we are proposing could largely be looked at as credit risk transfers that do not rely on negotiations with Fannie or Freddie. An originator will have multiple options for what it can do with the credit risk on the loans it originates. It could sell it to the FHA, to the Fannie or Freddie mutual, or to a newly approved mutual, or it could credit-enhance its own pools and retain some ownership in their performance.

Credit enhancers, in turn, could syndicate some of the risk by purchasing deeper mortgage insurance from an approved insurer; they could raise cash collateral from investors in first-loss credit risk, such as an insurer or REIT; or they could find new and innovative ways of fostering a mortgage credit risk market. As long as they retain some skin in the game, we would allow the market for these structures to evolve and grow.

The FHFA's job would be to ensure that all of these entities have adequate capital and operational capacity, just as it does now for more than \$5 trillion in credit risk managed by the GSEs. And the FHFA would be charged with ensuring economic comparability across all forms of credit enhancement and credit enhancers so as to mitigate capital arbitrage games that were inherent in the pre-crisis GSE model.

### ***Mortgage Insurance Fund***

Finally, we propose amending the FHFA charter to manage a backstop Mortgage Insurance Fund (MIF). The FHFA should collect a small fee, on the order of 5 to 10 basis points per loan, from all approved secondary market credit enhancers, including the GSE mutuals. Over time this fund should be built up to roughly 1 percent to 2 percent of total outstanding production; it would serve as a backstop to allow the FHFA to facilitate the winding down and transfer of the book of business from any credit enhancer facing insolvency.

Like the FDIC's Deposit Insurance Fund, the MIF would allow for the orderly disposition of a book of business. As with the FDIC, MIF premiums would build a reserve that taxpayers would backstop. In the event the MIF was depleted, ongoing MIF premiums would repay taxpayers and rebuild the MIF reserve.

An additional possible feature warrants consideration. The housing finance reform proposal advanced by Reps. Delaney, Democrat John Carney of Delaware, and Democrat Jim Himes of Connecticut also proposed relying on Ginnie Mae rather than creating a new federal guarantor agency. Importantly, their proposal also called on Ginnie Mae to reinsure a portion of its catastrophic risk with the private reinsurance market. That idea could be applied to our model as well, and the MIF could be required to reinsure a portion of its risk and use the market price from that reinsurance to help inform the fee it charges for its backstop.

## Operational Questions for Our Proposal

Below is a summary of a few of the operational questions our proposal raises.

### *1. What happens if an issuer becomes insolvent?*

Today Ginnie Mae faces the principal risk of an issuer becoming cash-flow-insolvent and therefore unable to remit principal and interest to the Ginnie MBS holder. We propose no change to this structure. In the case of an issuer failure, Ginnie Mae, as it does today, would initiate its well-understood process for transferring the issuer's book of business to another, well-capitalized Ginnie issuer.

### *2. What happens if a credit enhancer becomes insolvent?*

Similar to how Ginnie resolves an issuer, the FHFA would resolve/transfer the book of business of a failed credit enhancer. If, for example, the Fannie mutual was near insolvency, the FHFA would initiate a process of attempting to recapitalize it through its owners. If it became clear that such recapitalization, for whatever reason, was not viable, the FHFA, by leveraging its MIF, would initiate a process of transferring this book of business as well. It is for this reason that having multiple credit enhancers that leverage multiple forms of capital and credit risk transfer makes sense. It allows for the failure of individual credit enhancers, with the cost of those failures being borne by the housing finance industry. Any draining of the MIF by an insolvent credit enhancer would require its recapitalization by remaining secondary market participants once market conditions settled down and recapitalization was viable.

### *3. What happens if a borrower goes into default?*

In the case of borrower defaults, the Ginnie Mae issuer would first pursue loss-mitigation efforts to avoid default (as set forth in Consumer Financial Protection Bureau servicing requirements). It would then initiate a process of filing an insurance claim with the entity that provides the insurance and credit enhancement. This is perfectly analogous to the process today at the FHA. In a Ginnie securitization today, when a borrower goes into default, the issuer continues to remit P&I until such time as it can file an insurance claim with the FHA. Under our proposed system, this process would be the same, regardless of whether the credit enhancement was purchased from the Fannie or Freddie mutual or a new entrant. The issuer pays the Ginnie MBS holder par for the loan on a predetermined schedule, as done today.

