

## Areas of Alignment for Administrative Reform

September marked the 10th anniversary of Fannie Mae and Freddie Mac (“the GSEs”) being placed into conservatorship<sup>1</sup>, and there is growing recognition that Congress may not be able to tackle the complex issue of housing finance reform until 2019 or perhaps even later. But not all aspects of housing reform need to wait for action by Congress. The Trump Administration, particularly the Department of Treasury and the independent Federal Housing Finance Agency (FHFA) (once a new Director is appointed and confirmed) can do much to lay the groundwork for eventual legislative reform. While reforming the GSEs and putting the housing finance system on a more stable, sustainable path is the primary focus of this paper, it is essential that reform is not done in a vacuum. True housing finance reform should also address the Federal Housing Administration (FHA) and dynamics between private and government-insured lending channels to balance taxpayer protection with access to mortgage finance.

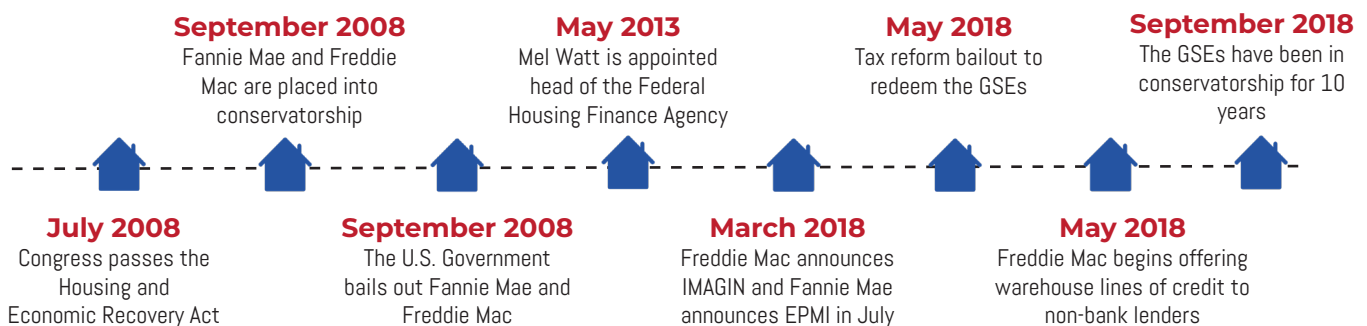
### Administrative Reform Proposals

While the Housing and Economic Recovery Act of 2008 (HERA)<sup>2</sup> limits the Administration’s ability to unilaterally eliminate or transform the GSEs (these actions require Congressional action), the Administration can still enact meaningful reforms – including requiring more oversight of their business practices and returning the GSEs to their intended role of promoting liquidity in the secondary market.<sup>3</sup>

Actions taken under Administrative reform could further reduce taxpayer risk, level the playing field between the GSEs and private market participants, and provide greater transparency regarding GSE pricing and practices. Further, Administrative reforms could be the catalyst needed to break the legislative logjam and enable Congress to enact comprehensive housing reform legislation.

There have been a number of proposals—from both progressive and conservative organizations, industry trades, and think tanks—about the reforms that are possible and plausible under Administrative reform. One critical similarity among the vast majority of perspectives on both comprehensive legislative and/or Administrative reform is the recognition that policymakers must reduce the GSEs’ duopolistic market dominance to create long-term safety and soundness in the housing finance system. There are several key areas of alignment among stakeholders and a number of Administrative actions that enjoy widespread support. Below, USMI highlights some of these areas of alignment, identifies additional areas where USMI members feel there is a critical need for Administrative reform, and provides recommended actions the Administration could take to address these areas.

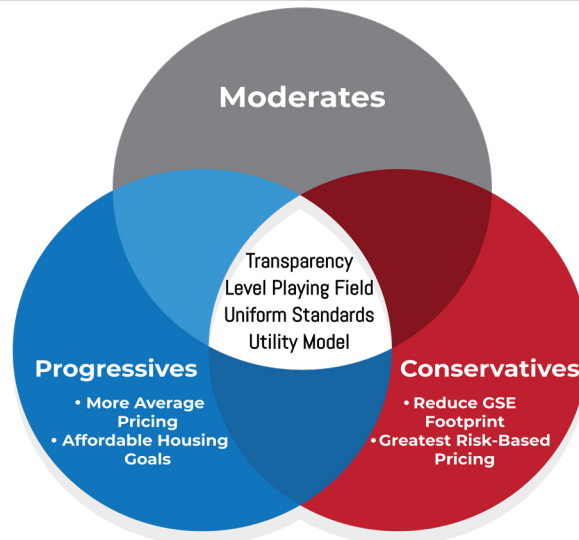
### CONSERVATORSHIP THROUGH THE YEARS



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## FINDING COMMON GROUND

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### REDUCE DUOPOLISTIC MARKET POWER OF THE GSEs

