Most of the major proposals to reform the housing finance system rely on two steps to minimize the risk that any one or two institutions can pose to the mortgage market: requiring that any institution that issues mortgage-backed securities guaranteed by the government share most of the related credit risk with others in the private market, and having a government or government-like utility manage the infrastructure used in issuing these securities.¹ Fortunately, we have already made significant progress on both of these fronts. Fannie Mae, Freddie Mac, and their regulator, the Federal Housing Finance Agency (FHFA), have developed a process by which Fannie and Freddie are sharing increasing amounts of credit risk, and they have begun to build a platform to handle much of the securitization functions that are today provided by Fannie and Freddie.

A great deal has been written about the first of these two efforts. Commentators have discussed and debated at length the degree to which their risk-sharing efforts have succeeded and how they can be improved, helping us sharpen our collective thinking about the role that risk sharing generally should play in a future system (Goodman and Parrott 2016; Goodman et al. 2016). Very little has been written about their work building a securitization platform, however, leaving us with a less developed understanding of the opportunities and challenges of this equally important piece of reform.
Why We Need a Securitization Utility

Historically, we have depended on two privately owned institutions, Fannie Mae and Freddie Mac, to manage the lion's share of the infrastructure we rely on in the operation of the secondary mortgage market. This is problematic for a host of reasons, but two in particular stand out.

First, leaving a critical component of the market in the hands of a duopoly constrains competition in those segments of the market that depend on it. This is most obvious where the duopoly uses its dominance of one segment of the market to achieve dominance over other segments, as Fannie and Freddie have dominated the guarantee market in part because of their dominance of the securitization market. But it also leads to more subtle market distortions, because the duopoly is able to set the terms for business in a wide range of markets that depend on the segments it controls. Where able, the duopoly will inevitably set them in a way that benefits the duopoly, and that will just as inevitably tilt the competitive playing field in favor of some over others. An example of this is the guarantee fee advantages that Fannie and Freddie provided larger lenders before conservatorship.

A second and more fundamental problem with allowing a privately owned duopoly to own and manage a key part of the market infrastructure is the too-big-to-fail risk that it creates. By leaving the health of the broader system at the mercy of two privately owned institutions, we cannot let them fail, creating an incentive for these profit-maximizing institutions to take excessive risk, which in turn exposes the broader financial system that depends on them to excessive risk.

By putting the key secondary market infrastructure into a government or government-like utility, you would reduce both of these market distortions.

Early Steps toward a Securitization Utility

Fannie Mae and Freddie Mac have established a joint venture called Common Securitization Solutions to design a Common Securitization Platform (CSP) to manage all of the data, issuance, settlement, bond administration, and disclosures associated with the single mortgage-backed security that will be issued by both Fannie Mae and Freddie Mac.

Upon its completion, Fannie and Freddie will continue to maintain loan-level control of the loans they purchase. They will continue to determine what kinds of loans they take on and on what terms, what should happen if those borrowers struggle to make their payments, and what happens if the loans go into foreclosure.

What Fannie and Freddie will pass on to the CSP is the management of the mortgage-backed securities that are issued once the loans are pooled. In the securitization process, the CSP will collect and perform data verification to ensure that the relevant loan- and pool-level data have been provided, manage the offering documentation, form the securities, register the securities with the relevant market utilities, and handle all relevant disclosures to investors. Once the securities are formed, the CSP will handle all ongoing data requests and data security, manage the payment files and disclosures
required for payments to be made to investors, and make ongoing disclosures to investors. And as loans in the underlying pools become delinquent, it will manage the related data and disclosures, including related changes to payment schedules.²

FIGURE 1
A Rough List: What the GSEs Do Today

<table>
<thead>
<tr>
<th>SUPPORTING PRIMARY MARKET</th>
<th>LOAN AGGREGATION</th>
<th>LOAN DELIVERY &amp; ACQUISITION</th>
<th>FUNDING &amp; CREDIT RISK MGMT</th>
<th>SECURITIZATION</th>
<th>P&amp;L MGMT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standards, programs, practices, and tools for underwriting, originations, and servicing</td>
<td>Cash window processes</td>
<td>Data submission, QC, certification, correction and security</td>
<td>Funding</td>
<td>Data QC, acceptance and security</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Balance sheet management</td>
<td>Commitment, delivery and pool eligibility checks</td>
<td>Pricing</td>
<td>Issuance support</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Pipeline hedging</td>
<td>Credit risk standards</td>
<td>Credit analytics</td>
<td>Disclosures</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Risk analytics</td>
<td>Credit enhancements</td>
<td>Bond administration</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Counterparty risk</td>
<td>Risk sharing</td>
<td>Master servicing</td>
<td></td>
</tr>
</tbody>
</table>

Notes: CSP = common securitization platform; NPL = nonperforming loan; P&L = profit and loss; QC = quality control; REO = real estate owned.

