

# Re-engineering the Mortgage Finance System: Charting a Future Course for the Secondary Market



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## ***Introduction***

From its beginnings in 1932, the U.S. system of support for housing finance has been rooted in a unique blend of public and private participation. A combination of direct federal subsidies, tax expenditures<sup>1</sup>, explicit guarantees, support for publicly-chartered, privately-owned corporations, and broad regulatory oversight of the primary markets carried the system for more than 70 years through a variety of economic and political circumstances.

The financial crisis that began in 2007 with the collapse of the subprime market has thrown many of the assumptions underlying this structure into doubt. The government's duty to stand behind large institutions whose size created systemic risks has been redefined. The roles of public and private interests in creating, stewarding and ultimately resolving financial investments for housing have shifted dramatically. While new roles have been adopted to meet shifting circumstances, views of how a long-term system should be structured in the wake of the meltdown are still evolving.

This paper reviews the history of Fannie Mae and Freddie Mac, examines the essential functions these entities performed, and analyzes a variety of potential new structures that might be adopted after their takeover by the federal government. It starts from the assumption that the federal government has an affirmative and important role to play in shaping and supporting a national housing policy. It endorses the importance of a broad policy framework that includes homeownership and rental housing, and single-

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<sup>1</sup> Tax support of homeownership began in 1913 with the inclusion of mortgage interest as a deductible expense for income tax purposes.

family as well as multifamily properties. It supports the notion that the national government has an abiding interest in assuring a steady flow of credit into the mortgage market. The paper assumes also that the current crisis has conclusively demonstrated the need for national regulation of mortgage origination and securitization practices to eliminate the worst predations that set off the conflagration that has overtaken the mortgage market.

This paper assumes that access to long-term, fixed-rate mortgages for both rental and homeownership is a specific and valuable goal of public policy. The presence of these instruments in the U.S. mortgage market has been one of its distinguishing characteristics compared with others around the globe. This distinction is the result of a series of federal policies, most notably FHA and the government sponsored housing enterprises (GSEs).

There are many potential ways these objectives – long-term, fixed-rate financing in a stable system that provides financing through varying economic conditions for both homeownership and rental housing, in both single-family and in multifamily properties – could be achieved. There are five fundamental questions that any new system of housing finance must be able to answer:

- Will it support the availability of long-term, fixed rate mortgages for consumers?
- Will it offer access to capital by as wide a variety of institutions as possible, from small community banks to large money center institutions?
- Will it foster and spread innovation in mortgage products to insure that helpful and sound new products can be made available widely in the marketplace?

- Will it fulfill a significant duty to serve underserved populations and communities?
- Will it provide financing both for affordable single family homeownership and rental housing?<sup>2</sup>

This paper reviews a number of potential structures and analyzes their relative and respective strengths and weaknesses. The paper also assesses the value of the different functions – securitization and portfolio lending – that have characterized the GSEs’ business models. Whatever one of these models, or combination of these models, emerges from the wreckage of the “old financial order,” it seems certain that the future mortgage finance system will look very different from the one that emerged from the last great financial crisis in 1934.

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<sup>2</sup> A set of “Principles to Guide Development and Regulation of a Renewed Mortgage Finance System” adopted by the Mortgage Finance Working Group, a collaboration of organizations and individuals sponsored by the Center for American Progress, is attached as Appendix II and provides a fuller description of these issues.

# *Part I: Government's role in secondary markets*

## *History*

The federal government has been directly involved in the mortgage system since 1932, when it created the Federal Home Loan Bank (FHLB) system as a cooperative owned by home lenders. The FHLB system provides advances to home lenders that are secured by collateral, usually mortgages, so that they can raise funds to make more loans.

But government involvement really ramped up with the creation of the Federal Housing Administration (FHA) in 1934 to guarantee long term, self amortizing, fixed rate mortgages. This breakthrough concept was designed to make homeownership more accessible to working families, and to jumpstart a banking system still prostrate in the Great Depression. The National Housing Act of 1934 also included the offer of a government charter for private investors to purchase these loans from lenders in order to create a more liquid market. None appeared. Still faced with a liquidity problem for the new long-term mortgage loans insured by FHA, Congress in 1938 chartered the Federal National Mortgage Association (Fannie Mae) as a government agency to fill this role

Fannie Mae issued government bonds and used the proceeds to buy mortgages insured by FHA. After World War II, it also bought VA mortgages. It operated as a portfolio lender, much like a giant thrift.

Since Fannie Mae's founding, and the establishment within the FHLB system of the Federal Home Loan Mortgage Corporation (Freddie Mac) in 1968, the nature and size of the government's engagement in secondary market financing has evolved. Fannie Mae morphed from a government agency to a cooperatively owned company in 1954 when sellers of loans to the agency were required to buy stock to support it. In 1968 the government sold its ownership share of the company and converted it to a public company owned by shareholders. The Government National Mortgage Association (Ginnie Mae) was left behind in HUD to continue providing liquidity for government insured mortgages, while Fannie Mae began providing that service for loans without government backing. Freddie Mac was sold to private investors itself in 1989 following the collapse of the savings and loan industry when that decade's real estate financing bubble burst.

All three agencies shifted in the 1980's from buying and holding mortgages to securitization of mortgage assets. By bundling mortgages from many originators and creating securities backed by the cash flows from these mortgages, the three significantly expanded the market for housing capital.

Ginnie Mae's securities are guaranteed by the federal government's full faith and credit. Fannie and Freddie's are guaranteed by the companies, who charge originators higher fees than Ginnie to cover their credit risk. Both Fannie and Freddie continued to operate portfolios, as well, growing them exponentially during the 90's and early 2000's through acquiring whole loans as well as their own and others' mortgage backed securities.

The 1990's and early 2000's confronted both companies with both unprecedented growth and profitability for their shareholders, and a series of crises that ultimately led their regulator, the Federal Housing Finance Agency (FHFA) to force them both into conservatorship, where they remain as of this writing.

Appendix 1 of this paper provides a more detailed history of the companies. What's important about this brief background is the long and evolutionary history of federal support for a liquid mortgage market. This support originated to insure that capital would be available for long term, fixed rate mortgages. In the years since their founding, Fannie Mae and Freddie Mac became the principal source of such financing, and Congress added additional expectations and responsibilities, especially in supporting affordable housing for low and moderate income borrowers and historically underserved communities. In the wake of the mortgage finance crisis that began in 2007, they have returned to this historic role, together providing more than 60 percent of the funding for home loans, primarily long term, fixed rate loans, while operating under tight supervision of their regulator under their continuing conservatorship.

## ***Systemic Benefits***

Fannie Mae and Freddie Mac were chartered by Congress with a balanced set of incentives, benefits and restrictions designed to enable them to carry out key functions in the housing finance system. The central purposes of their charter were to insure that the mortgage market remained robust and stable. The key roles the companies have played historically can be summarized as follows:

- Liquidity
- Standardization
- Access/Affordability
- Innovation

### ***Liquidity***

Liquidity is the secondary market's primary function. Without some outlet for mortgage loans, primary market lenders soon would bump against their own capital limitations and either raise mortgage prices or cut back on mortgage lending. Congress in 1934 expected private investors to provide this outlet. But when they did not, it acted to create Fannie Mae to provide this function. Since then, Fannie and Freddie became the dominant, but not the only liquidity providers in this market.

The portfolios and guarantees offered by the GSEs transformed mortgages from illiquid instruments into highly liquid ones. MBS's bundle many individual transactions that are difficult for investors to evaluate into smaller numbers of much larger transactions where standardization of terms and the pooling of risk make it possible for investors to purchase anticipated streams of income from the underlying mortgages. Historically, these pools have performed very well and with a high degree of transparency in their pricing, an important factor in their very deep liquidity. The GSE portfolios enable investors seeking an even more dependable rate of return to buy GSE debt that is used in turn to provide liquidity for whole loans and securities financed by entities with deep industry and market knowledge that other investors lack.

Fannie and Freddie's special charters helped them gain and maintain this dominance for most of their history. In turn they created a market where liquidity could be extended across a range of mortgage maturities, including 30 year terms, and where that liquidity could be depended on through different market cycles. The benefits and limitations of their charters have meant that they were able to raise capital for mortgages when the capital markets were closed to others, as in the 1998 credit crunch following the near-collapse of Long Term Capital Management and Russia's debt crisis.

As the asset bubble of the mid-2000's proved, private capital markets can and will flood into any asset class when the price and return looks positive. Private capital's rapid growth in mortgage finance in the early 2000's suggests that GSEs are not the only way to attract funding into the sector. But the current crisis also has demonstrated that unregulated private capital will withdraw from an asset class when returns decline. Despite more than \$1 trillion provided in Federal Reserve and Treasury liquidity to stabilize

lending at large banks, only Fannie Mae, Freddie Mac and Ginnie Mae are providing liquidity for home mortgages in 2009, more than two years after the mortgage credit meltdown began. And only the Fed's intervention through the purchase of nearly \$1 trillion in GSE securities has kept capital flowing at reasonable rates.<sup>3</sup>

Another aspect of the liquidity function is to provide credit throughout the United States, an implied obligation of the GSE charter that private capital providers would not have. Again, some have argued that experience in the private markets for other securitized asset classes suggests that these markets have matured sufficiently to provide this credit broadly without government support.

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<sup>3</sup> In 2008 mortgage rates began to climb as credit tightened, reaching more than 6.5 percent for a 30 year loan by late in the year. After the Fed's announcement to buy up to \$1.25 trillion in MBS the rate immediately began to decline, reaching less than 5 percent by April, 2009 when the Fed purchases had reached \$350 billion.

### ***Standardization***

Part of the value of having constant liquidity providers in the market is to stabilize it. The depth of the GSEs' market for both debt to fuel their portfolios and through their MBS has underpinned the broader market for decades. Having a constant bid in the market for long term, fixed rate and other mortgages has evened out the booms and busts in capital that characterize other secondary markets. Mortgage rates have remained remarkably stable, influenced more by the price of 10 year Treasury notes than by fluctuations in deposits or other market interest rates. Again, during the 1998 debt crisis when the cost of credit soared or when that credit disappeared altogether in other asset classes, the GSEs' market role provided smooth and stable access to credit. When other portfolio lenders had reached the limits of their appetite for holding adjustable rate or fixed rate mortgages on their own balance sheets, they could find ready buyers in Fannie and Freddie, enabling them to shift assets without disrupting their credit operations.

One of the key drivers of this stability is the GSEs' role as standard setters in the mortgage markets. Because all originators of mortgage loans would like to retain the possibility of selling most of these assets into the secondary market, the GSEs' underwriting standards are the de facto standard for the entire market. The GSEs' model also has commoditized mortgages and consequently driven their costs to consumers to very low levels. The GSE bid in the market for products they will finance assures any originator that there is an outlet for their loan, at a predictable price based on a future delivery. This certainty reduces the market advantage that very large firms with access to large amounts of deposits or other forms of capital would have over smaller firms with less flexible balance sheets.

This dominance has been criticized for impeding more rapid adoption of new products and underwriting practices, particularly with regard to products aimed at low and moderate income buyers that were developed by lenders to satisfy CRA or other obligations. But the flip side of this coin is that once the GSEs adopt a practice it can spread very rapidly throughout the entire market. New practices that otherwise would require the development of expertise and risk management in many places now can be implemented through developing it in only two.

The depth and breadth of this role has been a source of tension and controversy. The companies' basic role in establishing standards for "plain vanilla" long term mortgages is so pervasive and of such long duration that it has become widely accepted. But as the mortgage market grew in complexity and mortgage products began to proliferate, the role of the GSEs became increasingly complicated. Some critics resisted a government sponsored role in markets that were developing through private capital sources. The standardization and scale that the GSEs brought to markets they entered, combined with their market power and ability to offer products to any lender approved to do business with them meant that new product innovations could be spread rapidly through the system. When they did so, the margins that market innovators enjoyed with a new, exclusive product were reduced considerably.

Another concern was whether they should extend their imprimatur to products that were designed for less credit-worthy borrowers, had non-traditional features, and might be less advantageous or economical for consumers. This became particularly important as subprime and Alt-A lending grew in the non-GSE marketplace beginning in the late 1990's. Some argued strongly that the GSEs should expand into these new markets and impose standards and discipline to curb abuses. Others argued that these markets were

well served by private capital. Using the GSEs' chartered advantages to "compete" with private securities issuers was inappropriate, critics argued.

Fannie Mae in 2000 issued the first clear restrictions on abusive lending practices in the subprime market, and Freddie Mac followed suit. These did have the effect of drying up liquidity for loans that had these features, but the move engendered growing opposition to their expansion into these markets, and worries that the companies were enabling originators to market products with higher costs to consumers rather than focusing on their tried and true products. HUD in its housing goals regulations issued that year also proscribed loans with certain terms and conditions from counting when calculating the companies' housing goals performance. These proscriptions largely mirrored the steps Fannie and Freddie already had announced.

How far a federally supported secondary market should extend into and establish standards for new or potentially riskier mortgages is an important and unresolved issue. Fannie's and Freddie's moves to standardize the terms for lending to borrowers with damaged credit did eliminate a series of pernicious practices and improve the standards for subprime mortgage lending significantly, even among loans they did not finance. But their subsequent financings based on these guidelines ultimately exposed them to much greater risk and losses than their historical products. Similarly, the companies' expansion into low downpayment lending, even to borrowers with good credit, exposed them to higher losses when the housing asset bubble collapsed in 2007. When low downpayments and lower borrower credit quality, measured by FICO scores, were combined, these risks multiplied, and so did the losses in such loans suffered by both since 2007.

### ***Access and Affordability***

Both companies have had special obligations to assure access to mortgage credit and enhance affordability since their founding. Especially after Fannie was privatized, this has been an increasingly important focus of their charters. The responsibility to enhance lending to low and moderate income borrowers was clarified in the 1968 legislation that privatized Fannie Mae. This was extended and made much more explicit in the 1992 legislation that created OFHEO and charged HUD with the companies' "mission" regulation through, among other ways, establishment and enforcement of specific housing goals for both companies.

The GSEs' role should help enhance mortgage affordability in a number of different ways. One is through the lower operating and capital costs that their charter privileges afforded them. Another is through their ability to commoditize and standardize mortgages through their market power and underwriting guidelines. When the features of a standard mortgage are the same no matter who is offering it in the private market, its price rapidly converges on the lowest available offer in the market. Competition for customers, market share and volume all conspire in this model to drive mortgage costs down. The wide availability of automated underwriting engines and other e-commerce tools further drives down transaction costs and margins. Finally, the GSEs have eliminated the wide regional variations in the cost of credit that characterized deposit-based home lending before they came to dominate the secondary mortgage market.