While different reform proposals may call it different things and rely specifically on different infrastructures to achieve it, many of the leading legislative and Administrative proposals for GSE reform have leaned on some utility-like secondary mortgage market function to reduce the GSEs' current duopoly and market power in the mortgage finance system. Some proposals rely on Ginnie Mae's infrastructure and platform while others rely on the Common Securitization Platform (CSP) that is jointly owned by the GSEs. Nearly all proposals call for Fannie Mae and Freddie Mac to have capped rates of return, be limited in their scope of activities, and be more open and transparent to the private market, policymakers, and consumers. While enshrining the GSEs themselves as utilities may pose risk of making it more difficult to ever establish a conventional mortgage finance system independent of the GSEs, there are steps the Administration can take that could promote a liquid secondary market while reducing the GSEs' control within the system.

*“Congress should change the GSE corporate charters from the current government-chartered, shareholder-owned, publicly traded companies, to regulated financial utilities that are shareholder owned.”*  
- Independent Community Bankers of America <sup>4</sup>

*“...the GSEs should be restructured to operate as a utility that have a regulated rate of return and require the approval of new products and services... A new utility structure preserves the efficiencies and the key countercyclical role that the GSEs play while protecting private entities from unfair competition.”*  
- Center for Responsible Lending <sup>5</sup>

**Limit the GSEs' Activities.** Before conservatorship, there was an inherent conflict in that the GSEs had an assumed implicit government backstop that became explicit when the federal government stepped in to support the GSEs to the tune of \$187 billion during the financial crisis. Since then, there is no question about the government's support of the GSEs – direct and explicit. In the decade since their conservatorships began, the GSEs' role in the housing market has grown exponentially. They are further entrenched in the mortgage finance process – from appraisals all the way through to property dispositions. Moreover, the GSEs set standards, including capital requirements, for private sector businesses with which they directly compete. The Administration can, and should, take steps to contain the GSEs' market dominance. One simple but effective step would be to allow new products or programs only when there is clear and compelling evidence that the GSEs are needed to fill a market void that the private market cannot serve before initiating the program or product. In addition, new products and programs (including pilots and new activities) in areas where the private market currently operates should be subject to prior notice and comment, similar to Administrative Procedure Act (APA) requirements for other agencies. Finally, the Administration should limit the GSEs to secondary market functions in keeping with the “bright line” separation between the primary and secondary mortgage markets that is envisioned in their legislative charters. As some proposals have recommended, the Administration could conduct a comprehensive review of the GSEs' programs and the types of mortgages they guaranty and, if necessary, reduce their footprint in the market to align with their statutory missions.<sup>6</sup>

At a minimum, the Administration should seek public input to determine what functions of the GSEs are necessary for the private market to properly function, such as the GSEs' automated underwriting systems (AUSs) and loan level data that drives credit and pricing decisions, and work to make these systems transparent and available for public review. As other proposals have also suggested<sup>9</sup>, these AUSs could also be moved to a government corporation (such as Ginnie Mae) or to a utility (including the Common Securitization Platform) that could function similar to other financial market utilities. This open-access approach would not only create a level playing field that incents competition in the marketplace but would also promote prudent risk taking with greater transparency and information in the housing finance system.

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***“To further reduce the centrality of the GSEs and lay the groundwork for an easier transition to a new housing finance system, the next FHFA director should also expand the current effort to build out the common securitization platform... Opening up the CSP to other users would in effect turn it into a market utility.”***

***- Urban Institute<sup>7</sup>***

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Further, when the GSEs entered conservatorship, their capital requirements were suspended and today, the GSEs only hold a modest \$6 billion against the more than \$5 trillion in mortgage debt they guaranty.<sup>9</sup> Because the GSEs hold no real capital, there is no incentive to reduce their spending.