All of this will help modernize the housing finance system's securitization infrastructure, lowering costs and increasing efficiency. It will also make the system less reliant on Fannie and Freddie, which will no longer directly manage this infrastructure themselves. As long as the CSP is owned by and accessible only to Fannie and Freddie, however, it will fall well short of its potential for reform. That is because the benefits of the improved infrastructure will naturally serve to further entrench the dominance of the only two guarantors able to use it.

How the CSP Could Become a Centerpiece for Reform

If the CSP is converted to a government or government-like utility open to issuance by other guarantors, on the other hand, it could help us end the dominance of the duopoly and transition to a more competitive system. This is because putting the critical market infrastructure into an open platform would meaningfully reduce the barriers to entry for new guarantors, as those that want to compete with Fannie and Freddie will no longer have to create their own securitization infrastructure to do so.

To play this utility role effectively, the CSP would need to be developed with three objectives in mind. It should provide enough of the critical securitization infrastructure that the system can continue to function if any single guarantor fails. It should provide a platform that enables new entrants to
compete forcefully with Fannie and Freddie. And it should provide a level playing field for all those that rely on it.

Meeting the first two of these objectives comes down to much the same thing, as leaving functions with Fannie and Freddie that others cannot readily replicate not only undermines competition but leaves the system vulnerable to Fannie and Freddie’s failure. When deciding what to include in the CSP, then, the key question is what functions require such expertise or capital that institutions other than Fannie and Freddie are unlikely to be able to provide them on a competitive basis. Those that others are unlikely to be able to provide should go into the platform. Those that others are likely to be able to provide should not.

The third objective—maintaining a level playing field—is perhaps the most straightforward. The platform should not be implemented in a way that enables issuers, or any other market participants for that matter, to leverage their access to the secondary market to disadvantage other market participants. It should not allow volume-based pricing, for instance, thereby putting smaller lenders at a disadvantage.

An example of how the platform might be expanded beyond its current scope to better meet these objectives would be the addition of master servicing. Having the CSP oversee the servicing of loans in a pool on behalf of the securities investors would help standardize the norms of servicing generally, making it easier to improve outcomes for investors and homeowners alike. It would also remove a complex and costly function from the issuers’ responsibilities, reducing what would otherwise be a significant barrier to entry. And it would remove the possibility that an issuer uses its master servicing role in ways that benefit its larger customers, as may often be in its interest.

The idea requires more thought, of course, and may well wilt under deeper analysis, but what is important is that we begin to think through the items in figure 1 with that frame in mind. Which of the functions that Fannie and Freddie provide today could be moved to the CSP to help level the playing field for greater competition throughout the system?

How Hard It Is to Expand

Expanding the CSP to play the role of an effective market utility will not come easily, of course, so it is important to understand the challenges involved.

As a general rule of thumb, adding functions to the CSP will be less complex than adding institutions. In other words, expanding the things that the CSP does for an institution that already interacts directly with it is typically going to be easier than expanding the number of institutions that interact directly with it, whether the new institutions are to issue securities or perform other functions. This is because adding an institution to the CSP means syncing up all of the many processes that the institution will need to interact with the CSP.
Adding master servicing would thus be a complex effort, because you would have to allow hundreds of servicers to interact directly with the CSP. This would require adjusting thousands of distinct processes across the entire servicing industry. The effort would not be insurmountable—after all, most of the burden would be dispersed across the entire industry, and there are a number of national servicing bureaus that could be leveraged in the effort—but coordination alone would make this a significant lift.

Similarly, how difficult it is to open the CSP up to new issuers will depend on how many new issuers need to be added. Adding a few would not be a heavy lift, particularly if they are newly formed and thus can develop the relevant processes with this interface in mind. Adding hundreds, on the other hand, would be a challenge, particularly if many are legacy institutions with processes that will need to be overhauled in order to interact with the CSP.

**Why the CSP Rather Than Ginnie?**

The CSP is not the only securitization platform in the market, as Ginnie Mae securitizes loans insured by the Federal Housing Administration and the US Departments of Veterans Affairs and Agriculture. It is thus worth asking why we do not simply use this platform for the market utility. It already has widespread market adoption, after all, with hundreds of issuers issuing over a third of all new mortgage-backed securities off the platform.

A key difference between the CSP and Ginnie is that the former is being built to support a business model in which one of the key functions of its issuers—Fannie Mae and Freddie Mac—is the management and distribution of credit risk. Ginnie, on the other hand, is designed to support issuers that take little if any credit risk, because the credit risk on the loans that they pool and securitize is insured by the government. Thus, where the CSP is set up to collect information on the credit risk in the pools being securitized—such as borrowers’ credit scores, credit histories, and debt loads—Ginnie has neither the need nor the capacity to provide this kind of support to its issuers.