The GSEs themselves have argued that affordability is a central benefit of the companies' market role irrespective of any federal mandate. By passing on the financial benefits afforded through their charters, and offering market access to any lender, the companies asserted they were providing significant financial advantages to consumers. GSE opponents have countered that the charters' principle financial benefits were siphoned off by management for their own and shareholders' benefit.<sup>4</sup>

Whether the companies met all of their various stakeholders' expectations in this arena, every serious study of them has agreed that affordability was an objective of their special charters and that whether through regulation, market forces, or management actions some portion of that value was produced.

### *Innovation*

Because they have more information about mortgage loans' performance than any other player, and the broadest available platform from which to introduce new techniques into the marketplace, innovation became a significant role for the GSEs as they developed in the latter decades of the last century. Automated underwriting and mortgage scoring were being developed by others in the 1990's, for instance. But by developing their own platforms geared to their own risk appetites, Fannie and Freddie were able to establish their version of this innovation as the industry standard. GSE automated underwriting enabled smaller lenders to offer consumers the same price benefits of faster processing without having to shoulder the considerable expenses of developing it themselves. This also effectively blocked large lenders from

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<sup>4</sup> . "A comparison of the GSEs' profitability to other firms suggests that GSE benefits enabled Fannie Mae's and Freddie Mac's shareholders to earn increased profits." Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, United States Department of the Treasury, July 11, 1996, p. 42

using their own proprietary systems to force smaller lenders like community banks and credit unions into exclusive and potentially economically disadvantageous relationships in order to access this new technology.<sup>5</sup>

The GSEs also were able to spread innovations from the primary market rapidly throughout the system. Low down payment mortgages and alternative credit underwriting are two examples of this. This enabled more consumers to benefit from these changes, and it helped lower costs by reducing competitive advantages that innovators might otherwise have been able to leverage for their own benefit.

Some market leaders chafed at this role. The 1992 legislation that reformed the GSEs' charter vested in HUD approval authority over new GSE programs and HUD was pressured by other mortgage market actors over the years that followed to use this authority aggressively to prevent so-called "charter creep" from leading the GSEs into new market areas. But other market participants supported it as adding value for consumers. These supporters also included smaller community banks, credit unions and other lenders who saw the GSEs' ability to spread innovations throughout the system as a necessary counterbalance to the growing power of very large banks that emerged from the mergers and acquisitions of the 1980's and 1990's.

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<sup>5</sup> The GSEs' leadership role in establishing automated underwriting and giving it their imprimatur also may have contributed to an over-reliance on such tools by less experienced investors and securities issuers, particularly in the subprime and Alt-A securities markets. These markets' meltdown has amply demonstrated the dangers of too much reliance on models for pricing risk.

## ***Conflicting Roles***

### ***Serving Two Masters***

As private companies with a public charter, the GSEs were designed to balance the responsibility of providing public benefits with generating effective returns for shareholders. Their success or failure to reach the correct balance continues to be a major nexus of the debate over their future. A series of studies in the mid-1990's concluded in various ways that while the GSE structure did provide measurable public benefits in the form of lower interest rates for consumers, some portion of the measurable benefits of their charters was captured by management and by shareholders.<sup>6</sup>

Using private capital to achieve the desired public goals brought market efficiencies to the system. The GSEs' ability to invest in the deep infrastructure and sophisticated executives and managers with the appropriate experience and background needed to support the vast amounts of funding for which they were responsible, to acquire and roll out new technology initiatives, and to attract investment capital into the mortgage market at attractive prices all contributed to that market's success. The growth of homeownership and the escalating need for reliable access to long term financing required participation by

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<sup>6</sup> See, for instance, op cit, US Treasury; Housing Enterprises: Potential Impacts of Severing Government Sponsorship, testimony before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services, House of Representatives, June 12, 1996

private capital to meet market needs. The hybrid structure of the GSEs, with its bundle of benefits and restrictions allowed them to tap into vast pools of global capital by offering competitive returns with a minimum of red tape while relying on their own balance sheets and investor discipline to manage credit risk.

At the same time, the charter privileges they enjoyed prompted Congress to restrict their activities in various ways and to explicitly charge them with responsibilities to devote progressively larger and larger shares of their business to targeted, low and moderate income households and distressed neighborhoods.

Then-Treasury Secretary Henry Paulsen referred directly to the tensions sustained in the charters when announcing the government's seizure of the two companies in September, 2008. "I attribute the need for today's action primarily to the inherent conflict and flawed business model embedded in the GSE structure," Paulsen said in announcing the takeover.<sup>7</sup>

In hearings called to examine the causes of the GSEs' failure, former Fannie Mae CEO Daniel H. Mudd characterized the dilemma of the charter by noting that in the months leading up to the companies' takeover, "We were also balancing our HUD housing goals, our role in the global capital markets, our fiduciary responsibility to our shareholders, and critically, our need to help individual homeowners afford their mortgages, stay in their homes, and avoid unnecessary foreclosures. We sought this balance consistent with a strict interpretation of our Congressional charter."<sup>8</sup> He later asserted that "Events have

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<sup>7</sup> <http://www.ustreas.gov/press/releases/hp1129.htm>, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers, September 7, 2008

<sup>8</sup> During the question and answer period of this hearing, Mudd elaborated: "due to the hybrid nature of the company, a private company with a public mission, that charter, that structure gives rise to a number of challenges that become conflicts that

shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs.”<sup>9</sup> Unfortunately, Mudd offered no better or more specific explanation of how such a new GSE model might be structured.

### ***Meeting Affordable Housing Needs***

Mudd and Paulsen both alluded to the charter expectation that the GSEs should focus on expanding homeownership and rental housing opportunities, especially for underserved households and communities. These obligations were first adopted in the 1968 charter legislation, and were made more explicit in 1992 through housing goals that HUD was authorized to establish and enforce. Unlike obligations that depository lenders have under the Community Reinvestment Act (CRA), or the Federal Home Loan Banks (FHLBs) have under their charters, the GSEs are unique in having annual percent of business goals that are developed using a forecast of future market activity.

The housing goals were reevaluated and recalibrated by HUD roughly every four years beginning in 1994. In 2004 the Bush Administration’s HUD adopted a rule hiking the goals to unprecedented levels, and added new subgoals for home purchase loans that also escalated steeply during the four year period covered by the rule.

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become this very difficult balancing act that you describe between shareholders, homeowners, taxpayers, capital, liquidity, stability, which market to be in.”

<sup>9</sup> <http://oversight.house.gov/documents/20081209103231.pdf>

Current and past managements have suggested that the difficulties both companies faced in meeting these housing goals were partly to blame for their sudden financial reversals.<sup>10</sup> But it is important to recognize that the vast majority of the loans that counted toward the goals were acquired through the standard mortgage products offered in the market. As the goals levels increased, the importance of adding additional units at the margin increased, too. This definitely led both companies to experiment with alternative underwriting approaches and to acquire more seasoned loans with more flexible underwriting. It was one of the expected outcomes of the housing goals regimes.

In the wake of the mortgage market's meltdown, a number of critics have argued that the affordable housing goals signified a kind of unholy alliance between the companies, who were seeking loose oversight over compensation and their portfolios, and politicians, who were seeking favorable treatment for specific constituencies.

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<sup>10</sup> "The problem in the past was the increased requests for expanded affordable housing were made by the administration. No one ever balanced out exactly what that was going to cost. One of the most significant things that's happened is the setting of the affordable housing goals has now been moved to our regulator. So the regulator responsible for looking at safety and soundness is also the one looking at setting the housing goals, and therefore will be able to look at what the costs and risks are of expanding support for affordable home ownership in the context of running a for-profit corporation." Freddie Mac Chairman John Koskinen, Another Leg of Freddie Mac's Long Relay, Washington Post, Aug. 3, 2009 <http://www.washingtonpost.com/wp-dyn/content/article/2009/08/02/AR2009080202016.html>

But until FHFA or the companies themselves publish better and more granular information about the performance of loans that were developed specifically to increase their harvesting of loans that met the housing goals, the assertion that the affordable housing goals were a major driver of the companies' failure in 2008 remains unproven and open to challenge. An examination of the losses in their credit books and incomplete but provocative findings from at least one extensive partnership Fannie Mae managed with Self Help Ventures Fund in North Carolina suggest that these assertions are convenient but not accurate.<sup>11</sup>

Whether or not the HUD housing goals were significant contributors to the companies' financial woes, they are a perfect illustration of the difficulties in establishing measurable ways to assess the GSEs' public benefits. They were originally conceived in 1992 at a time when the Senate Banking Committee described information about the GSEs' actual lending performance as a "vacuum." They were designed to ensure that a meaningful share of the companies' single family and multifamily financings served targeted groups. The goals are limited to mortgage purchases, and until 2008's legislative changes, they gave HUD no discretion or latitude to take into account other activities such as equity investments in affordable housing or special lending programs for community development in assessing their performance.

As the housing market changed in the late 1990's with the rapid growth of subprime lending, growing portions of the goals market were being serviced by lenders who increasingly found ready buyers in Wall Street securitizers. At the same time, the GSEs' mortgage limits were rising (from around \$207,000 in 1996 to nearly \$500,000 in 2006). This meant that increasing amounts of the market from which they drew their

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<sup>11</sup> Where Has All The Money Gone?, [http://www.zigasassociates.com/blog/where\\_has\\_all\\_the\\_money\\_gone](http://www.zigasassociates.com/blog/where_has_all_the_money_gone)

business were beyond the reach of the targeted borrowers, either by price or because the loans were being written and sold by nontraditional mortgage players who did not rely on the GSEs for liquidity. Moreover, the types of loans being offered in the primary market had morphed rapidly into new and exotic forms. In 2004, for instance, the Mortgage Bankers Association (MBA) reported that 46 percent of the dollar value in new mortgage loans, and about one-third of total mortgages written were 2/28 ARM loans, a huge spike from 29 percent and 19 percent, respectively, the year before. Subprime lending increased to 20 percent of 2004 mortgages, up from less than one-tenth in 2003.<sup>12</sup>

The impact of the housing goals on mortgage availability for the targeted groups also has been questioned. Both companies significantly increased the share of their financings that served the targeted groups as HUD raised the goal. Moreover, a higher share of the growth in serving low and moderate income households, for instance, took place among lower rather than moderate income borrowers. On a strictly nominal basis, it seems inarguable that the goals stimulated the direction of more GSE-funded capital to the targeted groups than would have been the case without them.

However, in its recent review of the GSEs, the Government Accountability Office (GAO) concluded after examining the companies' performance that the goals' "effectiveness in supporting homeownership opportunities for targeted groups and areas is not clear."<sup>13</sup> GAO also cited other studies suggesting that

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<sup>12</sup> Bailout Nation, Barry Ritholz, John Riley and Sons, 2009, p 128

<sup>13</sup> Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long Term Structures, GAO-09-782, September, 2009, p. 22

the growth in GSE share of targeted household mortgages came largely at the expense of FHA mortgages that otherwise would have served them, creating only a small net difference.

HUD, on the other hand, concluded in reviewing the companies' performance from 2001-2005 that both companies achieved a higher percentage of financings for targeted groups than the primary market did in the same studied period<sup>14</sup>, suggesting that the goals did have the effect of increasing liquidity for this class of loans.

Whatever shape the federal government's involvement with the secondary mortgage market takes in the future, resolving the conflicts between attracting private capital and supplying liquidity to an expanding market while retaining a focus on serving specific parts of the "affordable" market will remain at the heart of the design challenge.

## ***Overarching Questions***

The design of any new system will have to address several key organizational and operational issues. One is whether or not a new agency or agencies should operate a portfolio. Another is whether and what form any implicit or explicit form of guarantee should include. A third is what role the new secondary market system should play in underwriting affordable housing for low and moderate income housing.

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<sup>14</sup> The GSEs' Funding of Affordable Housing Loans: A 2004-2005 Update, HUD Working Paper No. HR-18, Harold J. Bunce, June, 2007,

## ***Portfolio***

The portfolios of Fannie and Freddie have been the center of controversy since Fannie's early days. Large portfolio lenders in that time saw Fannie's portfolio as a threat to their own business model, which was still based then on making and holding whole loans. During the 1980's Fannie's botched management of its portfolio – holding long-term, low yield assets funded with short-term debt that rapidly escalated in price – nearly sank the company.<sup>15</sup> It recovered through a program of restructuring its debt maturities and by rapidly building an MBS guarantee program to grow through off-balance sheet assets.

During the 1990's and early 2000's, both Fannie and Freddie rapidly grew their portfolios as the housing boom expanded. Between 1990 and 2003, Fannie and Freddie's combined share of outstanding single family mortgage debt held in their portfolios rose from 5 percent to 22 percent.<sup>16</sup> The portfolios also were very profitable. In 1995 alone, their retained portfolios accounted for 74 percent of Fannie's income and 50 percent of Freddie's income.<sup>17</sup> They accomplished this by leveraging their lower debt costs

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<sup>15</sup> "Fannie Mae responded to its new powers by rapidly building its mortgage portfolio, which soon exceeded that of even the largest savings and loan institution. Indeed, Fannie Mae's balance sheet looked much like that of a savings and loan, with its assets nearly all in long-term, fixed-rate mortgages and its liabilities relatively short-term. When interest rates soared in the late 1970s and early 1980s, Fannie Mae encountered some of the same difficulties as did savings and loans, and by 1981 had a negative net worth of almost \$11 billion." Treasury study, op cit, p. 19

<sup>16</sup> William Poole, <http://research.stlouisfed.org/publications/review/07/05/Poole.pdf>, p 147

<sup>17</sup> HUD report, op cit, p. 16

with low capital ratios.<sup>18</sup> With these advantages they were able to out-compete other asset holders and amass portfolios that reached nearly \$1 trillion each before their accounting missteps and supervisory oversight forced them to scale back.

