The May 15, 2014, passage by the Senate Banking Committee of S. 1217, the Housing Finance Reform and Taxpayer Protection Act of 2013, otherwise known as “Johnson-Crapo,” marks a key moment in the ongoing debate over housing finance reform. Nevertheless, it appears unlikely the bill will reach the Senate floor this year.

Accordingly, Laurie Goodman (LG), Ellen Seidman (ES), and Jim Parrott (JP) sat down to discuss and distill progress in this Congress, identifying the fault lines in the negotiations, where reform stands now, and the likelihood and consequences of further action or inaction in the coming months.

Q: Do you think Johnson-Crapo captured part of a growing consensus around Government-Sponsored Enterprise (GSE) reform?

LG: Yes. Most of the proposed bills are based on a similar set of principles. This includes not only Johnson-Crapo, but also several bills and discussion drafts in the House of Representatives, including those by Representatives Delaney-Carney-Himes, Waters, and Campbell-Peters.

Among the common principles are:

1. The 30-year fixed rate mortgage must be preserved.
2. To preserve the 30-year fixed rate mortgage, we must preserve the TBA (To-Be-Announced) Market for mortgage-backed securities, a market in which large quantities of securities are traded as if they are completely fungible. (In fact, the buyer does not know which mortgage loans will stand behind his security, hence the TBA moniker.) To make the securities fungible, the government must ultimately stand behind the credit of these securities.
3. Private capital must take the first loss, with the government providing a catastrophic guarantee behind that first loss.
4. A Federal Deposit Insurance Corporation (FDIC)-like fund can provide the catastrophic government guarantee.
5. The liquidity of this market is best served with a single platform and a single security.
6. The infrastructure of the system should be run by the government, and separated from the risk taking.
7. Some type of affordable housing provision is necessary.

JP: I agree for the most part. While it’s easy to focus on what ultimately doomed negotiations in the committee, one shouldn’t ignore the remarkable degree of consensus that we now appear to have on a range of thorny and previously controversial issues. In particular, the “get the government out of backing the market” crowd has all but fled the field for the moment, or retreated to parts of the House, and even there they appear resigned to fight over design issues rather than the existential question of a government backstop.

The one qualification I would offer is that I think there is stronger support for a quasi-nationalized housing market than I had expected. Some progressive groups, and perhaps even some members, appear to be deeply skeptical of increasing the role of private capital in the system. You didn’t hear the argument made explicitly, because it would have been a nonstarter, but you saw it lurking beneath the surface in various arguments over the role of private actors in the system, and in particular in concern over how underserved communities would be treated in a system in which these private actors would play such a central role.
Q: Why do you think that is?

ES: I agree with Jim that the breadth of progressive opposition to Johnson-Crapo as negotiations came down to the wire came as something of a surprise. People asked why the focus was on bringing in private capital and protecting investors, rather than on ensuring that Americans are well-housed. My sense is that this was based on a concern that the consensus Laurie describes had developed without anyone really coming to grips with how the structure proposed was going to affect current and upcoming generations of first-time homebuyers. What would this kind of reform do to access and to the price of mortgages? That’s an important issue not only for those potential homebuyers, but also for the economy, and our society as a whole.

Q: Why didn’t the relatively broad consensus translate into broader support for the bill in committee?

LG: It is a lot easier to agree on general principles than on specific design features. The two issues that are the most problematic are the amount and form of private capital ahead of the taxpayer and the design and reach of the affordable housing features.

Q: As the bill moved from Corker-Warner to the initial Johnson-Crapo draft and then to the bill voted out of committee, there was a pretty significant shift on this first issue. The bill began with a model that was quite permissive as to who could take the risk ahead of the government and in what forms, and ended up with one that was quite restrictive. What happened?

JP: There was indeed an interesting progression on this through the course of negotiations. The original model proposed by Senators Corker and Warner was almost agnostic on the issue. As long as the issuers of the securities found a way to secure protection against the first 10 percent of loss for those securities, they could go to the Federal Mortgage Insurance Corporation (FMIC) for government-backed reinsurance. It didn’t really matter who took the risk or what form that protection took.