To serve the broader market, a securitization platform will have to support issuers in their assumption and distribution of credit risk. Ginnie could certainly develop the infrastructure needed to do this, but it would be a significant lift. Just to match what the CSP is already being developed to handle would require them to collect and process roughly 10 times the number of data fields that they currently collect. And expanding beyond this to further reduce barriers to competition with Fannie and Freddie, which is critical for the reasons discussed, would require Ginnie to build still more new infrastructure to support risk-bearing guarantors. While all of this is feasible, it is considerably more challenging than simply drawing from infrastructure that already exists in Fannie and Freddie, as the CSP is doing today.

A second key difference is that expanding the Ginnie Mae platform to serve as a broader market utility would require running through the Department of Housing and Urban Development (HUD) procurement process and a host of rules and regulations under the Administrative Procedures Act.
While this could be changed through legislation, progress in the meantime will be cumbersome, and linking the fate of housing finance reform to reforming HUD may complicate the effort. Again, the challenge here can be overcome, but it is better avoided altogether.4

Conclusion

The work that Fannie, Freddie, and the FHFA are doing on the CSP is vastly underappreciated, both for the meaningful impact that it will have on today's system if it continues along its current course and for the much greater impact that it will have on a reformed system if its course is adjusted with that larger role in mind. Their work deserves the kind of critical attention that we have given the credit risk transfer process, so that as with that process, we can finally come to understand its promise and challenges and the central role that it could play in the system of the future.

Notes


3. I use the terms "issuer" and "guarantor" interchangeably in this piece, depending on which functions I'm focused on at the time. I assume that issuers in the new system will also guarantee timely payment of principal and interest, as Fannie and Freddie do today.

4. This is not to say that we should not give serious consideration to having Ginnie Mae provide an explicit government guarantee of the securities issued off of the CSP, which would not involve the heavy lift described here. Indeed, having Ginnie "wrap" the securities issued off of the CSP may be the simplest, most efficient way to provide the government backstop of the reformed system.

References


About the Author

Jim Parrott is a nonresident fellow at the Urban Institute and owner of Falling Creek Advisors, which provides financial institutions with strategic advice on housing finance issues. Before joining Urban in 2013, Parrott spent several years in the Obama White House as a senior adviser at the National Economic Council, where he led the team of advisers charged with counseling the cabinet and president on housing issues. He was on point for developing the administration’s major housing policy positions; articulating and defending those positions with Congress, the press, and public; and counseling White House leadership on related communications and legislative strategy. Before his time in the White House, Parrott was counsel to Secretary Donovan at the US Department of Housing and Urban Development. Before that, he was a litigator, first in New York with Sullivan and Cromwell, and later in North Carolina with Smith Anderson. Parrott serves on the advisory board of the J. Ronald Terwilliger Foundation for Housing America’s Families and the Ackland Museum of Art. He also served in Sri Lanka with the Peace Corps. Parrott has a BA in philosophy from the University of North Carolina, an MA in philosophy from the University of Washington, and a JD from Columbia Law School.
Acknowledgments

The Housing Finance Policy Center (HFPC) was launched with generous support at the leadership level from the Citi Foundation and John D. and Catherine T. MacArthur Foundation. Additional support was provided by The Ford Foundation and The Open Society Foundations.

Ongoing support for HFPC is also provided by the Housing Finance Innovation Forum, a group of organizations and individuals that support high-quality independent research that informs evidence-based policy development. Funds raised through the Forum provide flexible resources, allowing HFPC to anticipate and respond to emerging policy issues with timely analysis. This funding supports HFPC’s research, outreach and engagement, and general operating activities.

This brief was funded by these combined sources. We are grateful to them and to all our funders, who make it possible for Urban to advance its mission.

The views expressed are those of the authors and should not be attributed to the Urban Institute, its trustees, or its funders. Funders do not determine research findings or the insights and recommendations of Urban experts. Further information on the Urban Institute’s funding principles is available at www.urban.org/support.

ABOUT THE URBAN INSTITUTE

The nonprofit Urban Institute is dedicated to elevating the debate on social and economic policy. For nearly five decades, Urban scholars have conducted research and offered evidence-based solutions that improve lives and strengthen communities across a rapidly urbanizing world. Their objective research helps expand opportunities for all, reduce hardship among the most vulnerable, and strengthen the effectiveness of the public sector.

Copyright © July 2017. Urban Institute. Permission is granted for reproduction of this file, with attribution to the Urban Institute.