The portfolios have been especially important in supporting multifamily housing finance. Beginning with its Delegated Underwriting multifamily lending program in the mid-1980's, Fannie Mae became an increasingly important source of financing for apartment loans. Freddie Mac followed suit, but its program remained smaller than Fannie Mae's. In a recent unpublished study, Paul Weech reported that

“...the total amount of mortgage debt associated with Fannie Mae's book of business – investments in multifamily mortgages plus Fannie Mae-backed pools, grew by almost \$100 billion from \$125 to \$221 or 43.5 percent. Freddie Mac experienced similar above average growth in its total book from \$56 billion to \$87 billion, or 36.2 percent. Sometime in 2007, Fannie Mae's total book of multifamily business passed that of the entire commercial banking sector as presented in the Federal Reserve Board data.”<sup>19</sup>

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<sup>18</sup> Treasury report, op cit, p. 33

<sup>19</sup> More than Homeownership: The Importance of Fannie Mae and Freddie Mac in Multifamily Housing Finance, Paul Weech, Innovative Housing Strategies LLC, September 15, 2009, p. 5

Both companies used their portfolios to hold whole loans and securities backed by multifamily loans. Freddie's portfolio strategy emphasized securities more heavily and earlier than Fannie Mae, but the latter followed with a significant growth in its CMBS securities in 2006 and 2007.<sup>20</sup>

The portfolios' growth generated opposition and concern. As Fed Chairman Bernanke noted,

“[I]t is also in the shareholders' interest for the GSEs to maximize the size of their portfolios to take advantage of the differential between the returns to mortgage-backed securities and the low GSE funding costs arising from the perceived guarantee. However, as the Federal Reserve has argued for many years, the enormous GSE portfolios pose risks to financial stability.”<sup>21</sup>

In addition, critics also have charged that although the portfolios generated significant earnings for the two companies, they provided little substantive value for consumers in return. William Poole, an official with the St. Louis Federal Reserve Bank, wrote in 2007 that the portfolios did not influence mortgage spreads against 10-year Treasury rates:

“What happened to the mortgage spread when the GSEs stopped accumulating ever larger portfolios? Nothing. Because fixed-rate mortgages are subject to

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<sup>20</sup> Weech, *ibid*, p. 8

<sup>21</sup> Bernanke, *op cit*, p. 5

prepayment risk, whereas the 10- year Treasury bond is not, there is a degree of variability of the mortgage spread. But if the cessation of the GSEs' portfolio growth had made a difference, it surely would have shown up in the data. The annual average of the spread in 2003, before the OFHEO orders that restricted Fannie and Freddie's portfolio growth, was 180 basis points; the spread was 157 basis points in both 2004 and 2005."<sup>22</sup>

However, a 2001 HUD-funded study identified value for investors and borrowers through the portfolio. Author Stuart Gabriel observed that "...despite the lower credit quality of the GSEs' guarantee, conventional MBS had higher prices and lower yields than Ginnie Mae MBS." Ginnie Mae bonds are backed by government's full faith and credit, a much better explicit guarantee than that offered through either Fannie or Freddie that should have driven up their price. He concludes that "An important source of pricing disadvantage for Ginnie Mae is its lack of portfolio capability....The model results indicate that Ginnie Mae MBS yields would have been one or two basis points lower than yields on Fannie Mae MBS if Fannie Mae did not increase the liquidity of the MBS market through its portfolio purchases."<sup>23</sup>

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<sup>22</sup> Poole, op cit, p. 147

<sup>23</sup> Opening Doors to Homeownership: Challenges to Federal Policy, Cityscape: A Journal of Policy Development and Research, Vol. 5, No. 2, 2001, U.S. Department of Housing and Urban Development, p 38-39

These concerns were put to the test in the credit crisis that began in 2007. By that time both companies already were under supervisory agreements with their regulator, OFHEO, which had constrained their portfolio growth.

But in early 2009 the FHFA encouraged both companies to once again use their portfolios to acquire mortgage assets in order to insure continued liquidity for MBS as the government tried to keep mortgage lending flowing and mortgage rates low. The portfolios thus operated as an important countercyclical tool in a liquidity crisis. Since the conservatorship, the Federal Reserve has stepped into the market with a \$1.25 trillion commitment to purchase GSE MBS in order to support the market. The Fed effectively has replaced the portfolio role of the GSEs in doing so. Its announced intention to end the program when it has reached its initial purchase commitment early in 2010 has caused new concerns in the market about a potential rise in mortgage interest rates and possible decelerating impact on the already weak housing sector recovery.<sup>24</sup>

Moreover, Fannie and Freddie are required under the terms of the conservatorship to begin reducing their mortgage portfolios by 10 percent per year until they reach \$250 billion each. The impact this is likely to have on the market and the cost of mortgages is unclear. In late 2009, the Treasury amended the terms of its investments in the GSEs to require the wind-

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<sup>24</sup> "Bernanke Housing Plan May Prompt Calls to Extend Aid," Bloomberg.com, Nov. 3, 2009

<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVCMmlgrxkKs>

down to start at \$900 billion, rather than the at whatever level they had reached by year-end 2009 under the original terms.<sup>25</sup>

The companies' portfolios clearly played a significant role in their growth and shareholder and management profits. But they also provided other market benefits. One is the liquidity function noted above. Another is that by offering debt across the yield curve the GSEs have given investors a secure and reliable alternative to investing directly in MBS. Their debt was attractive because of their government sponsorship, which gave "agency" debt pricing only slightly more expensive than Treasury debt of similar duration. A third is that the GSEs can use their portfolios to purchase and hold loans for which there is little or no market demand. This can enable them to introduce new products and grow them while the market assesses them. It also could enable them to hold mortgages with higher risk or lower return profiles, much the same way other portfolio lenders do. However, there is not much evidence that the GSEs used their portfolios extensively in this way in the recent past. Finally, as noted earlier, the GSE portfolios have been the single most significant source of capital for affordable apartment mortgages, both through whole loans and CMBS purchases.

If the GSEs were forced to liquidate their portfolios as part of a conversion to a guarantee-only business model, it seems reasonable to assume that these assets would simply move onto other large institutions' balance sheets. As Susan Woodward, former Chief Economist at HUD,

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<sup>25</sup> [http://www.financialstability.gov/latest/pr\\_1052010b.html](http://www.financialstability.gov/latest/pr_1052010b.html)

has pointed out in a comprehensive blog posting on Fannie and Freddie, “any policy to whittle down the portfolios would only result largely in depositories holding more mortgages and MBSs than they now hold. In other words, the 30-year fixed-rate loans are not likely to leave the Federal umbrella, but only move to another place under it.” Moreover, she notes,

“Reducing the portfolios of F&F would not be without pain for the mortgage and housing markets. Even in the early 1990s, when the mortgages held by the insolvent thrifts had to find a new home, mortgage rates were clearly elevated by this displacement. We cannot imagine that policy makers would choose any time soon to force F&F to sell their portfolios, as this would just depress mortgage values and force already beleaguered banks to make down their assets once again.”<sup>26</sup>

### ***The Federal Guarantee***

The federal government’s relationship with Fannie since 1968 and Freddie since 1989 has straddled a grey zone. The companies’ securities by law carry a disclaimer that they do not carry the government’s guarantee. Until the 2007 credit crisis, neither company ever had received any direct financial assistance from the government. Although their charters gave them access to a \$2.5 billion line of credit at the Treasury in case of a liquidity crisis, by the

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<sup>26</sup> <http://woodwardhall.wordpress.com/2009/01/>

1990's this was perceived as more symbolic than useful, as the companies' liquidity needs had grown so large as to make the credit line more or less irrelevant.<sup>27</sup>

Yet study after study in the 1990's and later identified the GSE sponsorship as carrying an "implicit" government guarantee that gave the firms significant advantages in their borrowing costs. In addition to this "subsidy," critics argued that the implicit guarantee created a significant degree of "moral hazard" by encouraging the firms to take on more risks and use higher leverage with the comfort that the government would step in to rescue them if they stumbled.

Continuing concern over the extent and nature of this implicit guarantee and how the government could protect its interests led to the adoption of new, more stringent regulatory authority over the two companies in 2008. Shortly after these new provisions were enacted, giving their regulator expanded powers to regulate the companies' capital and take them into conservatorship should they encounter financial difficulties, FHFA triggered the conservatorship provisions and took over both companies.

But the future disposition of this issue for any ongoing secondary market support is clouded by the grim fact that the credit crisis of 2007 demonstrated that many US financial institutions have become "too big to fail." The simple facts are well known – the government

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<sup>27</sup> The 1996 Treasury study does note that investors continued to support Fannie Mae's debt during its economic problems in the 1980's and attributes this to the market's belief that the government was standing behind them.

allocated trillions of dollars in direct loans, investments and guarantees to prevent major financial institutions like Citigroup, JP Morgan Chase, Bank of America, AIG and others from failing. None of these institutions had any form of government sponsorship beyond deposit insurance for the banks; AIG had nothing at all. But when push came to shove it turned out all of them were implicitly guaranteed by the government. Ironically, the substance of this assistance exceeded that extended to the GSEs when they were taken into conservatorship. Banks' senior debt, for instance, was fully guaranteed by the federal government for a limited period, a benefit that was not extended to the GSEs.

All very large financial institutions, in other words, are likely to be treated as GSEs regardless of their charters, absent adoption of proposed restrictions on so-called "too big to fail" institutions.

This turn of events has several important consequences when considering government support in the secondary mortgage markets. First, formal GSE status without an explicit guarantee is unlikely to confer the same, if any, significant funding advantage over other entities. Second, if all very large institutions have the same status as the GSEs, specific organizations designed to support the secondary mortgage market may be redundant. With the same implied advantages that Fannie and Freddie used to enjoy, any large institution should theoretically be able to provide the same functions and benefits to consumers. Third, if the implied guarantee extends to all very large institutions, government must identify the obligations that this guarantee imposes. In the mortgage space this likely would include specific obligations to serve low-mod borrowers and underserved areas, as well as national coverage, constant participation in the market, and so on.

As noted elsewhere in this paper, the GSEs' benefits always extended beyond the government guarantee. This whole of the bundle likely exceeded the sum of its parts, and was designed to specifically advantage mortgage capital. Extension of an implied guarantee to all very large institutions would not offer the same advantages as this bundle, nor would it necessarily provide sufficient incentives to operate in the secondary mortgage market space comparably to the former GSEs.

### ***Affordable Housing***

Both Fannie and Freddie were given an implicit and explicit focus on financing housing for low-, moderate- and middle-income households.

There is a rich literature concerning whether or not the GSE housing goals were effective. Some advocates argue that depositories were subject to more stringent regulation through the Community Reinvestment Act (CRA). Others argued that the structure of the goals was too lax, allowing the companies to focus on the higher portions of the targeted market. HUD itself concluded in a 2007 analysis of the GSEs' housing goals performance that Fannie Mae's share of business serving the legislatively targeted populations exceeded that of the primary market in the income-based goals 2001-2005, and that Freddie exceeded the market in the income based goals in 2005.<sup>28</sup>

Congress in 2008 expanded the companies' housing goals responsibilities to include new "duties to serve" in markets including preservation, multifamily rentals and manufactured and rural housing. It also

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<sup>28</sup> HUD Working Paper, op. cit, pp. 4, 7

created a new requirement that the two companies divert a specified amount of their earnings to fund a new National Affordable Housing Trust Fund. By diverting some portion of retained earnings to support subsidized housing through a government program, the assessments would help restore the balance between public and private benefit.<sup>29</sup>

The Trust Fund assessment is analogous to the Affordable Housing Program (AHP) set-aside imposed on the FHLBs in 1986. However, unlike the GSEs, the FHLBs do not pay federal income taxes. Their assessment was developed, in part, to bring their total public benefits assessments (including the obligation to retire REFCORP bonds floated to finance the RTC after the S&L bailouts) more in line with Fannie's and Freddie's, as they, too, historically have been profitable enterprises whose earnings flow into dividends that benefit their bank and thrift owners. As adopted, the assessments amount to a surtax on the two companies to finance subsidized housing programs.

A more durable and equitable design for squeezing more public value from the secondary market would be to impose a small charge on all mortgage backed securities, regardless of the issuer. A millage like this would be more equitable, covering all companies engaged in the secondary mortgage market. This could be an especially attractive option in a market with multiple chartered MBS issuers, as has been proposed by some. Considering the significant tax benefits that homebuyers receive, a small charge on all financing of single family homeownership seems reasonable.

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<sup>29</sup> FHFA issued draft regulations for comment on the duty to serve requirement in mid-2009. It has not yet issued final regulations.

In a system with specially chartered entities whose responsibilities and benefits would extend beyond those of other private securities issuers, it would be appropriate to include some form of additional investment in affordable housing and community development by these more specialized entities. However, requiring that investment to be carried out through the entities in the form of risk pools or below market rate investments could provide far greater leverage of their investments and engagement in the work than a mere assessment diverted to the government. And every further requirement placed on such entities to address particular market segments potentially raises the capital loads they would have to carry. The balance between obligations that are appropriate and feasible and those that make the entire structure uneconomical is not altogether clear.

### ***Transition Issues***

Any transition to a new system of secondary mortgage finance begs the question of how to maintain stability in the current MBS market. Fannie Mae and Freddie Mac are the guarantors of more than \$4 trillion in whole mortgages and securities. The GSE MBS market has historically been the deepest and most liquid securities market available. Even in these straitened times, the companies have been able to package and securitize mortgages, although the Federal Reserve has become the principal buyer to maintain liquidity at low prices.

Shifting to a different system could lead to higher consumer prices and a less liquid securities market, at least in the beginning as investors learned about new securities and the

supply reached a sufficient size to trade deeply. Meanwhile, some management of the outstanding MBS would have to be organized to maintain their liquidity.

Fannie and Freddie have developed sophisticated staffs and tools to manage their MBS. Duplicating these capabilities would not be easy. A recent analysis by Credit-Suisse concluded that “FN/FH TBA (*to be announced securities, the principal means of issuing GSE MBS*) liquidity is the result of multi-decade branding/continuity. This is our primary argument for rebuilding the GSEs rather than reinventing the wheel.”<sup>30</sup>

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<sup>30</sup> *GSEs – Still the best answer for housing finance*, Credit Suisse Fixed Income Research, October 8, 2009. Available at [http://www.zigasassociates.com/images/uploads/GSEs\\_-\\_Still\\_the\\_best\\_answer\\_for\\_housing\\_finance.pdf](http://www.zigasassociates.com/images/uploads/GSEs_-_Still_the_best_answer_for_housing_finance.pdf) Posted with permission of the authors

# *Part II: Designing A System for the Future*

This paper assumes that there is a legitimate and valuable role for the federal government in the operation of the home mortgage market. This is by no means a universal opinion, but one which this paper embraces. Given that assumption, there are a host of key questions that any future design of the system must take into account.

## ***Segmenting the Market***

The mortgage market is not monolithic, but stratified into a number of different sectors. Not all of these have as large a claim on federal support as others, and there is no basis whatsoever for federal support for some of them. These are quickly summarized below.