This meant that issuers could go directly into the capital markets to get the required risk coverage, laying the risk on Wall Street one pool at a time. Larger lenders could also set up their own vertically integrated channels, in which they would originate the loans, aggregate them into pools, provide the first-loss risk protection, and sell the government-backed securities.

The thinking behind this original model was that as long as the system required a strong capital buffer ahead of the taxpayer’s risk—and recall that in the original Corker-Warner bill that 10 percent buffer was 10 percent equity, so it had real teeth—then it is better to let the market sort out who was in the best position to handle the first-loss risk and in what forms. Let many flowers bloom, as it were.

LG: In my view, 10 percent equity was excessive, especially in the context of well-diversified insurers, or even large, well-diversified pools. Yes, we all like the idea that the taxpayer risk is remote, but this would add a huge cost to each and every mortgage.

To put this in perspective, a 4–5 percent capital cushion would have allowed the GSEs to sustain the adverse home price declines that were experienced by the 2007 vintage; 2.5–3 percent would be sufficient for the GSEs if the price declines for the 2007 vintage were grafted onto the current book of business.

A more reasonable framework for a guarantor execution, assuming 10 percent capital is the final requirement for political reasons, would be to require an equity amount (say, 4 percent) that would be sufficient to sustain a guarantor in a 2007-type scenario. Then you allow preferred stock, debt, relief through risk syndication, and the value of future guarantee fees (in short, less expensive financing) to make up the balance. The equity amount could rise if stress testing indicated the need for more capital.

ES: The work Laurie and others did was important in helping clarify the importance of size and diversification (whether of pools or insurers) in setting an appropriate level of capital. If you are concerned about protecting the government, there’s a world of difference between a pool of 2006-vintage...
loans from Arizona, and a diversified insurer with a large book of business covering all the states and many vintages. A government regulator on the ball can require additional capital of an entity if stress tests suggest potential problems; there’s no such opportunity with a pool of securities, where the capital on day one must suffice for the entire life of the pool.

**Q: So what was the problem with allowing the market to determine the form of the private capital?**

**JP:** While the idea is appealing in the abstract, many were uneasy with how it would actually work in practice. For starters, many were convinced that, although there was nothing prohibiting bond guarantors in the Corker-Warner system, the “capital markets execution,” as it came to be called, would be much more efficient in good economic times and thus come to dominate the market. Laurie can explain better why that would be, but the dominance concerned folks for two main reasons: these transactions would slice and dice the market in a way that undermined the TBA market, which depends on homogeneity; and at the first sign of distress this much more nimble form of capital would flee for less risky investments. The result would be a market with uncertain liquidity in good times and a great deal of instability in bad.

**LG:** The idea of letting all forms of private capital partake is indeed intuitively appealing: it should allow the lowest mortgage rate to be passed through to borrowers. However, there are several problems in practice.

Jim mentioned the challenge to the TBA market and the inevitable instability of a mortgage market with dual execution. The issue here is that capital markets execution dominates in good times. If there is a shock and optimal execution shifts to the guarantors, the guarantors may not be able to attract capital quickly enough to fill the origination void.

Another concern is that the regulatory regime needed would be prohibitively difficult. With the capital markets execution, FMIC would need to act as a rating agency, putting into place the infrastructure and personnel that could determine if 10 percent capital is enough, or more is required, on a transaction-by-transaction basis. It is not clear that any regulator has ever done anything of this magnitude.

FMIC would also need to decide how to equilibrate the capital in a capital markets transaction with that of a bond guarantor. As Ellen pointed out, they are fundamentally different: the capital in a capital markets transaction is fixed at the very beginning, on a deal-by-deal basis. With guarantor execution, stress testing can identify the need for additional capital. And while the guarantor is an ongoing entity, its safer vintages will, in practice, cross subsidize the weaker vintages.

**JP:** Folks were also uneasy about this part of the model because it appeared to allow the larger banks to dominate the system. Those banks would be able to provide their own first-loss coverage, whether by setting up their own bond guarantor or just using their capital markets shops to go directly into the capital markets. As a result, they’d be able to offer terms to borrowers that were superior to anything anyone else in the market could provide.