### *4. What happens to the Common Securitization Platform?*

We propose Ginnie Mae be directed to undertake a due diligence review of the CSP. If it finds a value proposition for its operations, Ginnie Mae should be authorized to purchase the CSP on a cost-plus basis. If Ginnie rejects such a purchase, then the FHFA, as conservator, in consultation with the Treasury

Department under the existing Treasury support agreements, would offer the CSP for sale to the market, perhaps as a utility for any licensed credit enhancer, including the Fannie and Freddie mutual. A third option is to sell the platform to support a revitalized private-label market.

5. *What is the process for ending the conservatorships of the GSEs?*

Once Fannie and Freddie are ready to be recapitalized as mutuals by their lenders, and a new governance structure is established, they would be put through receivership and emerge as new lender-owned credit enhancers. The FHFA, as receiver, could contract with these new entities to manage the runoff of the conservatorship books of business.

At the time the conservatorships are ended, all outstanding Fannie and Freddie securities, including their MBS, would remain backed by the Treasury support agreements. An option that could be explored is whether to permit the resecuritization of some (the most recently issued MBS, say), or perhaps all, of these securities through Ginnie.

## Summary of Taxpayer Capital Protection

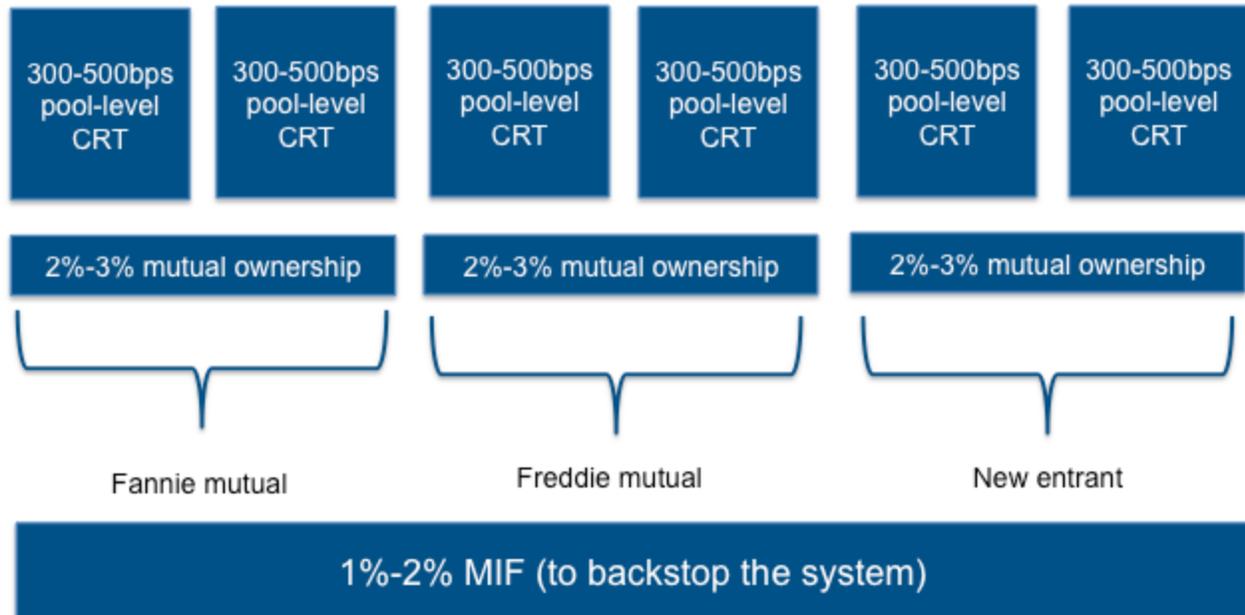
To summarize taxpayer protections, the capital under our structure comes from three sources:

1. The new Fannie and Freddie mutuals and any new approved credit enhancers would be required to shed credit risk via credit risk transfers as required by the FHFA and Ginnie Mae to achieve the required level of credit enhancement; 400 basis points is a sensible starting point for discussion, as it is the amount of risk-based capital a community bank must hold for mortgages in its portfolio.
2. Behind this, each credit enhancer would have an operating capital cushion made up of share ownership from its members. The FHFA would be mandated to design capital rules for all market participants substantially similar to the total amount of capital required of the Fannie and Freddie mutuals from the combination of CRT and lender-owned shares. Something in the area of 2 percent seems to make sense. The FHFA would conduct regular stress tests, similar to those conducted by the Federal Reserve, of all approved credit enhancers, while Ginnie Mae would conduct regular stress testing of its approved issuers. Any capital inadequacy under adverse conditions would require the raising of additional capital.
3. Finally, an MIF of roughly 1 percent to 2 percent would be created to backstop the entire system and manage an orderly resolution of any entity that faces insolvency.