**Homeownership.** There is a long tradition of federal support for homeownership. Federal sponsorship in the primary and secondary markets is only one of them. Federal tax policies that strongly favor homeownership through deductions for mortgage interest, property taxes, and capital gains and the exclusion of imputed rent for owner occupants are far more powerful macroeconomic incentives. Homes remain the single largest asset that most households own, even after the steep value losses of the last

several years. While nearly 70 percent of all US households own a home, fewer than 50 percent have stock market investments, and these are typically a far smaller share of total assets than the home. As a consequence, they have been a reliable and important means of generating and passing on wealth. The continuing difference between homeownership rates among minority and White households remains an important driver of the wealth disparities between these groups.

**First-time homeownership.** For many renters that aspire to own a home, long-standing barriers like a lack of capital for a down payment and inadequate credit remain principal obstacles. For some others, lack of information about the process and who can qualify for a loan also are barriers.

**Vacation or second home ownership.** Over time residual federal benefits for second home ownership through tax treatment of mortgage interest have been pared away from the system. While the GSEs provided financing for second homes, they did so at significantly higher rates and with stricter down payment requirements that eliminated most if not all of the benefits these borrowers might have received as a result. Second homes are important sources of employment, income and wealth in some rural areas that depend on tourism and vacation homes for a significant portion of their economy, but it is hard to argue a good reason why federal housing policy should support them.

**Investor owned homes.** In some parts of the country, investor-owned single-family homes (1-4 units) provide a significant portion of the rental housing supply, particularly for low and moderate income renters. Indeed, more than one-half of all rental units are in single family dwellings, and a significant

additional share is in properties with fewer than 10 units. (Rental housing by definition involves investor-owners; sometimes these are smaller “mom and pop” operations, and the larger the properties the more likely ownership is held by partnerships and corporations.) These are good reasons for identifying how the benefits of federal support can extend to homes rented to people of modest means. At the same time, investor owners do not behave or perform in the same ways that owner occupants do. Their loss rates are higher, and their willingness to stay with a property when it declines in value or when the income it generates is no longer sufficient to generate a profit is much lower. Historical data from Fannie and Freddie indicates that investor owned single-family properties pose a significantly greater credit risk than owner occupied ones. While some federal support for this sector may be warranted, it requires a different and more cautious approach than for owner occupants.

**Rental homes.** Balanced national housing policy must include a significant focus on assuring a reliable and adequate supply of rental housing. Some of this, perhaps even the largest share of it, will be provided through single family homes, as noted above. But larger multifamily properties also play a significant role. This is particularly true for elderly and disabled persons, for whom multifamily housing can be particularly appropriate. But all Americans start their independent lives and spend much of their young adulthood and beyond in rental apartments. A strong federal role in assuring adequate capital to this sector remains important.

# *Clarifying the Desired Results*

A restructuring of the mortgage finance system should address each of the following key questions:

- Will it support the availability of long-term, fixed rate mortgages for consumers?
- Will it offer access to capital by as wide a variety of institutions as possible, from small community banks and credit unions to large money center institutions?
- Will it foster and spread innovation in mortgage products to insure that helpful and sound new products can be made available widely in the marketplace?
- Will it fulfill a significant duty to serve underserved populations and communities?
- Will it provide financing both for affordable single family homeownership and rental housing?<sup>31</sup>

In addition, a means to insure a smooth transition and protect the liquidity for existing MBS must be part of the solution.

While Fannie Mae and Freddie Mac in their current forms have suffered grievous financial losses and had their structures criticized from different political and economic points of view, the fact remains that they contain decades of experience, technology and staff that continue to provide financing for the lion's share of all mortgages being made today. While maintaining

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<sup>31</sup> A set of "Principles to Guide Development and Regulation of a Renewed Mortgage Finance System" adopted by the Mortgage Finance Working Group, a collaboration of organizations and individuals sponsored by the Center for American Progress, is attached as Appendix II and provides a fuller description of these issues.

them in the current status or using the conservatorship to nurse them back to health and then allow them to return to the former state may be infeasible for political reasons, alternatives must be able to adequately answer the questions above in order to be a viable path.

A new system also must insure that the frantic “race to the bottom” in underwriting standards that fueled the housing bubble and was financed largely the shadow banking system of unregulated investment banks cannot be repeated. This will require imposition of strong regulatory oversight in the primary mortgage market, much of which has been put in place in the wake of the meltdown. But it also requires a more systematic approach to the world of mortgage backed securities. A system that fails to take such steps only invites an eventual repeat of the mistakes that led the system to the brink of failure.

### ***Long Term, Fixed Rate Financing***

While various studies of the GSEs have concluded that long term fixed rate financing would be available without GSE support, evidence from the rest of the world suggests this is not the case.<sup>32</sup> Long-term mortgages carry both credit and interest rate risks. The credit risk is obvious, and applies to short and long

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<sup>32</sup>“The United States is unique in having a 30-year, fixed-rate, prepayable mortgage. Other industrialized countries have mortgages with long (25-30) lives, but only in the US do they have an interest rate that is fixed for the full term and the loan is prepayable. Only Denmark, population 6 million, has anything close. Other industrialized countries do have long-term (25 to 30 years) amortizing loans, but the rates adjust at least once every 5 years. As even we in the US have experienced, long-term, fixed-rate prepayable loans can cause systemic trouble.” Woodward, op cit

term debt. The interest rate risk includes at least two components. One is the risk if the holder's costs of debt rise while the interest income stream from the assets does not. Fannie Mae and many other portfolio holders experienced just this squeeze at various times. The other risk associated with interest rates is prepayment speeds. If offering rates drop over the life of a long-term loan, borrowers are much more likely to prepay their existing loans and refinance with a new, lower cost one. The U.S. experienced several such refinancing waves throughout the last 20 years. Similarly, if long-term rates increase, the duration of the mortgage assets will lengthen, potentially exposing the investor to a mismatch in the duration of assets and liabilities.

The GSEs have adopted strategies, including reliance on the guarantee, rather than portfolio, function to manage these risks. They also have been able to borrow efficiently across the yield curve in order to be able to manage the inherent interest rate risk of holding long term assets. Their inherent market advantages enabled them to accept the prepayment risk without shifting the cost onto borrowers.

Other mortgage market players could replicate this liquidity function, as the precipitous rise of the private label securities market illustrates. But as the current crisis illustrates, they will not necessarily have the willingness or ability to stay in the markets through a variety of credit cycles. Other portfolio holders, like banks, would have a significant incentive to offer adjustable rate products that shift interest rate risk onto consumers, because these are much easier assets for them to manage. Longer term debt likely would carry prepayment penalties through which issuers could assure investors of a more predictable yield. In either case, consumers would have to absorb the higher costs.

It is possible that other institutions would step in to fill this particular role played by the GSEs. A number of analysts have opined that 21<sup>st</sup> century markets are not the same as 1938's, when there were no

private sector takers for the original Fannie Mae charter, and that modern finance will adequately substitute the functions for which the GSEs were created. But experience from other countries suggests that this is not the case. From a sheer efficiency point of view, it is hard to argue why lenders not specifically chartered for this purpose would find long-term fixed rate loans the most profitable means of offering mortgage credit.

### ***Innovation***

A benefit of the GSE model was the companies' ability to adopt and create new innovations and make them widely available throughout the market. Large private institutions have every incentive to carefully guard innovations and resist their widespread use, as this reduces their first adopter advantages and the margins that can be charged as more competitors enter the market. The GSE model meant that once they adopted a change it could be offered to any institution of any size, overcoming the advantages of scale held by large lenders. The scale of the GSEs' participation in these new markets quickly reduced margins and saved consumers money. A new system needs to replicate this function to both foster innovation and insure its rapid diffusion.

A secondary market system dominated by large financial services companies is unlikely to provide the same broad access to financing and products as one that includes government sponsored entities. Large institutions have a natural tendency to drive aggregation and as much vertical integration in their business models as possible. Without a counterbalance with a specific purpose of providing access to all institutions, a system dominated by large financial institutions likely would significantly limit smaller institutions' choices and business models. This might increase efficiency in the short run. But it also would undermine

the positive virtues of having a highly deconcentrated originations system that includes community banks and credit unions who likely would suffer under a more consolidated and integrated model.

The need to insure access to safe and affordable credit products is more obvious today in the wake of the financial crisis. Any new system must address this issue and insure that the “race to the bottom” in mortgage underwriting that drove the subprime and Alt-A crisis is not repeated through unregulated mortgage marketing at either the primary or the secondary level.

### ***Level Regulatory Playing Field***

One of the critical elements of the recent mortgage crisis was the ability of other large institutions such as Wall Street banks to compete in the secondary market with securities of their own. Even at their pre-crisis peak, Fannie and Freddie did not account for more than 60 percent of the mortgage securities issued. So-called “private label securities” accounted for the rest. But as the housing asset bubble inflated, so did the role of these private securities in providing capital, driving GSE shares below 20 percent.

While Fannie and Freddie guaranteed their MBS payment streams, PLS relied on subordination within the bond structures to provide investors with a form of insurance. Ratings agencies played a critical role in this system. By classifying the different “tranches” of these issues the agencies supposedly gave investors the ability to buy them without knowing the character of the loans underlying them. It turned out, however, that the agencies ratings were woefully, if not negligently, inaccurate, failing to identify the significant risks included in these securities. Thus bonds with AAA ratings looked comparable to GSE bonds, but carried higher yields because they began to include more higher priced, higher risk products.

Without comparable regulation and oversight, these private market competitors initiated a “race to the bottom” in underwriting and securitization. This vicious cycle directly led greater inflation of property values, and to the failure of the subprime and Alt-A mortgage securities, which in turn triggered the near collapse of the banking system.

One solution to this dilemma would be to require any institution offering mortgage backed securities to obtain a regulatory license from the government. This license could establish minimum requirements for capital, structures, ratings and other aspects of the business. This would enable the government to assure some basic set of regulatory standards for the industry and help avoid the proliferation of private unregulated MBS issuers that directly fueled the credit boom and crisis. This charter need not offer specific benefits beyond the ability to issue MBS. Instead, it would ensure the registration and oversight of the entire industry, much the same way any portfolio mortgage lender is subject to similar scrutiny through its basic charter. It also could require the payment of a small fee on all mortgage securities transactions to help finance affordable housing for very low income residents.

### ***Specialized Focus***

With the overall field thus leveled, a specific form of sponsored mortgage market enterprise could be established to insure that the key aspects of the market – including liquidity, standardization, innovation and access – continued to be assured whether or not fully private and newly chartered MBS issuers were active at all times. Assuring this constant presence could include additional benefits, such as some or all of

those that the GSEs enjoyed in the past. In return, these entities could have specific requirements to focus on affordable mortgage lending, and perhaps other specific “duties to serve” that Congress could establish.

In another alternative, Susan Woodward has suggested re-chartering Fannie and Freddie as special purpose banks, devoted to the secondary mortgage market, their debt guaranteed or insured as deposits in other large institutions are insured. This would put them on a par with other “too big to fail” institutions and give the government leverage to establish appropriate fees and capital requirements in exchange for the insurance.<sup>33</sup>

## Further design principles

Incorporating the following principles into a new design of secondary mortgage market entities would help avoid some of these difficult tensions in the old Fannie/Freddie model.

- **Any sponsored enterprise’s focus should be limited to a much narrower slice of the market than became the case with Fannie and Freddie.** With the exception of the two coasts, house prices for low-, moderate- and middle- income families consistently average well below the national median price. (Regional housing costs vary widely, and another related approach would be to have the enterprises use differentiated mortgage limits to reflect these differences.) A lower cap on their maximum mortgage amount would could achieve a number of beneficial results:

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<sup>33</sup> Woodward, op. cit.

- A higher percentage of the companies' financings would serve moderate income homebuyers, and in the past would have helped the companies meet the HUD goals without requiring extraordinary actions by the companies or putting as much strain between their profit-maximizing responsibilities to shareholders and their mission value to the government.<sup>34</sup>
- It would have limited the amount of implicit/explicit risk backed by the federal government. This would be true whether such a guarantee was implicit as in the past, or made more explicit through requiring secondary market actors to pay for insurance that would protect investors in MBS guaranteed by the firms.
  
- **Model success in meeting housing mission through a much broader and more subjective series of tests than a simple numeric goal.** More than two decades of experience under the 1992 statute has eliminated any problems with understanding the complexion of Fannie and Freddie's businesses. There is extensive information available to HUD and private researchers about their lending patterns through the public use database that HUD publishes from GSE provided information each year. It remains important to assure that any sponsored enterprise devotes time and energy to assuring that it is providing adequate liquidity to targeted groups through mortgage purchases. But the companies have developed a myriad of other ways to invest in affordable

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<sup>34</sup> Over the years California, with its traditionally higher prices and population growth, has been the locus of agitation for ever-higher mortgage limits. The CA Association of Realtors® has been an especially vocal proponent of higher mortgage limits.

housing as well. These included developing and leading the market in investing in Low Income Housing Tax Credits; developing and offering new technologies to support nonprofit housing counseling; investing in Community Development Financial Institutions (CDFIs) and other initiatives. By failing to acknowledge and credit these initiatives, HUD's regulation of the housing goals tended to make Fannie and Freddie's "mission" requirements synonymous with the goals alone. This weakened management's incentives to identify and develop other important ways to support affordable housing and community development and discouraged other more creative and possibly impactful investments.

- **Align compensation more closely with a balanced scorecard of accomplishment.** It is beyond the scope of this paper to determine whether the amount of compensation for company executives was appropriate or not. OFHEO and later FHFA approved executive compensation on a regular basis and both companies benchmarked their compensation around the median of their comparator group, also approved by their regulator. More important than the actual benchmark for total compensation are the indicia of success that are used to determine executive payouts. For many years, earnings-per-share growth was the key determinant of variable pay at the two companies. When it was met, bonuses in cash and stock were paid; when not, the amounts were much lower. This was good for the shareholders, but not necessarily for meeting mission objectives, as Dan Mudd's and John Koskinen's comments cited earlier illustrate. Performance at sponsored companies must be measured in a more balanced and disciplined fashion.

- **Improve board governance and increase the government’s role in it.** Although their charters assigned five of their eighteen board seats to directors appointed by the President, the White House declined to appoint any from 2003 onwards. And those who had been appointed in the past generally were not appointed because of their mortgage industry or affordable housing expertise. Because GSE board members received compensation, in cash, stock and options, these were coveted appointments. Presidential appointees seldom served more than one term, while other board members typically served for many terms. These appointees could and should have acted as a moderating and public-oriented voice on both boards. Instead, they tended to be of little consequence from either a governance or policy point of view. OFHEO’s investigations of the GSEs in 2003 and 2004 revealed board governance at both to be weak and far below even the lax standards that predated Sarbanes-Oxley reforms. In this they were probably no worse than most private companies. But given their special status, and the central role they came to play in one of the most important sectors of the economy, any future governance structure must be designed to provide a maximum of independent influence and expertise to bridle impulses to overweight decisions toward profitability rather than mission value.