**Q: So how did the next iteration—Johnson-Crapo 1.0—deal with all these concerns?**

**JP:** To address the concern about the dominance of the capital markets execution, they tried to restrict that path and strengthen the bond guarantor execution. They narrowed the range of capital markets structures the FMIC could approve to those that explicitly addressed the risks raised. The regulator could not approve structures that threatened the TBA market, for instance.

Second, they defined how guarantors would be set up and how originators would use them, making it much clearer why and how they would fit into the new system.

And third, they attempted to minimize the advantage that the 10 percent first-loss and capital requirements provided to the capital markets execution.
To address the concern that larger banks would have an unhelpful advantage in the new system, they set up a “small lender mutual.” The mutual would function as an aggregator open to all originators with assets of less than $500 billion. As this excluded only the four largest lenders, it perhaps would have been better named the “everybody-but-the-big-lenders mutual.”

Q: But this is not quite where the legislation landed, ultimately.

JP: Right. As negotiations over Johnson-Crapo 1.0 got under way, it became apparent that these steps weren’t quite enough to address either concern. Key players were uncomfortable that even with the modifications, the capital markets execution would still dominate and ultimately destabilize the market. And though the smaller lenders liked the mutual, many around the negotiating table were comfortable with the idea that the larger lenders could create their own vertically integrated channels in the system.

So as the mark-up drew near, there was a great deal of additional focus on these issues. There was, in particular, extensive discussion about dropping the capital markets execution altogether. This would be the easiest way to address the complex list of concerns associated with it, and became one of the key asks not only of several industry and consumer groups, but, more importantly, of the key progressives the supporters of the bill were courting heading into mark-up.

Ultimately, the bill that was voted out of committee—let’s call it Johnson-Crapo 2.0—didn’t have the ban, but this was because the progressives who favored it did not sign on. Had they been willing to sign on, the capital markets execution almost certainly would have been dropped. So the take-away, I think, is that the only bill that would have made it to the floor would have required originators to go through bond guarantors to get their first-loss protection.

Work on the concern over vertical integration made it further in negotiations, with both sides agreeing on an outright ban on originators setting up bond guarantors. And while they ultimately allowed originators to go directly to the capital markets, they agreed to regulate the originators that did so more rigorously.

So the upshot is that the core we began with in Corker-Warner migrated dramatically by the time of Johnson-Crapo 2.0. We began with a system in which much of the risk ahead of the taxpayer would have been managed in a heterogeneous mix of complex structured finance transactions, and where many large lenders would have adapted into vertically integrated channels connecting borrowers, mortgage-backed securities (MBS) investors, and the government guarantee. And we almost ended with one in which that risk would be managed through a number of monoline insurance companies, in a market with a much clearer delineation between primary and secondary market actors.

Q: Was this shift ultimately a good thing? Did they land on a better proposal, or close to it?

JP: I think yes, though with a word of caution. The migration undoubtedly removed the risk of a more fragmented and unstable market that was posed by the capital markets execution, and reduced the risk that the large banks would come to dominate the new system. But it did so at a cost. Under the model we were about to land on, there would be fewer institutions to take on first-loss risk ahead of the taxpayer. And there will be an awful lot of this to take on in the new system.

So while I for one was by and large happy with where this was landing, if indeed that is where we ultimately land, policymakers will need to monitor whether we’ve overcompensated here, restricting the ability of institutions to take on credit risk so much that the system as a whole just doesn’t have enough capital to provide the liquidity we expect of it.

LG: I do think we were eventually going to land in the right spot—guarantors only. It is hard to imagine that the system won’t have the capital to provide the liquidity expected of it. Let’s start with the math: assume the GSE replacements are approximately the size of the GSEs today—$4.5 trillion—and that 10 percent capital is required—that is, $450 billion. The non-agency market, in which the overwhelming majority of the
bonds are rated less than AAA (and hence taking mortgage credit risk), was much larger than this at one point, approaching $1 trillion in market value.