In 2017 alone, the GSEs spent nearly \$5 billion on administrative expenses – much of which was spent on proprietary technologies and infrastructures that make Fannie Mae and Freddie Mac more central to the housing finance system, and any attempt to move outside of their technologies and systems almost impossible, which further ingrains the enterprises into the housing finance system.<sup>10</sup>

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## KEY TAKEAWAYS

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- 1.** The Administration should limit the GSEs' activities to secondary market functions that include areas that the private market cannot and does not currently do, to preserve the “bright line” separation between primary and secondary mortgage markets.
- 2.** New products, activities, or pilots should only be allowed when there is clear and compelling evidence that the GSEs are needed to fill a market void that the private market cannot meet. Products and pilots that impact private market participants since the GSEs entered into conservatorship should be subject to an APA compliant process to afford stakeholder assessment, comment, and judicial review.

## INCREASE TRANSPARENCY

To strengthen the housing finance system and better balance taxpayer protection with facilitating access to mortgage credit, the Administration can and should make the GSEs' capital framework, pricing, and underwriting standards – which are currently opaque at best – transparent and publicly available. A first step to greater transparency would be for FHFA to publicly release the *current* Conservatorship Capital Framework (CCF) to better inform market participants about the GSEs' pricing and capital levels. The CCF is used today to determine guarantee fees and loan level price adjustments (LLPAs). This would be a major first step to increase transparency and understanding about the levels of capital appropriate for the GSEs and pricing decisions. The Administration should publish the current CCF and the models, as well as any future proposed framework.

The GSEs themselves should be transparent entities whose operations allow for full visibility for policymakers, industry participants, and consumers. This would allow housing finance system participants to comprehensively understand the mortgage credit risk at the GSEs, assess their pricing structures, and identify benefits for borrowers.

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*“The next FHFA director could also ease the path to reform by requiring the GSEs to be more transparent... The FHFA has already done this to some degree...[but]...The next step would be to increase transparency around the GSEs’ capital framework and pricing.”*

*- Jim Parrott and Mark Zandi <sup>11</sup>*

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USMI has supported increasing transparency around how the government guaranty is priced so that it is done in a manner that reflects losses and fully takes into account all the risk-reducing benefits of credit enhancement, such as private mortgage insurance. The Urban Institute has echoed these calls and commented that “[t]he next FHFA director could also ease the path to reform by requiring the GSEs to be more transparent...The FHFA has already done this to some degree... [but] The next step would be to increase transparency around the GSEs’ capital framework and pricing.”<sup>12</sup>

Further, the Administration should also establish a coordinated and consistent housing policy to define and limit the GSEs’ scope and reduce the jockeying for market share between each of the GSEs as well as the competition for market share between the GSEs and FHA. Identifying the Federal government’s policy on homeownership and the government’s role in supporting sustainable homeownership will help clarify which borrowers should be served by the conventional market that is backed by private capital and which are better served by the government-insured market. One element of determining the borrowers that qualify for and are best served by the conventional market is a better understanding of the GSEs’ AUSs that they have developed during conservatorship and while instrumentalities of the federal government. The GSEs’ AUS technologies and the factors that go into the credit and pricing decisions should be made transparent to all market participants, so that participants have full insight into the analytics underlying those tools including: Freddie Mac’s Loan Product Advisor® (LPA) and Fannie Mae’s Desktop Underwriter® (DU) systems, collateral valuation tools, systems/processes for income, asset, and employment validation, and the loan level data sets. Some have suggested that the two systems could be harmonized and moved to the CSP to allow for new entrants.<sup>13</sup>

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## KEY TAKEAWAYS

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- 1.** The Administration should publish the *current* CCF and the models as well as any future proposed framework. This would be a major first step to increase transparency and understanding about the levels of capital appropriate for the GSEs and pricing decisions.
- 2.** The Administration should promote reforms to address greater transparency around the federal government’s policy on homeownership and the government’s role in supporting sustainable homeownership by clarifying which borrowers should be served by the conventional market that is backed by private capital and which are better served by the government-insured market.
- 3.** The Administration should require the GSEs’ AUSs and standards to be fully transparent to provide loan level data and decisioning requirements that drive credit and pricing decisions in order to promote prudent risk taking, appropriate market discipline, and competition within the marketplace.