### **Recommended approach**

An integrated approach to housing policy needs to balance these different market segments and approaches to tailor policy responses that provide the most effective support with the lowest cost or exposure for the government and taxpayers. Resolving the federal role

is critically important. Housing markets today are depressed and the outlook for credit in both the ownership and rental markets is cloudy. But over the next decade, population growth will continue to drive demand for housing of all types. The Joint Center for Housing Studies at Harvard University earlier this year projected that household growth will total between 12.5 and 14.8 million over the next decade.<sup>35</sup> This will require trillions in additional mortgage capital to finance homes. And with minority, and particular Hispanic, households representing an increasingly large portion of this growth, housing for all types of families will require continuing support to meet demand.

The following key recommendations are based on the analysis in this paper, and are proposed as the starting point for discussions about specific new models for the secondary market.

1. This paper endorses a specific and continuing federal government in the secondary mortgage markets. This role should focus on ensuring liquidity, stability and affordability for consumers in the mortgage markets. It should encourage long term, fixed rate financing for consumers.
2. The federal government should require all issuers of mortgage backed securities to obtain a federal “license” outlining their roles and responsibilities. The purpose of this charter would be to

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<sup>35</sup> [http://www.jchs.harvard.edu/publications/markets/son2009/son2009\\_executive\\_summary.pdf](http://www.jchs.harvard.edu/publications/markets/son2009/son2009_executive_summary.pdf), State of the Nation’s

Housing 2009, p. 5

establish oversight of the entire field and subject all participants to minimal standards of care and uniformity.

3. In addition to chartering all MBS issuers, the government should create at least one specialized and sponsored entity offer focused specifically on providing credit liquidity to rental and ownership housing for low, middle and moderate income households. These entities should receive a form of federal insurance on their MBS, which should be financed through insurance premiums levied on them, as suggested by Woodward and others and akin to deposit insurance. In return, these entities would have restrictions on the maximum mortgages they could finance and have regulated returns to investors, be required to operate in all markets at all times, and provide durable liquidity for long term fixed rate mortgages. These entities would manage portfolios focused on providing reliable liquidity for their targeted mortgage segment and to insure financing for multifamily and potentially other community development lending. These also would be available for counter-cyclical intervention in markets when necessary to sustain liquidity. They should have strong, independent safety and soundness regulation. They also should have comprehensive, measurable obligations to provide financing for targeted households and economically disadvantaged communities. A portion of their retained earnings should be allocated to specialized products and programs to assist in the production and preservation of affordable rental and ownership homes for targeted populations, as well as community development activities. These could include restructured versions of Fannie Mae and Freddie Mac, as suggested by Credit Suisse's analysis, as well as any other enterprises that were willing to accept the same terms. While Credit Suisse

suggests that the barriers to entry for new companies would be high, the possibility of new competitors is an important issue. However these successors are structured, there must be a credible and effective means to transition from the current model and insure the continued viability of the TBA MBS market in the meantime. Congress also should consider a hybrid corporation in which the government retains a significant ownership stake, while attracting private capital to help underwrite its functions. Like Fannie Mae between 1954 and 1968, such an organization would gain a form of implicit backing through the government's ownership stake. This could function like the utility model advanced by some, with limited returns for private investors and clear and limited powers and responsibilities. Government ownership would give it a natural stake in governance, as well, which could provide necessary public interest oversight of the organization's operations.

4. All MBS, whether or not they are insured under this new structure, should include a new fee to provide funding to support affordable housing efforts through the National Affordable Housing Trust or some other suitable vehicle. This fee would be added like a guarantee fee to all issuances.

# ***Part III: Review of Alternative Models***

*The following section outlines a series of policy options that have been offered recently for supporting the secondary mortgage market and offers a critical examination of pros and cons.*

## ***Full Government Ownership***

Under this model, Fannie Mae and Freddie Mac would be absorbed completely into the federal government. The implicit guarantees that underpinned their former lives would be converted into full faith and credit backing by the federal government; they would become unified with Ginnie Mae and become a nationalized source of mortgage capital. This model would eliminate the inherent tensions so evident in the GSE model by eliminating private ownership. Staff and executives would become civil servants. Their compensation would be decoupled from the performance of the business. Congressional oversight would increase dramatically. University of California economist Dwight M. Jaffee has proposed a version of this outcome that he dubs the “Middle Income Mortgage Program,” or MIMP. This proposal would move the Fannie/Freddie securitization businesses into the government. Borrowers would be charged an insurance/guarantee fee to provide capital behind the government’s guarantee. Jaffe’s model envisions mortgages with 20 percent minimum down payments, although he allows that this might be reduced to 10 percent with appropriate guarantee fees. Ginnie Mae presumably would continue to securitize FHA and VA

guaranteed low down payment loans, although this is not explained fully.<sup>36</sup> Note also that the CBO believes that the level of government control of the GSEs through the conservatorship already means that the GSEs should be on budget.

### ***Pros***

1. This model would eliminate the historical conflict between public mission and return to shareholders.
2. It would give the federal government a powerful tool with which to manage liquidity for some defined segment or segments of the mortgage market.
3. It could retain the key functions of liquidity, stability and standardization but under strict government control.

### ***Cons***

1. A government owned structure diminishes, if not eliminates altogether, incentives for risk taking and for effective risk management. In bureaucratic organizations, inertia is often the most powerful management driver. Risk avoidance is generally rewarded more reliably than risk

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<sup>36</sup> Jaffee, Dwight M., Reforming Fannie and Freddie (February 18, 2009). Regulation, Vol. 31, No. 4, Winter 2008-2009, page

56. Available at SSRN: <http://ssrn.com/abstract=1346044>

management. The difficulties of launching new initiatives or changing existing ones while subject to close congressional oversight and approval requirements also can be a serious obstacle to efficient and nimble operations.

2. Government compensation models and management systems are unlikely to attract or retain the level of experience that would be necessary to effectively operate a full scale secondary mortgage market operation. Ginnie Mae today operates with a very small staff primarily because it relies almost entirely on the FHA and VA guarantees that underlie its mortgages to secure its credit guarantees, and because it does not operate a mortgage portfolio that requires the raising of capital and the management of portfolio interest rate and duration risks. Fannie Mae, Freddie Mac and other secondary market players were able to build large scale operations partly by recruiting staff and management in highly compensated and competitive competency areas. A government run organization would be unlikely to be able to replicate their success in this.
3. Such an organization could play a more expansive role than has been the case for Ginnie Mae. But close congressional oversight, the need to rely on legislative authorization for new initiatives, and pressure from private interests likely would keep such an entity's activities closely confined to that of providing liquidity for a well-defined set of mortgages. FHA provides a sobering model for the limited agility and ability to respond quickly to changing markets that such an entity likely would represent. A close focus on loans to foster first-time homeownership for low, moderate and middle income households and affordable rental housing would likely evolve as sustainable objectives for such a full guarantee operation.

4. The organization's total obligations would transfer onto the US Government's balance sheet. The total outstanding balance of mortgage debt in their portfolios today is around \$1.5 trillion with another roughly \$4.5 trillion guaranteed through their MBS. US public debt is estimated to reach more than \$12 trillion in 2009; adding the GSEs thus would be significant increase in the government's balance sheet.

### ***Fully Privatized***

Since Fannie and Freddie were launched, other private investors have developed robust secondary markets in a series of asset classes, including mortgages. As a Treasury study of privatization concluded in 1996,

“There seems little doubt that securitization and the secondary mortgage activities pioneered by Ginnie Mae, Fannie Mae, and Freddie Mac are now well-established and that the secondary market for conforming, conventional mortgages could operate efficiently and effectively even if Fannie Mae's and Freddie Mac's government

sponsorship were altered. However, the broader potential effects of ending that sponsorship remain uncertain.”<sup>37</sup>

It is unclear whether the past decade’s experience would alter this relatively comfortable view of private securitizations for housing finance.

A recently floated trial balloon to separate the GSEs’ assets into a “good bank” and “bad bank” could be a path to full privatization of the companies. Their current portfolios could be stripped of their most troublesome assets and the remainder sold to whoever believed they could make a go of the business starting with a healthy balance sheet. The government would recoup some or all of its investments in shoring up the companies, and accept the responsibility to liquidate the “bad” debt as profitably as possible. Government involvement in the secondary market would begin and end with Ginnie Mae’s continuing liquidity function for US-guaranteed mortgages.

A working group of mortgage and housing policy experts convened by the Center for American Progress<sup>38</sup> has considered a plan through which any entity that creates mortgage backed securities, including a fully privatized entity like this, would have to acquire a charter whose primary purpose would be to regulate the terms of such investments. The charter would confer no specific benefits but would

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<sup>37</sup> Treasury, op cit, p. 83

<sup>38</sup> The members of this group and a set of principles they have adopted as the basis for discussions of policy alternatives is included in Appendix 1.

attempt to prevent the excesses that private mortgage securitization demonstrated in the last few years. These terms could include regular audits and oversight, and requirements for greater transparency and risk-ratings than proved to be available in the past.

Absent legislation to the contrary, the federal government's actions in the current crisis have cemented in the market's mind that all very large financial institutions, regardless of the businesses they pursue, carry an implicit federal guarantee. A charter to do MBS would not affect this, or any more ordered structure that might emerge from ongoing debate about financial restructuring and "too big to fail" or "systemically important institutions." Instead, the purpose of a charter would be to ensure that all issuers of MBS follow the same standards of disclosure and accounting to help prevent the destructive "race to the bottom" that was such a driving force behind the collapse of the mortgage market. It would protect institutions that resisted quality erosion under market pressures like those experienced by all secondary market players as Wall Street developed its mortgage securitization engines.

*Pros*

1. Private firms would have unfettered ability to enter and exit parts of the mortgage market. A lightly regulated regime would enable private capital to adopt quickly to changes in market and credit conditions, supporting innovation and enabling primary market lenders to develop new markets and products.
2. Unconstrained by federal controls on compensation, fully private firms could hunt for and retain talent in a competitive market.

3. Without specific federal support for their operations, the government would be freed of any greater guarantee of their success than would be available to any very large institutions of any kind.
4. Private investors and not taxpayers would bear the risk of failure, subject to whatever rules are adopted to restrain the growth of “too big to fail” institutions of any kind.

## *Cons*

1. Because the current crisis has demonstrated that systemic risk considerations make all very large financial institutions “too big to fail,” the ultimate benefit of having fully privatized secondary market actors is unclear. The moral hazard that full privatization is advertised to prevent has been shown to be fully present even when the federal government offers very large institutions no overt sponsorship of any kind. Consequently, whether new secondary mortgage market entities are free standing or, as is more likely, part of much larger institutions, it appears that federal intervention is likely if they grow big enough to threaten the overall system’s stability. This is particularly true for something so important to American households as mortgages. In some ways, this precedent has made the GSE model, for all its evident flaws, significantly more protective of federal interests than any privatized model is likely to be. If OFHEO or FHFA had effectively regulated the GSEs’ businesses by reining in their riskiest behaviors, or by dramatically increasing their required capital as risks in the system grew, it’s more likely that both would have survived the meltdown in much better shape. The Wall Street securitizers had no such oversight and in a future without federal sponsorship would continue to have none. When the federal government’s implicit guarantee is triggered by size alone and not by business line, there is really no such thing as full privatization. There is only unregulated sponsorship.
2. Fully privatized market players would have no incentive and no similar regulatory requirement to serve housing needs that were such a focus of GSE regulatory oversight. Many critics continue to argue that neither Fannie nor Freddie fully met the full measure of their responsibilities under the old regime. But no one can disagree that the regime contributed to a significant increase in both

companies' investments in affordable housing. Investors free of any government sponsorship would have no responsibility to focus on any sectors of the housing economy except those that provide the highest possible return for shareholders. While much of the GSEs' investments met their housing goals without requiring specific concessions or preferential pricing, some of it did. And in a finance world where there is neither an upper limit on the size of mortgages that can be financed, nor a minimum requirement to serve the lower end of the market, it is unclear that private capital would serve markets that offer lower, if still profitable, returns. Fully private institutions could be subject to a regime like the Community Reinvestment Act (CRA), but this would require separate regulatory expansion of that regime that could prove very hard to carry out.

3. A fully privatized system would have strong disincentives to offer long-term fixed rate mortgages without prepayment penalties. This would be a difficult outcome, as this is the default mortgage of choice for most consumers, and offers the most stable financing for homeownership. The result could be higher costs for consumers as they are asked to bear either the cost of adjustable rate mortgages or to pay for the right to prepay at any time.

## ***The Regulated Utility Model***

The notion of a regulated utility model for the GSEs has been floating around since the eruption of the credit crisis. But there has been very little specific structure actually proposed around it. In essence, a utility approach would start from the foundation of a government sponsored, private enterprise and layer

in significantly higher levels of regulation and constraints. This model has acquired favorable comments from both former Treasury Secretary Henry Paulsen and Fed Chairman Ben Bernanke. In considering the model, Bernanke noted that

“...a public utility model might allow the enterprise to retain some of the flexibility and innovation associated with private-sector enterprises in which management is accountable to its shareholders. And, although I have noted the problems associated with private-public conflict, that conflict is not always counterproductive; an entity with private shareholders may be better able to resist political influences, which, under some circumstances, may lead to better market outcomes.”<sup>39</sup>

Paulsen in a January, 2009 speech to the Economic Club of Washington said that “...establishing a public utility-like mortgage credit guarantor could be the best way to resolve the inherent conflict between public purpose and private gain.”<sup>40</sup>

Jaffee rejects the utility approach, noting that “The public utility model, however, is a strange prototype because it is generally considered to be a clumsy and inefficient regulatory device. Its common

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<sup>39</sup> <http://www.bepress.com/bejeap/vol9/iss3/art2>, p. 8

<sup>40</sup> <http://www.ustreas.gov/press/releases/hp1345.htm>

use arises only because there are really no other viable regulatory models for dealing with natural monopolies such as water, gas, and electric providers.”<sup>41</sup> Jaffee also questions whether a utility approach could offer an attractive enough return to interest private investors.