These non-agency securities were readily absorbed because, during the course of the crises, the returns on these securities became very attractive relative to alternatives, so hedge funds, total return money managers, and others invested the time and money to develop expertise, buy data, and develop systems to evaluate mortgage credit risk. The institutions now have this expertise as part of their core skill set, and with the non-agency market much smaller in size, are looking for alternative investments that allow them to utilize their expertise. Providing capital for guarantors is one way to deploy this expertise. Some of these investors are solely fixed income; they can’t do equity investing. However, the guarantors can do their own capital markets transactions, which would allow the system to draw capital from these investors. And these capital markets transactions are likely to be more standardized and hence more attractive to investors than subordinate securities from a capital markets execution sponsored by a smaller originator or aggregator.

Q: Moving on, the second difficult issue in the negotiations was, as Laurie mentioned, access to credit. After working through a dizzying array of enormously complex issues, it appears that negotiations finally foundered on how to ensure that the new housing finance system served traditionally underserved borrowers and communities. Why were people particularly sensitive to this issue?

ES: Notwithstanding the negative experience during and after the recession, Americans of all ages, incomes, wealth, and ethnicities still believe that owning a home offers stability, the opportunity to build wealth, access better schools and neighborhoods. And, especially in minority and low-income communities, there is a strong belief that the communities were victimized, rather than served, by mortgage lending during the boom and have been excluded from being able to buy since the bust, when lower house prices made homes affordable with safe, well-structured mortgages. Moreover, many of these communities have negative memories of earlier housing busts during periods when the Federal Housing Administration (FHA) loans were the only loans available. Finally, potential homeowners in rural communities, as well as young families, feel cut out of the opportunity to own by lack of lender attention and inflexible credit standards.

In the face of these concerns, many progressives and representatives of the consumer and civil rights communities felt strongly that a new housing finance system should not retreat from the goal of serving all creditworthy borrowers and, indeed, making extra efforts to reach out to those borrowers. They also saw that, in a world in which Fannie and Freddie were essentially excused from serving a broad population, such borrowers were not being served by anyone other than FHA (about which prior experience generated substantial unease). And Mel Watt’s change of direction at the Federal Housing Finance Agency (FHFA) raised hopes that the current system could be reformed to serve the full range of the population for the long term, thus diminishing interest in what was perceived as a more uncertain future system.

Q: So what currents in the negotiations cut the other way?

ES: The push to ensure access and affordability in the new system faced two strong concepts in opposition: the superiority of business judgment and the importance of pricing purity.

The idea that a lender’s business judgment should not be questioned came from a current underlying the debate: that “the affordable housing goals caused the crisis.” While this precise form of the argument was generally discredited, the idea that the crisis was caused by lenders being forced to make loans to people who couldn’t afford them definitely affected the conversation, reflected in the insistence that lenders’ “business judgment” should not be questioned.

The second broad force in opposition was grounded in the notion that the new system should be fully priced and transparent, with any subsidy explicit and “paid for.” This suggested that lenders both
should and would engage in granular risk-based pricing, with no internal cross subsidization—and certainly no cross subsidization based on anything other than an individual lender’s business judgment. Any directive relating to a “duty to serve” or obligation to pay particular attention to particular borrowers or communities was seen as contrary to this push for pricing purity.

Q: Wouldn’t the increase of private capital taking on credit risk in the system also encourage less cross subsidy?

LG: Yes, it is very clear that if you have private capital in the first-loss position, in the absence of a further directive, you will get risk-based pricing. It is the rational way for a guarantor to price. And if I, as a guarantor, cease to do risk-based pricing while other guarantors continue to do so, I will do very little business guaranteeing higher-quality loans. I do believe that guarantors will lend to lower-quality borrowers, even in the absence of a “duty to serve,” but the price may well be prohibitively high.

ES: It became increasingly clear the pricing purity concept was likely to significantly increase mortgage interest rates for underserved borrowers and communities even beyond the already increased rates likely to result from bringing more private capital into the system and explicitly charging for the government guarantee. And, as the debate went on, progressive voices became far more vocal in asserting that any government participation in housing finance should be focused on ensuring increased access to affordable loans for a changing American population.