In total, the system will have an approximately 8 percent unexpected-loss absorption capacity plus substantially enhanced regulatory oversight in front of the Ginnie Mae backstop guarantee.

We would also propose that the FHFA be given the mandate to explore the market for catastrophic risk reinsurance of the MIF.

# Sources of capital



Note: bps = basis points

## Impact on Interest Rates

Any housing finance reform proposal will of course prompt the question: What does this do to borrower interest rates? We believe that our approach will have a minimal impact on rates, for a few reasons.

First, the primary source of capital that we are “bringing” into the system comes via credit risk transfer securities. This roughly 400 basis points of capital will be the first line of defense against losses. But requiring this should not have much of an impact on today’s borrowing costs, if any at all, for one simple reason: Guarantee fees (g-fees) charged by Fannie and Freddie today already account for this cost of capital. Fannie and Freddie, under FHFA direction, have already initiated a process of comparing the cost of mortgage credit implied by the market price for CRT securities with the g-fees they charge, and the FHFA believes these costs are already priced in. So the first line of capital protection we require does not impact rates.

Second, the next line of defense against loss in our system is the entity-level capital required of the mutual. But this is a mezzanine tranche of risk, not a first-loss source of capital—it kicks in only after CRT is exhausted—so the yield hurdle is well below 10 percent. Additionally, these shares are mutual ownership shares. Their primary purpose is not to generate substantial profit for the end investor but to keep credit enhancers solvent and operational for the lending industry. But for the sake of argument, let’s say this capital buffer is 2 percent and, even under conservative standards, required a 10 percent yield. This would increase rates by just 20 basis points. (Note that this analysis ignores the target return Fannie and Freddie already earn on their holding of the residual risk they retain today, so this overstates the expected market impact.)

Finally, an MIF backstops the system, and the FHFA would have control over the amount it charges to capitalize this. Let's say for the sake of argument that this fee was initially set at 10 basis points.

Putting it together, then, we would have a 20-basis-point increase in pricing from entity capital plus 10 basis points for the MIF.

However, we are moving from a Fannie and Freddie MBS to a Ginnie MBS. Ginnie MBS trades at a lower yield because it has an explicit full-faith-and-credit backing and favorable Basel accord capital treatment. This migration actually reduces secondary market rates on the order of 15 basis points simply because of this dynamic. The increase in liquidity from having one security could make this rate reduction even more significant.

Thus, even looking at this conservatively, we are talking about a total of a 15-basis-point increase in borrowing rates (20 + 10 – 15) phased in over many years. Again, this to us is a conservative estimate and assumes a required return on ownership shares that is higher than would likely be required. We believe this is a price worth paying to put the issue of housing reform to bed, as the alternative—relying on full taxpayer support and a potential future crisis—comes with many unpredictable variables.

## Summary of Benefits Under Our Approach

### *Competition in Loan Origination and Credit Risk Syndication*

The first and most obvious source of new competition would be a new mutual if the origination industry cared to apply to create one. Mortgage insurers and mortgage real estate investment trusts (REITs) are other possible sources of competition. If, for example, the primary mortgage market felt that Fannie and Freddie as mutuals were not being as responsive to the needs of the market as they could be, it could petition the FHFA to allow it to charter a new corporation. The same rules would apply for both capital and access for this new entity. It is possible the industry would not feel the need to do this, as it would have ownership control of the enterprises. But it is one way that we could allow a new entrant or two to break any duopolistic tendencies of simply having two mega enterprises acting as large mortgage insurers. As noted earlier, a crucial component of our proposal is that Fannie and Freddie must operate in a competitive environment where a disruptor can enter and improve the market. Mortgage insurers and mortgage REITs could be sources of such disruption. Of course, they would need to satisfy the same requirements as any other mutual credit enhancer.

The framework we propose promotes competition in loan origination, credit risk syndication, and mortgage servicing. With loan origination, the thousands of mortgage lenders operating today would all be able to originate and sell loans into a well-functioning secondary market. Moreover, they would have several vehicles to access that market, not the limited set they now have.

Credit risk would shift from two balance sheets to perhaps countless balance sheets, thereby greatly reducing systemic risk of the failure of a single entity—Fannie and Freddie are perhaps the single greatest examples of “too big to fail” in the entire American financial system—and creating a meaningful private-capital market function for measuring and evaluating mortgage credit risk. The existence of

several hundred Ginnie Mae issuers ensures numerous options for mortgage servicing and for the management/oversight of such servicing through master servicing responsibilities of the issuers.