This is an important question. Fannie and Freddie emphasized significant “growth” sector returns to investors from the early 1990’s on. Fannie Mae Chairman and CEO Frank Raines promised investors 15 percent earnings per share growth shortly after his return to the company in 1998, for instance, and this became a driving force within the company for its compensation and among investors speculating in its stock.<sup>42</sup> But even without a drive to “growth stock” returns, the mortgage market historically generates a healthy growth rate simply because of household growth and house price appreciation. A mortgage finance utility that grew at the same rate of between 6 and 8 percent a year, as total mortgage debt outstanding has historically, would be offering a “value” sector return that would be attractive to some investors.

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<sup>41</sup> Jaffee, op cit

<sup>42</sup> Whether this level of growth ever was achievable or sustainable given later revelations of the two companies’ inadequate investments in infrastructure, accounting and other back office expenses during this period that would have been a drag on these historic growth numbers we will never know. We do know that both companies’ earnings were cut back significantly from what had earlier been reported at the end of their accounting restatements.

## *Pros*

- 1. The utility model seeks to maximize the use of private capital through a shareholder owned entity while closely regulating it to maximize its focus on public, rather than private, returns.*
- 2. A utility model could tightly restrain the size and types of mortgages it targeted. This would enable there to be a more highly focused use of the public benefits while still using private capital. Similar restrictions could be imposed on Fannie and Freddie now. But a utility structure would reduce, if not eliminate, the significant pressure that could bear on investors under regulatory initiatives in a less overtly constrained set up.*
- 3. It could provide predictability and fairness for the primary market in pricing, access, etc.*

## *Cons*

- 1. There is no certainty that investors would find a utility model appealing unless it was granted a monopoly so it could compel pricing that ensured its investors their return. Without sufficient capital to invest in guarantees and a portfolio, the model would be of limited use.*
- 2. The level of oversight and regulation implicit in a utility model might hamper innovation and agility to respond quickly to market developments. If the utility could not respond quickly, market innovations could be constrained, or other investors would arise to seize the market and the utility would be relegated to a much more limited share of the market.*

3. *A heavily regulated entity could be subject to an excessive amount of political influence in its operations. FHA provides an example of how difficult it can be to respond quickly to market changes and adopt new business approaches when Congress must approve such changes. Likewise, FHA's struggles to overcome persistent congressional support for seller-financed downpayments in its programs, even in the face of strong evidence that they are driving high failure rates in FHA's book, shows how difficult such close oversight can be.*
4. *A utility easily could become focused primarily on serving lenders' needs at the expense of consumers', given its focus on steady returns. The lack of competition could leave the market without a reliable means to develop or spread innovation.*
5. *It would be much harder to require specific attention to more difficult to serve parts of the housing market if returns in a utility were strictly regulated and constrained.*

## ***Mortgage Bankers Association Proposal***

In August, 2009, the Mortgage Bankers Association of America (MBA) published a set of proposals for restructuring the secondary market. This paper proposed the establishment of a government guaranteed wrap of mortgage backed securities that would be issued by regulated “mortgage credit-guarantor entities (MCGEs)” that would hold capital to back their MBS and sit in the first position for any losses. They could require additional credit enhancements to bolster their position. The federal guarantee would extend only to the MBS, not the issuing company, and would be available only for “core” mortgage products, described as the “standard” products now securitized by the GSEs in both the single and multifamily markets. The proposal also envisions a limited portfolio authority to enable the MCGEs to manage transitional business operations such as warehousing and liquidations, “highly structured” multifamily mortgages not easily securitized, and for fostering research and development of new products prior to their full securitization.<sup>43</sup>

The MCGEs’ regulator “should be strong, empowered and adequately funded” through the insurance premiums on the federal guarantee, and permit a conservative return on equity and control products, pricing and capital levels.

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<sup>43</sup> *MBA’s Recommendations for The Future Government Role in the Core Secondary Mortgage Market*, Mortgage Bankers Association Council on Ensuring Mortgage Liquidity, August, 2009. All quotes in this section are from this publication, available at <http://www.mortgagebankers.org/advocacy/issuepapers/ceml.htm>

The proposal suggests transitioning Fannie and Freddie's capabilities to these new securities issuers and to transfer existing servicing, origination and other relationships through a transition to keep mortgage capital flowing.

***Pros***

The MBA proposal likely would insure a continuing supply of long term, fixed rate credit, by offering the federal guarantee behind the securities' repayment.

1. The proposed structure would put private capital in the first risk position, and by restricting the government's guarantee coverage, insulate taxpayers from the costs of an issuer's failure beyond the outstanding MBS obligations.
2. The MCGEs could recruit management and staff outside the constraints of federal hiring processes.
3. By separating the guarantee of the securities from the entities themselves, MBA's proposal neatly confronts the dilemma of implicit guarantee. Private entities would be allowed to fail if necessary, with government responsibility flowing only to the investors in the securities, whose servicing could be picked up by other, surviving MCGEs.

## **Cons**

- 1.** By constraining the federal participation to a limited set of “standard” mortgages, the proposal would leave the development, diffusion and marketing of other innovations to unregulated market participants. While this would provide a “safe haven” for long term, fixed rate mortgages, it would do nothing to help smaller institutions gain access to new products or features. This could reduce the ability of community banks and credit unions to independently offer a range of products and accelerate industry consolidation.
- 2.** The proposal explicitly removes any obligation to address the needs of underserved communities or households from the MCGEs, relegating this role to FHA and Ginnie Mae. This could rapidly lead to a two-tiered system where credit that these families and communities need could only be accessed through direct government support, and allow the MCGEs to focus entirely on the most credit worthy and profitable segments of the market. It was exactly this situation that led to the enhanced housing goals adopted by Congress in 1992.
- 3.** By restricting the government’s wrap only to a selected number of products and players and its oversight to their issuers, the proposal would do nothing to address the proliferation of private label securities and the underwriting “race to the bottom” that characterized the latter years of the mortgage boom.

## *Credit-Suisse*

In an October 6, 2009 “Mortgage Market Comment,” Credit-Suisse’s Fixed Income Research group recommended “rebuilding the existing GSEs rather than reinventing the wheel.” Like the MBA, after shifting both companies “bad assets” out of their balance sheets, future MBS would receive an explicit guarantee, similar to that proposed by MBA, and paid for through a fee. The GSE portfolios would be scaled back significantly to provide the ability to act as “THE counter-cyclical buyer of mortgages.” As in the MBA proposal, the new GSEs would underwrite only loans within well-defined parameters defined by the current regulator, FHFA, and approved by Congress. “We anticipate that this box would conform to the traditional GSE products and largely cater to full documentation, relatively high credit, and modest leverage loans.”

The affordable housing market would be shifted entirely to FHA and other explicit government subsidy programs.

The Credit-Suisse paper provides significant details on proposed pricing and guarantee levels.<sup>44</sup>

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<sup>44</sup> GSEs: Still the Best Answer for Housing Finance, available at [http://www.zigasassociates.com/images/uploads/GSEs - Still the best answer for housing finance.pdf](http://www.zigasassociates.com/images/uploads/GSEs_-_Still_the_best_answer_for_housing_finance.pdf) by permission of the authors.

## ***Government Owned Corporation***

An alternative to the fully private and fully government options is the government owned corporation, a model in which the organization functions outside the direct agency of the government, but is wholly or partly owned by it. The Government Corporation Control Act of 1945 establishes a process for such entities. Examples of this model in the US include the Tennessee Valley Authority, the U.S. Postal Service, Amtrak, and the Corporation for Public Broadcasting; it is widely used in other countries, as well.<sup>45</sup>

As the sole or majority shareholder of chartered corporation, the government obtains control over its operations while still being able to compensate management outside of civil service constraints. The enterprise aims to be profitable, but as the owner, government gets to decide how profitable and where the profits are invested. Such a corporation would have more limited congressional oversight than a government agency and greater latitude to launch new programs or markets than a government agency would.

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<sup>45</sup> Given recent dramatic events in finance, this list arguably also could include AIG, Citigroup, General Motors, and, of course, Fannie Mae and Freddie Mac.

This structure has been proposed for the FHA by the Millenium Housing Commission,<sup>46</sup> among others, precisely to try to overcome some of the deficits facing that organization because of bureaucratic and political constraints that consigned it to a very small and marginal sector of the market before the credit collapse.

The management of Fannie Mae and Freddie Mac during the first year of their conservatorship, during which the government effectively has held and exercised ownership control, is instructive. Conservatorship is designed to provide for the companies' orderly transition back to profitability.

Together the companies are supplying roughly 70 percent of the nation's mortgage capital. The government, however, is using its ownership status to use the companies to carry out other public policy goals, as well. The two companies are operating the Administration's *Making Home Affordable* mortgage modification program, for example. Once their economics are stabilized along with the credit markets, why couldn't this model continue to provide an effective and stable platform?

There are possible variations on the government ownership scheme. Its stake could range from 100 percent to something less, for instance. Fannie Mae operated under a mixed ownership model from 1954-68, when lenders doing business with the company were required to purchase stock in it and the government retained a significant ownership share.

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<sup>46</sup>Meeting Our Nation's Housing Challenges, Report of the Bipartisan Millennial Housing Commission

Appointed by the Congress of the United States, May 30, 2002, p. 46 <http://govinfo.library.unt.edu/mhc/MHCReport.pdf>

## Pros

1. This model could retain and attract private capital in some form (certainly debt with the government backing implied – and probably some forms of preferred stock with fixed dividends), while ensuring a durable government interest through its ownership stake.<sup>47</sup> This stake would be a strong sign of the government’s interest in the enterprise and could substitute for a direct guarantee and provide a powerful platform for oversight and governance. This could offer the benefits of the past “implicit” guarantee in the new regulatory environment in which all very large enterprises will enjoy some similar protection.
2. Recruitment, compensation and personnel management all could be conducted outside of civil service system constraints.
3. The government would share in upside profitability, as it did when it sold its share of Fannie Mae in 1968.

## Cons

1. Even though government ownership reduces the perceived conflict between public purposes and private benefits, it would not eliminate it. Indeed, such a structure would make government an

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<sup>47</sup> Even as of this writing, investors continue to buy and sell Fannie and Freddie’s common stock. Although their value is only a small fraction of what it was before the government claimed an almost 80 percent ownership stake, the common stock is not worthless.

active potential beneficiary of a profitable enterprise, possibly forcing it to decide between the two.

2. Although government ownership need not include a full faith and credit guarantee of the enterprise, it's possible that markets would perceive this to be the case. How different this might be from the guarantees that all very large financial services corporations will be perceived to have in the future is unclear.

## ***Cooperative Model***

Another ownership variation is a cooperative model, in which the secondary market agency or agencies would be owned by the lenders that are its customers. This is similar to the Federal Home Loan Bank model, and lenders were required to purchase Fannie Mae stock during its mixed ownership period between 1954 and 1968. The same pros and cons for government ownership would apply to this model, with one additional complication.

Fannie's and Freddie's ability to fund mortgages from any seller and its willingness to extend new products across their customer base made them a valuable counterparty for small lenders. A secondary market agency owned by lenders likely would have little interest in building systems that could undercut the pricing, marketing or technology advantages of large lenders. Absent the competitive access that Fannie and Freddie provided, a cooperatively owned institution could become primarily an outlet for very large institutions that could use their market power to force smaller lenders into direct and ultimately potentially limiting partnerships in order to access those important competitive features.

## ***Covered Bonds***

A final alternative that has attracted attention since the credit meltdown is covered bonds. These are very common in Europe, particularly in Denmark, where they are the principal source of mortgage capital. Under the covered bond model, lenders issue mortgages that are converted into securities that are sold to investors. The assets backing the bonds are held on the issuer's books, and the bonds typically are

overcollateralized. Issuers must replace failed mortgages with new ones to preserve both the principal and yield on the bonds.

Mortgages in the Danish system until very recently have all had 20 percent down payments and 30 year terms. The system recently has begun offering adjustable rate mortgages; the consequences for financing are not yet fully known.

Covered bonds are a more structured and less liquid form of mortgage backed securities. Given the very deep existing market in US mortgage securities, their liquidity and flexibility, and the fact that originating lenders need not hold capital against the underlying assets as they do with the bonds, it is unclear that a covered bond option would be attractive to lenders. Jaffee notes that “In Europe, covered bonds are much more common, but it appears this mainly reflects the lack of an institutional and legal structure to carry out asset-backed securitization in an efficient manner. Thus, given a choice, it appears that well-designed securitization instruments will dominate covered bonds.”<sup>48</sup>

Fed Chairman Ben Bernanke also reviewed covered bonds, and noted that the Federal Home Loan Banks provide lenders a direct source of competitively priced capital with which to make mortgages, and repeats Jaffee’s observation that the relative maturity of the US securitization regime coupled with a lack of the extensive oversight and regulatory capacity that covered bonds would require argues against their likely substitution for securitization in the US.<sup>49</sup>

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<sup>48</sup> Jaffee, op cit, p. 56

<sup>49</sup> Bernanke, op cit, p. 7-8



# *Appendix I*

## *A Short History of the GSEs*

Reviewing the history of the government's support of the secondary mortgage market provides a perspective on how it has evolved over time and how intimately tied it has been to larger policies of economic growth and stabilization. The structures and role of Fannie Mae and Freddie Mac have evolved along with housing and capital markets. This changing role and the flexibility in the system are useful benchmarks to consider as future structures are considered.

The U.S. government's role in the mortgage system began in 1932 with the chartering of the Federal Home Loan Banks (FHLBs). These institutions were created as cooperatives owned by home lenders. Their charters enabled them to raise money with the implicit guarantee of the U.S. Government. These funds were then made available to member banks in the form of advances. These were secured by collateral, usually mortgages. The purpose of the system was to provide a constant source of liquidity for primary market lenders to enable them to make home loans by offering these advances and adding to the traditional deposit base for home lending.

But it was not until 1934, with the adoption of the Federal Housing Act of 1934 and the creation of the Federal Housing Administration (FHA), that the government's intervention was able to kick-start a prolonged period of new investment in housing. FHA adopted a radical concept. The Government would

insure long-term, fixed-rate, self-amortizing mortgages to people of modest means. Before this innovation, mortgages were typically short-term obligations, usually with balloon payments following a short period of amortization. Other forms of credit included land sales contracts, an installment kind of lending, where consumers paid over a period of time and did not build up equity in the property until the loan had been paid off.

The advent of the FHA loan meant that borrowers could take out a significant loan with the assurance of a regular, predictable and affordable monthly payment that would not vary over the life of the loan. Combining interest and principal payments in a single level payment assured that both would be extinguished at the end of the loan's term. Equity began to build with the first payment. It accelerated as the loan matured.