## EXPAND PRIVATE CAPITAL AND REDUCE TAXPAYER RISK

Since the financial crisis when the GSEs required an infusion of roughly \$187 billion in capital from U.S. taxpayers, there has been broad bipartisan support for reducing the risk at the GSEs by increasing private capital ahead of taxpayer exposure to mortgage credit risk.

The GSEs implemented credit risk transfer (CRT) programs in 2013 at the direction of the FHFA to transfer to private investors a substantial amount of credit risk on mortgages acquired by the GSEs. The GSEs' CRT programs have been lauded by many housing finance stakeholders but there is a growing recognition that the programs have relied too heavily on capital markets structures that may not be available when the housing market softens. USMI agrees with the objective of laying off risk, provided that all first-loss risk is transferred to private entities that have the ability to underwrite and manage mortgage credit risk and the ability and commercial interest to remain in the market across cycles. Done right, CRT can further reduce the GSEs' – and therefore taxpayer – risk exposure.

The Administration should strengthen and enhance the sources of permanent private capital standing in front of the GSEs. To ensure consumer access, taxpayer protection and market stability during all markets, the Administration should promote greater use of entity-based private capital done primarily through loan-level credit enhancement that is well capitalized and available throughout all housing market cycles. To reduce the GSEs' and government's dominance in the housing finance market and promote greater transparency and accountability, the Administration should require that these entities are able to prudently underwrite and hold mortgage credit risk during all market cycles. Further, the Administration could encourage/require these private entities to disperse credit risk, similar to how private mortgage insurers currently operate, to the reinsurance and capital markets. Relying on GSE-centric risk transfer only serves to further build the housing finance system around two government-advantaged entities and increase systemic risk.

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***“We believe mortgage insurers are the most promising area for CRT expansion. This expansion is valuable for the mortgage insurers and for the GSEs.”***

*- Urban Institute <sup>14</sup>*

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***“The next FHFA director should continue to develop a set of structures that will allow institutional equity to compete effectively for the GSEs' credit risk...while this approach means introducing some counterparty risk to the transactions, this risk is manageable and well worth taking given the benefits to the system”***

*- Jim Parrott and Mark Zandi <sup>15</sup>*

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***“Credit transfers need to be upfront, transparent, and put in place at origination. They should not be done in the murky, black-box that they're being done in today by the GSEs.”***

*- Ed Pinto <sup>16</sup>*

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***“Private capital should bear all but catastrophic mortgage credit risk so that market discipline contains risk. The government should provide an explicit, full faith and credit guarantee on MBS but with a pre-set mechanism to ensure any catastrophic losses that call upon taxpayer support will be repaid fully.”***

*- Ed DeMarco <sup>17</sup>*

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Finally, a government guaranty should be remote – drawn on only in catastrophic scenarios. One of the most efficient, effective and transparent means of achieving this credit protection is through the use of transferring more first-loss credit risk through the use of greater private mortgage insurance, such as coverage down to 50% of the value of the loan.

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## KEY TAKEAWAYS

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- 1.** The Administration should strengthen and enhance the sources of permanent private capital standing in front of the GSEs. To reduce the GSEs' and government's dominance in the housing finance market and promote greater transparency and accountability, the Administration should require that there be greater reliance on entities that are able to prudently underwrite and hold mortgage credit risk during all market cycles. Further, credit enhancement should be done at the time the loan is originated and done at the loan level.
- 2.** A government guaranty should be remote—drawn on only in catastrophic scenarios.

## PROMOTE A STRONG REGULATOR THAT ESTABLISHES UNIFORM STANDARDS AND USES TRANSPARENT PROCESS TO ASSESS GSEs' ACTIVITIES AND PRODUCTS

Finally, in appointing a new Director at the FHFA, this Administration has an opportunity to promote greater transparency and oversight of the GSEs and correct what has proven to be at times a conflicting role that the FHFA currently plays as both conservator and regulator of the GSEs. Consistent with nearly all other federal financial regulatory regimes, the Administration can ensure that FHFA acts as a prudential regulator that supervises the GSEs' risk management processes and financial health. FHFA should use its regulatory authority whenever possible (as opposed to conservator authority) and minimize regulatory arbitrage by having a coordinated and consistent oversight approach as with other federal and state regulators. In addition, the regulator should establish and monitor standards and requirements for all GSE counterparties.

Lenders and other market participants should feel confident that they can access the secondary market on a level playing field with their competitors, based on clear and transparent standards.