### *Alignment of Incentives*

In some sense, the idea of mutualization borrows from the intellectual undercurrents of risk retention, which were initially a hallmark of some of the mortgage reforms in Dodd-Frank but have since been modified to accommodate a marketplace where mortgage credit risk-taking from the private sector is still lacking. By requiring lenders to own shares in the mutuals Fannie and Freddie or any new entrants or to retain a piece of risk in any credit enhancement they do themselves, we are offering a very simple way to achieve many of the goals of credit risk retention—namely, the industry has a stake in the quality of the loans it produces.

This is a critical element to ensuring that g-fee-for-volume dynamics that produce low-quality, poorly underwritten loans no longer distort the housing system.

By aligning incentives throughout the housing finance ecosystem, we can have greater faith that the market will not race to the bottom and simply pass along risk like a hot potato, ultimately landing at the feet of the taxpayer. And because the market for credit risk would be a private market, disputes among market participants regarding loan performance, reps and warrants, and so on would be resolved using normal contractual and judicial mechanisms and would not be subject to False Claims Act liability.

### *Simple Transition*

These reforms would take only a few years to accomplish. As we have pointed out, we are simply proposing changes to charters that build efficiently off a market structure that is well known and globally accepted. And Ginnie Mae already has the operational capacity to adopt these changes in relatively short order.

## **Affordability Strip**

In order to enhance the sustainability of America’s housing system, we propose that all private-credit-enhanced securitization that goes through Ginnie Mae require a 10-basis-point affordability strip, which would begin to be collected once the MIF was sufficiently capitalized.

These funds would be used to fund a housing trust fund with strong congressional oversight. In our forthcoming third paper, we will advocate for these funds to be used to augment the buildup of equity for first-time, low-income homeowners; to help improve access to affordable rentals; for counseling programs that have a proven track record of lowering the risks of default and improving borrower education; to improve access to shelter for some of America’s most vulnerable families; and other purposes.

## **Conclusion**

We propose three steps to achieving lasting housing finance reform. One, amend the GSE charters to make them mutuals owned and operated by their seller-servicers. Two, amend the Ginnie Mae charter to make it an independent agency with control of its own budget and the ability to accept forms of

credit enhancement other than just FHA/VA/USDA. And three, amend the FHFA charter to give it authority over the entire system and approve the entry of new competitors to take on mortgage credit risk in a regulated manner, while managing a Mortgage Insurance Fund that backstops the entire system as a final buffer against emergency congressional bailouts.

Reform need not elude policymakers any longer. Perhaps trapped by thinking that reform must either return, hat in hand, to the failed model or represent a rebuilding of the entire housing market infrastructure from the ground up, we have made little legislative progress since 2008. But by instead building on what we know works and by simply amending the charters of the legs that hold up today's housing finance stool, we can substantially reduce taxpayer risk, improve market efficiency, keep mortgage rates affordable for all Americans, introduce competition, and finally buy peace on this thorny and important public policy issue.

## Next Steps

The complexity of the mortgage securitization process, including the complicated interplay of capital rules, accounting rules, and tax rules, plus liquidity requirements and contracts to ensure satisfaction of those requirements, mean that the proposal here likely leaves unanswered some important operational questions. Moreover, the framework we outlined here may be unclear as regards certain features of the marketplace we envision. Thus we look forward to receiving comments from market participants and analysts on the framework and we expect to respond to key questions and issues raised by such feedback.

Our first paper made the case for why reform is needed, and this paper sets forth our vision for a competitive market structure for the secondary mortgage market. Key issues still remain. In subsequent papers we will address housing policy, including multifamily lending, underwriting standards, and fundamental policy questions regarding affordable rental opportunities and promoting home ownership, especially for lower- and moderate-income families, first-time homebuyers, and loans that may be more challenging to make. We will also address an array of topics that fall under the general heading of the "plumbing" of our housing finance system, that is, the legal and operational infrastructure affecting everyday lending decisions and credit availability.

## About the Authors

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Ed DeMarco is a senior fellow in residence at the Milken Institute. Prior to that, he was a 28-year civil servant, culminating with his role as acting director of the Federal Housing Finance Agency from September 2009 to January 2014. There he dealt with the challenges of managing the mega-institutions Fannie Mae and Freddie Mac. DeMarco crafted the 2012 FHFA Strategic Plan for Enterprise Conservatorships and the associated scorecards and set into motion the credit risk transfer and common securitization initiatives that underpin administrative efforts today.

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