This revolutionary approach to mortgage lending was terrific for borrowers. But it created new problems for the finance system. While lengthy amortizations are great for consumers, they lengthen repayment streams for lenders. For a system dependent primarily on deposits and advances for lending capital, this long repayment period, and the capital requirements it entailed, meant that lending eventually could be choked off for lack of new capital to lend. Moreover, the very idea of providing long term credit to working people was new and challenging for lenders of the day. Lenders and potential investors were wary of borrowers' ability to repay, and uncertain about the depth and durability of any market in such instruments. Congress proposed a solution to this dilemma by authorizing in Title III of the 1934 Act the incorporation of private national mortgage associations that would buy and hold these loans long term. It had been hoped that private sector investors would seek such a charter for these purposes. But none did.

### ***Enter Fannie Mae***

The absence of a secondary market for these new long term mortgage loans threatened to derail the basic purpose of the FHA program, which was to use federal guarantees to kick-start lending in the moribund mortgage field. In 1938 Congress responded again by creating the National Mortgage Association (later changed to Federal National Mortgage Association, popularized as Fannie Mae). This federal agency's purpose was to issue government guaranteed debt and use it to buy FHA-insured mortgages, hold them in portfolio, and to re-sell them to private investors where possible in order to provide liquidity in the housing market.

The creation of Fannie Mae succeeded in bringing liquidity to the mortgage market, and after World War II and the establishment of the GI Bill of Rights, Fannie Mae began buying mortgages insured by the Veterans' Administration (VA) for returning servicemen and women, as well.

In 1954 Congress adopted the Federal National Mortgage Association Charter Act. This legislation created a mixed ownership model for the company that incorporated some elements of FHLB cooperative ownership. The U.S Treasury retained nonvoting preferred stock in the company. Lenders selling loans to Fannie Mae were required to buy nonvoting common stock in order to continue to do so. The company also acquired specific responsibilities to carry out specialized mortgage lending programs at the direction of the Congress and President, and to manage the existing portfolio.

In 1968 Fannie Mae was fully privatized with the sale of the Treasury's preferred stock and its transition to nationally chartered private shareholder ownership. With this privatization, the agency's functions were split. The newly-formed Department of Housing and Urban Development (HUD) retained a new entity, the Government National Mortgage Association (Ginnie Mae) to provide liquidity for government guaranteed

home loans, primarily those backed by FHA and VA. Fannie Mae in its new, private form was charged with secondary market functions for the conventional market, although it could and did purchase government guaranteed loans in some amounts.<sup>50</sup>

The charter that Congress adopted to privatize Fannie Mae gave HUD regulatory authority over the new company. HUD also had the authority to require that a reasonable portion of the company's loan purchases furthered HUD's broader mission of providing affordable housing opportunities to low and moderate income families.

### **Freddie Mac Founded**

In 1970, the secondary market was expanded with the addition of a new entity, the Federal Home Loan Mortgage Corporation (Freddie Mac), capitalized through the sale of \$100 million in stock to the 12 Federal Home Loan Banks. The company was authorized only to issue securities backed by home loans acquired

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<sup>50</sup> The 1968 privatization was a major turning point for U.S. housing policy and for the structure of the secondary markets. The principal impetus for this shift was not a sudden affection for fully private enterprise in the secondary market space, although this was a part of the move. It primarily served to raise funds for the U.S. Government at a time when the costs of the war in Vietnam were escalating and President Lyndon B. Johnson was struggling to maintain his pledge to provide both "guns and butter" without busting the budget. The "fire sale" of U.S. assets that provided a short term boost to the government's balance sheet by adding the proceeds of the sale and eliminating the liabilities of Fannie Mae's mortgage portfolio from the federal balance sheet was a principal driver behind this change.

from lenders. It did not maintain a portfolio function. Freddie Mac was designed, and operated for more than a decade, as the secondary market arm for the Home Loan Bank system. It was housed within the Federal Home Loan Bank Board (FHLB), which was the FHLB system's overseer.

Freddie pioneered the use of mortgage backed securities (MBS) through its issuance of Mortgage Participation Certificates. These instruments expanded upon the initial mortgage backed securities first introduced by Ginnie Mae with full faith and guarantees from the government. This device enabled the thrifts that owned Freddie Mac to maintain a secondary market outlet that did not directly compete with their portfolio holdings of home loans, which at the time were extensive and their principal source of earnings.

#### **Fannie Mae's First Crisis**

The late 1970's and early 1980's saw record high interest rates, particularly in the short-term paper market. Fannie Mae, which had operated on a staid, auction-based system of acquiring long-term mortgage assets and funding them with short term government guaranteed loans, found itself saddled with a large book of low-interest, long-term loans in its portfolio, while interest rates on its debt soared to record levels. This mismatch in duration and cost created a serious financial crisis for Fannie Mae.

A key part of the company's recovery strategy was to shift its business model to rely heavily on mortgage backed securities, off balance sheet assets that did not have the same interest rate risk for the company. It also broadened its market by investing in adjustable rate mortgages (ARMs), which were popular with thrifts and other portfolio lenders because of the lessened interest rate risk. It initiated a "swap" program that made it easier for lenders to convert their long- or short-term mortgages into mortgage backed securities that were more liquid and could be traded more easily.

These efforts paid off, and by the mid-1980s the company had returned to profitability and its volumes soared as the thrift industry began to experience its own troubles. In 1987 it created a variety of innovative MBS structures to attract more investors, as well as real estate mortgage investment conduits (REMICs) that allowed further tailoring of assets, durations, and other features that expanded the investor market.

Fannie Mae's growth surged after it emerged from its financial crisis. This was fueled by its shift into more diversified business lines, and also by the collapse of traditional portfolio lending by savings and loan institutions following that industry's calamities in the late 1980's.

The ability of Fannie Mae and later Freddie Mac to step into the vacuum left by the collapse of the S&L industry illustrated the important function of stability that the model could provide. By providing an outlet for struggling S&L's and liquidity for the rising ranks of mortgage banks without access to deposits or deep capital reserves, the GSEs insured a continuing supply of mortgage funding . In Fannie Mae's case, this enabled them to book more than \$300 billion of the \$400 billion on its books at the end of the 1980's during that decade alone.<sup>51</sup>

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<sup>51</sup> Funding Universe, op.cit.

## Charter Reform

The S&L crisis awakened growing concern in Congress over systemic risks that large institutions with relationships to the government might pose. In 1992 it responded by adopting the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. This legislation modernized the two companies' charters to require specific capital tests, with both ongoing regulatory and risk-based capital standards. It established a new regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), independent of, but affiliated with HUD. OFHEO was charged with safety and soundness oversight of the two companies. It was funded by assessments on the two firms, although its budget was subject to congressional appropriations each year. HUD retained general policy oversight, fair housing, and new program approval responsibilities.

The 1992 Act also reinforced HUD's role in overseeing the two companies' success in fulfilling their mission of providing affordable mortgage credit to low, moderate and middle income families. This obligation actually dated to the 1968 charter revisions. But HUD's enforcement had been weak and inconsistent. The law charged HUD with developing and promulgating specific numeric housing goals to serve low- and moderate homebuyers and renters, as well as "central cities, rural areas, and other underserved areas." HUD issued short term transitional rules explicating these goals in 1994, and adopted the first full set of these regulations the following year. The goals established specific percentages of homes financed by Fannie and Freddie in each of the congressionally adopted categories.<sup>52</sup>

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<sup>52</sup> The Act also established separate dollar denominated goals for multifamily investments in special affordable housing. HUD also decided in the 1995 regulations to replace the congressional goal of lending on properties located in central cities to a different geographic test based on

The adoption of the GSE housing goals accelerated both companies' initiatives to provide more flexible mortgage terms.<sup>53</sup> Their secondary market dominance had turned their underwriting rules into defacto standards for the entire industry. Many portfolio lenders adopted more flexible terms earlier and more aggressively than the GSEs. But their integration into Fannie and Freddie's own underwriting standards made them more broadly available. Fannie Mae introduced its first 3 percent down payment product in 1994; Freddie Mac shortly followed. Over the next decade, both companies introduced new underwriting flexibilities and specialized products that gradually reduced down payments in some products to zero, and adopted alternative means of measuring credit-worthiness to expand the pool of borrowers who could qualify for a home loan. In turn, home mortgages became more widely available on better terms than at any other time.

#### **Homeownership boom and new market models**

Coupled with a period of sustained economic and job growth, and a long period of historically low interest rates, the mortgage initiatives of the primary and secondary markets led to a rapid growth in the national homeownership rate to a record-high level of 69 percent overall. Minority homeownership rates,

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"underserved areas." These areas were determined through a combination of economic and racial data measured on a census tract level. Although mirroring the geographic requirements imposed on federally regulated depositories in the Community Reinvestment Act (CRA), these were not exactly the same, establishing an enduring tension between lenders subject to CRA and the goals-related efforts of the two companies.

<sup>53</sup> The new goals also had the effect of forcing Freddie Mac to re-energize its own multifamily financing programs, which it had suspended after suffering significant losses in its initial incarnation. Freddie lagged Fannie Mae for a number of years in this area as it ramped up its capacities and its appetite for multifamily risk.

which lagged those of White households by double-digit amounts, also grew significantly during this period, and both the Clinton and Bush Administrations actively promoted broad homeownership efforts in which they enlisted the GSEs.

The 1990's also saw the introduction of automated underwriting and credit scoring systems and their broad adoption through the primary and secondary markets. When combined with federal policies late in the decade that kept interest rates at very low rates, these new tools helped bring into the secondary market a host of new players backed by Wall Street and based in the private securitization of mortgage assets. This accelerated in the new century and attracted the participation of lenders that specialized in subprime asset backed lending.

Subprime mortgage lending grew rapidly in the late '90's and first decade of the 2000's. Focused first on refinancing, a flood of new capital financed lending to borrowers on terms that were significantly beyond the GSEs' underwriting standards. These lenders had special success in minority and elderly communities, where home equity could be tapped by borrowers who either had not had access to it before, or who had focused previously on retiring, not expanding mortgage debt. Aggressive and sometimes predatory marketing drove more and more volume into the subprime space. Sometimes borrowers who could have qualified for better terms in the prime market were steered by salespeople and brokers into subprime loans that had higher prices and deleterious terms. In addition, these subprime offerings cut deeply into FHA's market share, as groups for whom FHA had been the only reliable financing source for homeownership increasingly were marketed to heavily by subprime lenders.

The wide availability of cheap mortgage money fueled a steady rise in home values that outstripped increases in real incomes. One result of this imbalance was the introduction of mortgages with increasingly

lax terms, focused on initial low monthly payments. Marketed as “affordability products,” these mortgages combined low down payment and relaxed credit qualifications with low or no documentation that became known as “Alt-A” products because they were purported to serve prime borrowers with alternative terms. Wall Street firms provided a flood of capital to acquire and securitize these mortgages, relying on high quality ratings to sell them to investors.

### **Accounting scandals and new competitors**

In the midst of these market developments, Fannie Mae and Freddie Mac found themselves on the wrong end of investigations of their accounting practices. In 2003 Freddie Mac’s new outside accounting firm charged the company with inappropriate accounting. OFHEO’s investigation that followed resulted in the dismissal of Freddie’s long-serving Chairman and CEO, Leland Brendsel, and a subsequent even deeper top executive level shuffle.

The discovery of these accounting irregularities at Freddie prompted an OFHEO investigation of Fannie Mae that concluded in 2004 that it, too, had applied accounting principles incorrectly leading to a significant misstating of past earnings.

As a result of these investigations and findings both companies were consumed for most of two years with massive restatements of their earnings for several prior years.

### **Rise of the Shadow Market**

During this same period the new flood of mortgage liquidity fueled by Wall Street securitizers eroded Fannie and Freddie’s share of the market. While they had together accounted for more than 50 percent of all new mortgage credit throughout the 90’s, by 2006 their combined share was below 30 percent and sinking. In response to this challenge to their central role in the mortgage system, under pressure from

shareholders/investors to be more aggressive and resume their growth trajectory, and in pursuit of the higher revenues they were losing to these new entrants, both companies drove into the Alt-A market, which they largely had resisted until then. They eventually acquired more than \$500 billion in these assets through swapping Alt-A loans into GSE guaranteed securities. In a few short years, these loans came to account for roughly 15 percent of both companies' credit risk portfolios.

Both companies also had provided liquidity to the subprime mortgage market, principally through purchasing highly rated tranches of non-GSE securities in the open market. Freddie's acquisitions seem to have been driven in some part by HUD's housing goals, which had been raised repeatedly since 1994 and especially in 2004. According to HUD's analysis, more than 40 percent of the Freddie's home purchase loans that qualified for the goals in 2004 and 2005 were acquired through subprime securities. In contrast, less than 5 percent of Fannie Mae's qualifying loans were acquired through these bonds.<sup>54</sup>

The GSEs' participation in the subprime marketplace was the center of debate throughout the late 1990's and early 2000's. On the one hand, HUD was anxious to insure that the GSEs did not create excess liquidity for these products or use products with abusive terms to meet their regulatory requirements. On the other hand, some industry and consumer advocates saw an opportunity for the GSEs to bring a measure of discipline and standardization to a market that was rife with fees and added costs that especially burdened low and moderate income owners and buyers.

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<sup>54</sup> HUD Working Paper No. HF-018, Harold L. Bunce, HUD Office of Policy Development and Research, June, 2007

The tension between the GSEs' traditional role of providing liquidity to the standard marketplace of 30-year, fixed rate loans and its chartered role to provide standardization in the marketplace was fully tested during these primary market changes. In early 2000, Fannie Mae issued a Lender Letter outlining specific features that could not be included in any products it financed. Copied quickly by Freddie Mac, these were for some time the only restrictions in the subprime mortgage market. By setting boundaries on what they would purchase, the GSEs were attempting to flush out certain practices through the leverage of their potential participation as buyers of the loans and securities. At the same time, both companies also incorporated new scoring models in their automated underwriting systems to enable them to compete against subprime lenders for borrowers whose credit profile was below the standard for other products. These loan products carried higher fees and costs for borrowers, as well as loan level mortgage insurance coverage, to offset their higher perceived credit risk. They were aimed at the "top tier" of potential subprime borrowers, and were limited in their ability to match the terms offered borrowers with even weaker profiles through subprime channels.