While diminished under a more utility-like system, there will still be a conflict for the GSEs to set counterparty standards, as there will continue to be opportunities to arbitrage the rules to compete with the private market and/or to pick winners and losers in the marketplace. Therefore, it should be the responsibility of the regulator, not the GSEs, to use the appropriate APA process to establish strong risk-based capital and operational standards for all credit enhancement providers to ensure the availability of first-loss, loan-level credit enhancement across market cycles—and to monitor these standards and requirements for GSE counterparties.

It is also important that the FHFA create uniform and transparent standards that promote a level playing field to not advantage a certain class of entities over others.

## KEY TAKEAWAYS

1. The FHFA should not be able to put its role and responsibilities as conservator ahead of its role and responsibilities as regulator.
2. USMI supports the FHFA promulgating strong risk-based capital and operational standards for all credit enhancement providers to ensure the availability of first-loss, loan-level credit enhancement across market cycles.
3. The FHFA should aim to create uniform and transparent standards that promote a level playing field that does not advantage a certain class of entities over others.
4. The FHFA should implement a transparent approval process for activities and products (including pilots) that complies with the APA and includes a public comment period to allow all interested stakeholders to provide beneficial feedback on how new activities or products could affect the strength of the housing finance system and access to mortgage credit.

***"FHFA and other regulators [should] develop a consistent approach to evaluating counterparties that is transparent and applied consistently across regulatory regimes."***

***- Ed DeMarco<sup>18</sup>***

In addition to regulating the GSEs' financial condition and setting uniform counterparty standards, the FHFA must also actively oversee the GSEs' footprint in the housing finance system, especially when the entities seek to expand their role and activities. As such, it is critical the FHFA implement a transparent approval process for new activities and products that complies with the APA and includes a public comment period to allow all interested stakeholders to provide thoughtful and beneficial feedback on how new activities or products could affect the strength of the housing finance system and access to mortgage credit.

## Endnotes

<sup>1</sup> Statement of FHFA Director James B. Lockhart at News Conference Announcing Conservatorship of Fannie Mae and Freddie Mac (September 2008).

<sup>2</sup> Pub. L. 110-289, 122 Stat. 2654 (July 2008).

<sup>3</sup> 14 USC § 4617 authorizes the Director to appoint the FHFA as conservator or receiver for Fannie Mae or Freddie Mac for the purposes of reorganizing, rehabilitating, or winding up the operations of the entity. Under HERA, the Administration (FHFA) can put each of the GSEs into receivership, where their existing obligations under the Senior Preferred Stock Purchase Agreements (PSPAs) can be transferred to a "bad bank" with the remaining "good bank" to exist to maintain business operations, including to raise capital. Under even this receivership scenario, however, the Administrations is limited in what it can do structurally to the GSEs as the charters of the GSEs would stay in place.

<sup>4</sup> "Principles for GSE Reform and a Way Forward" (April 2018).

<sup>5</sup> Testimony before the House Financial Services Committee for hearing entitled "A Failure to Act: How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk" (September 6, 2018).

<sup>6</sup> Edward Pinto, Peter Wallison, "The Taxpayer Protection Housing Finance Plan: Gradually Winding Down Fannie and Freddie Mac and Improving the FHA", American Enterprise Institute (January 2018).

<sup>7</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>8</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>9</sup> Fannie Mae and Freddie Mac Second Quarter 2018 10-Q Filings.

<sup>10</sup> Fannie Mae and Freddie Mac 2017 10-K Filings.

<sup>11</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>12</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>13</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>14</sup> Laurie Goodman, "Credit Risk Transfer: A Fork in the Road", Urban Institute, June 2018.

<sup>15</sup> Jim Parrott, Mark Zandi, "GSE Reform Is Dead – Long Live GSE Reform!" Urban Institute, May 2018.

<sup>16</sup> House Financial Services Committee hearing entitled "A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk" (September 6, 2018).

<sup>17</sup> Testimony before the House Financial Services Committee for hearing entitled "A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk" (September 6, 2018).

<sup>18</sup> Testimony before the House Financial Services Committee for hearing entitled "A Failure to Act: How a Decade without GSE Reform Has Once Again Put Taxpayers at Risk" (September 6, 2018).

*The recommendations set forth in this paper are strictly those of U.S. Mortgage Insurers. Quotes from organizations or individuals included in this paper do not necessarily reflect the organization/person's support of all of the principles and recommendations proposed.*