At the same time, the mortgage market was undergoing a rapid and fateful shift. Non-traditional loan products in both the subprime and Alt-A space had developed and grown in different business channels than traditional mortgage loans. These primary market lenders bypassed the GSE liquidity model to obtain funds directly from the capital markets, through Wall Street investments firms anxious to package mortgages into bonds they could sell through structured financial transactions. As these alternative channels grew, the GSEs' influence over mortgage terms was weakened, as was their market share of total mortgage securitizations. The growth of this increasing alternative market, largely unregulated and dependent on complex capital market structures to assess and hedge risks, put unanticipated pressure on

the GSE financing system. This flood of new capital put continuing upward pressure on housing prices, which in turn priced homes further out of borrowers' reach. As the pool of qualifiable borrowers became more and more shallow, this new capital found more and more creative ways to offer financing, encouraging a "race to the bottom" in underwriting standards.

### **Credit and Financial Crisis**

When the asset bubble generated by these trends finally popped in 2007, both companies were pulled under with unexpected ferocity. As monoline companies, both had unusually high exposure to the rapid depreciation of property values that ensued. House prices nationally dropped in one year by double digit amounts; in some markets, these reductions exceeded 25 percent. Their decision to compete with private firms for mortgage market share through the Alt-A and subprime markets ended up costing them both dearly. While Alt-A loans accounted for only about 10-15 percent of their total credit exposure in early 2007 and 2008, these loans were responsible for nearly half the credit losses the two companies suffered.

Congress had been debating new charter reforms for more than five years in response to fears of the systemic risk they represented. The unfolding mortgage and financial crisis spurred resolution of long-standing disagreements between the White House and Democrats and Republicans in Congress, resulting in adoption of a significant overhaul of the companies' regulatory structure in July, 2008. Congress also granted the government extraordinary new standby powers to step in to assure liquidity and solvency at both companies. At the time, then-Treasury Secretary Henry Paulsen likened these to a "bazooka in my pocket," nice to have, but unlikely to be necessary.

But in September, 2008, with the credit crisis deepening and both companies hemorrhaging cash, and concerns that foreign investors, in particular, might balk at purchasing their debt and other securities, the companies' newly established overseer the Federal Housing Finance Agency (FHFA) stepped in and placed both companies in conservatorship. The Treasury pulled out its "bazooka" and pledged \$200 billion (later raised to \$400 billion and then, in late 2009, extended indefinitely) in capital to back up the companies. In return, it received \$1 billion in senior preferred stock in both companies, along with warrants for up to 80 percent of the common stock in return for future investments in the companies. Existing preferred and common stockholders' holdings became nearly valueless. The companies' CEO's were fired, and their boards put on notice that they would be, too. Fannie and Freddie had effectively become government agencies once again, answerable to FHFA as their conservator.

# *Appendix II*

Center for American Progress



**DRAFT FOR DISCUSSION PURPOSES**

## Principles to Guide Development and Regulation of a Renewed Mortgage Finance System

### **1. Access to credit and liquidity**

The first goal of a mortgage finance system must be to provide sufficient credit for the development and purchase of single family and multifamily units adequate to meet the housing needs of the country. Consistent and adequate liquidity is essential to the availability of quality credit. To achieve this goal our country needs:

#### **a. Strong primary lending facilities**

Although secondary mortgage markets have grown to encompass a large share of overall mortgage lending—discussed in greater detail below—primary lenders are still the foundation of the mortgage finance system. Bank lenders are directly and intimately overseen by regulators, and their relationship to borrowers is typically a direct one. As such, primary lenders are a key to maintaining consistent and comprehensive access to credit and liquidity, and are less likely to see fluctuations in these areas that occur as a result of rising and falling investor demand.

b. Well-functioning secondary markets

Over the past few decades, funding from capital markets became an increasingly important part of mortgage lending. Initially this funding came through guaranteed mortgage backed securities from Fannie Mae, Freddie Mac, and Ginnie Mae; then through private-label, mortgage-backed securities, and most recently through the introduction of mortgage derivative products such as collateralized debt obligations. Worldwide investor demand for high yields spurred excessive risk taking to create ever larger issuances of bonds and derivatives based on mortgages. Coupled with a lack of regulatory oversight, this high demand created improper incentives and skewed the market into excessively complex and risky products, without any concomitant safeguards or changes in risk pricing.

Secondary market incentives must be aligned with credible and sustainable credit risk management (discussed in greater detail below). Secondary markets, however, remain important to liquidity and thus to a renewed mortgage finance system. Well-functioning and robust secondary markets will attract investors to provide capital for housing finance and maintain market confidence in mortgage-backed securities—on a continuous basis—in all economic environments.

c. Careful but creative innovation

While recent history suggests that innovation without adequate regulation or standards is dangerous, a system that encourages appropriate innovation remains essential to ensuring sufficient credit access and liquidity. At its best, financial innovation has the potential to provide increased liquidity at lower cost and thus make credit more available to serve more of the market. Innovation is important in origination, business processes, and secondary market vehicles. For example, innovations such as CAP's proposal for Shared Equity Ownership, which would pay down the principal owed by troubled homeowners in exchange for homeowner concessions that would effectively place the home into an affordable housing trust, have the potential to help communities and lenders alike. Process innovation that leverages technology to improve workflow and document management, enhances communication between borrowers and lenders, and enables more transparent mortgages and securitized mortgages, is a critical feature of a well-functioning market. While innovation can be

highly beneficial for consumers, it must also be augmented by direct government support for some types of housing and carefully balanced with the goal of consumer protection.

d. Adequate access to credit for all appropriate forms of housing

Public subsidies, tax policy, fiscal policy, and systemic biases toward homeownership may have contributed to an imbalance in capital availability for homeownership and rental housing. While there can be significant societal and individual wealth accumulation benefits from homeownership, there are many consumers for whom it is not appropriate at certain times. A renewed system of mortgage finance should provide liquidity and capital access for all forms of housing and meet the needs of consumers throughout society whatever their income and wherever located. Special attention should be paid to ensure that the renewed system provides sufficient capital to meet society needs for affordable rental housing. While the current market-based model is providing adequate capital for large multifamily properties and in the luxury end of the market, there is significant room for improvement in the delivery of credit to smaller properties that provide much of the supply of affordable rental housing.

**2. Countercyclicality: measures to ensure consistent access to credit and liquidity**

A successful housing financing system should ensure a consistent flow of credit, appropriately priced for market risks whether in good or bad times. This means preventing the overextension of credit during periods of expansion in order to prevent asset bubbles and reduce the impact of consequent deleveraging. This also means creating mechanisms to provide countercyclical liquidity during periods of contraction. One possible mechanism might be the adoption of fluctuating capital requirements, increased during times of easy credit, and decreased during times of deleveraging.

### **3. Risk management and oversight**

A vital component of a stable and successful mortgage finance system is ensuring that credit risk is appropriately measured, priced, distributed and overseen. Regulation of credit risk should be comprehensive and robust, covering all aspects of the mortgage markets, including the secondary markets. A commitment to improving credit risk oversight will help craft a fairer system that will see fewer homeowners default on their mortgage obligations. Key steps to ensure this happens are:

- a. A level-playing field: robust and comprehensive regulation

Regulators possess ample regulatory authority over the federally insured primary lenders to address capital adequacy and levels of risk, but largely failed to exercise it

during the housing bubble. Non-bank lenders were not subject to similar regulation. Going forward, bank regulators must exercise their significant regulatory power over primary lenders consistently and thoroughly.

Currently, there is a large gap in regulatory coverage of the secondary markets. Major market players, such as Bear Stearns Cos. and American International Group, Inc., were woefully under regulated, as were complex financial products such as credit derivatives, which became an enormous part of the financial system. The market events of the last few years have made clear the interconnectedness of our financial system—unregulated products and institutions can have enormous consequences on regulated products and institutions. Regulatory coverage must be extended over many of the currently unregulated products and institutions.

It is also important to ensure that opportunities for regulatory arbitrage, such as charter shopping, are eliminated. All financial transactions should be treated uniformly by regulators, regardless of the charter held by the institution engaging in the transactions.

b. Strong underwriting standards

Stronger underwriting criteria that are based on a thorough understanding of these variables will undoubtedly be a part of minimizing credit risk both institutionally and

systemically. Mortgage finance cannot ultimately be successful in managing risk if its core underwriting standards are weak. Strong underwriting means both the incorporation of stringent documentation and measures to eliminate fraud—such as in assessments or borrower stated income—as well as a better allocation of credit based on the borrower’s risk profile.

Stronger underwriting standards should, however, be tied into actual credit risk, and not simply be a proxy for withdrawing credit availability from underserved communities. Much of the credit failure driving the current crisis is the result of loan features such as prepayment penalties, adjustable rates, reduced or no documentation, as well as other factors that were not directly linked to borrower credit risk. More analysis must be done to understand the underlying credit drivers of mortgage performance, especially for borrowers with a low level of assets seeking access to non-traditional credit.

While a drive for better risk management is likely to lead to tighter underwriting standards, as well as lower loan-to-value ratios and higher down payment requirements, we must be careful to ensure these changes are based on criteria that are empirically tied to credit risk rather than on theoretical or ideological assumptions about the credit profiles of certain communities of borrowers. Stronger underwriting should ultimately result in a more careful allocation of credit, not a deprivation of credit in underserved communities.

### c. Risk assessment and capital adequacy

Risk assessment was horribly mismanaged during the past decade. Financial institutions and regulators alike were overly reliant upon credit risk ratings of private label mortgage-backed securities provided by the rating agencies, which we now know were terribly flawed. As a result, these bonds were mispriced against the risk they represented, contributing to the overextension of credit and the creation of an asset bubble. Consequently, banks were left holding inadequate capital against their actual risk, which has exacerbated the deleveraging process and contributed to the credit crunch. Any reforms of credit risk oversight must include changes to how the markets assess risk, currently through the rating agencies, as well as how risk-based capital requirements are determined for banks and bank holding companies, as well as other financial institutions,

## **4. Standardization**

Standardization provides benefits to consumers and investors, helps ensure the safety and soundness of financial institutions and improves the transparency and liquidity of housing finance. The benefits of standardization, however, must be balanced against the benefits of innovation and meeting unique needs, especially of underserved borrowers.

For consumers, standardization provides products that are more easily compared. As we saw during the lending boom earlier this decade, many borrowers are ill-equipped to assess different types of mortgages, such as an interest-only adjustable rate mortgage as compared to a standard 30-year-fixed rate loan. While innovative products may help to meet consumer needs in unique circumstances, they should be limited to places where appropriate and the terms should be written so their features are easily compared and understood.

For investors, standardization provides certainty which increases liquidity and thus capital availability. The diversity in the terms of pooling and servicing agreements for private label mortgage-backed securities is one reason why restructuring mortgages has proven so difficult, creating greater uncertainty and risk for investors than was properly understood.

Standardization also allows for better risk regulation. Where underwriting and documentation standards are the same across the board, it is easier for regulators to assess risk and set capital and liquidity requirements accordingly. Case in point: Fannie Mae and Freddie Mac sustained their greatest credit losses from their investments in non-standard Alt-A mortgage products. Losses on their standard books of business are more severe than predicted in large part because economic conditions have been more severe than anticipated.

Ultimately, standardization appears most likely to be created in one of two ways. The first is through secondary market institutions, which are in an excellent position to drive standardization through their provision of capital—either through their existing structures (Fannie Mae and Freddie Mac) or through something new—throughout the system and across primary lending platforms. The second is through comprehensive regulation of primary and secondary market actors.

## **5. Transparency and accountability**

One of the major failures of the mortgage finance system that led to our current situation was the lack of accountability by key players at each rung of the mortgage finance delivery process, including mortgage brokers, originating lenders, securitizing banks, and rating agencies. In many cases, all of these institutions lacked sufficient incentives to insure that the mortgages or mortgage instruments they were promoting were ultimately sustainable. In the “originate to distribute” model, all too often key market participants lacked any “skin in the game.”

This lack of accountability was accompanied and exacerbated by a lack of transparency. Buyers, sellers, and issuers of mortgage-backed securities and collateralized debt obligations shrouded their credit risk and credit loss exposures in a cloud of opacity, lessening confidence in the overall financial system and contributing to extreme credit illiquidity. Loan-level data information about the make up of mortgage-

backed securities and collateralized debt obligations are typically only available to those willing to pay a hefty price for it, again decreasing transparency and causing investors to assume the worst about individual mortgages and their ultimate loss levels. And at the origination level, mortgage brokers were less than transparent about the various mortgage options, and their relative benefits available to consumers, resulting in poor selections of mortgage products and a greater likelihood of defaults and foreclosures.

Reforms of the mortgage finance system must be cognizant of aligning incentives, promoting accountability, and ensuring adequate transparency. Greater accountability and transparency will inevitably lead to better risk assessment and management as well.

## **6. Systemic stability**

A critical issue that needs to be addressed in any reform of U.S. mortgage finance is the need to curb systemic risk, with a reformed system able to lessen the possibility of future shocks through the entire financial system. As Federal Reserve Board Chairman Ben Bernanke has noted, systemic risk regulation is important to consider as the financial system has become less bank-centered and as the risks of contagion are high. It is important to ensure that risk is appropriately understood and allocated, such that those holding the ultimate risk can afford to bear it. Better measures of gauging

counterparty and systemic risk must be adopted and consideration given to other mechanisms for containing and minimizing risk.

Design of a renewed mortgage finance system should also recognize the global nature of today's financial markets. While individual nations will inevitably retain separate regulatory regimes, far greater transparency and coordination through regulatory networks is necessary.

## **7. Enhanced consumer protection**

The purchase of a home is a complicated, highly technical transaction unlike any other consumer purchase, and it usually represents a household's single largest asset. Buyers are understandably reliant on the professionals they encounter during the process; however, in recent years, these professionals who typically owe no fiduciary duties to borrowers, have been compensated through incentives that are misaligned with consumer interests.

To address unequal information in the transaction, the system should have a built-in bias towards the long-term best interests of the borrowers. One example of this is a proposal for default mortgage model in which consumers would have to explicitly opt out of a 30-year-fixed rate mortgage in order to enter into a more complex loan

agreement. Reforms should not only protect borrowers against bad actors but also set up a system of better outcomes by default.

### **8. Equitable and fair access to credit for consumers and communities**

The mortgage finance system should be designed so as to eliminate disparities in the allocation of capital, although it is a mistake to think this is solely a matter of finance. What is more, there is a societal interest in ensuring that communities that have historically suffered from denials of credit or credit on discriminatory or predatory terms have appropriate access to credit from all parts of the finance system. This means ensuring that low-income households and underserved communities, many of which have high concentrations of minorities, have access to credit on terms appropriate to the level of risk represented. These are the communities hardest hit by the mortgage crisis and it is imperative that it is these communities and their residents are better protected and also better served in the future.