Q: This seems a pretty fundamental tension between where the consensus was heading—toward more private capital driving the system—and the concerns about access and affordability. Has that tension always been there, lurking beneath the surface of the debate?

ES: As the housing finance reform debate opened in about 2010, and attention was focused on the question of whether the government should be involved at all, some progressives were willing to think about a system in which participants would be required to mirror the primary market and forbidden to “cream” the best loans, and there would be financial incentives to encourage participants in the new system to serve broadly. However, by 2014, as the recession dragged on, more information about abuses during the boom were uncovered, and opportunities for homeownership became more and more remote, anti-creaming rules and financial incentives were no longer seen as sufficient.

Ultimately, the clash of fundamental beliefs about the government role in housing finance beyond just the guarantee, not concern about “access” per se, is what kept them from getting the support they needed on the Banking Committee. Was the point of government involvement to serve Americans’ housing needs or to protect the participants in the financing system, and how would you resolve any tension between those goals?

JP: Yes, in the end this particular disagreement was about more than the provision in the bill designed to ensure broad access to the system.

In the bill, guarantors would be assessed what they called a market access fee, the proceeds from which would be used to fund various measures to improve access to credit and expand affordable housing. The level of each guarantor’s fee would be determined in part by how well they served traditionally underserved markets, with those serving it poorly paying a higher fee. So the objective of the fee was twofold: to generate proceeds to improve access and affordability in the system, and to create an incentive for market participants to provide broad access to the secondary market. Some progressive groups and committee members were concerned that the fee would fail in its second objective, with guarantors choosing to simply pay the higher fee rather than back the desired lending.

At a deeper level, though, some were concerned that a system driven by the needs of profit-maximizing institutions couldn’t possibly be trusted to serve the interests of the communities they care about most, even with added incentives to change the cost-benefit analysis a bit. They were also concerned that giving up on the duty to serve and the broader
housing goals that had forced Fannie and Freddie to serve these communities was implicitly accepting the narrative that these obligations played a role in the housing crisis. And this wasn’t just a political concern: they were suspicious of the access provisions in part because they were designed with that narrative in mind.

**Q: Why wasn’t the committee able to accommodate the access and affordability concerns in the bill?**

**JP:** The desire to have a broad duty to serve instead of the flex-fee, or as a back-up if the fee didn’t work, ran smack into Senator Crapo’s concern with a regulator interfering with the risk-management decisions of the bond guarantors. Senator Crapo and other Republicans on the committee were worried that the enforcement regime for such a duty would recreate the incentive distortions that they believe drove the crisis, the narrative progressives did not want to endorse. The negotiators struggled with different ways to thread this needle, but ultimately couldn’t find a version that both sides were comfortable with.

**Q: Is there a path ahead here or are the positions irreconcilable?**

**JP:** Key players from both sides continue to work on it, but that is the $64,000 question. The answer really depends on how both sides view their likelihood of success outside these negotiations. If progressives think they have a better path to long-term reform through a Mel Watt-led FHFA, for instance, they are likely to remain pretty dug in. And if conservatives think they will face a better negotiating environment after the upcoming elections, then they’ll likewise dig in.

But I do think there are ways to solve the substantive differences, if perhaps not the optical ones. I do think you can design a mechanism to ensure adequate lending to underserved communities that is transparent and doesn’t distort the market in ways that should concern us. The politics are tricky, but whether they are insurmountable will depend a lot on how folks view the cost of failing to get a bill.

And of course the situation is fluid. Even if one or both sides view their alternatives as good enough to avoid the compromise needed to get a deal done today, that is likely to change if Fannie or Freddie begin to stumble again, or the shareholders win a few decisions in the lower courts.

**LG:** In my heart, I hope Jim is right that there is a path to compromise. But every time I think it all the way through, I come to the conclusion that the positions are irreconcilable, as we are unable to agree on how much cross subsidization the system is willing or required to permit. I believe that while an inability to agree on the back-up plan is nominally what killed the consensus, the real issue is more the fundamental cross subsidization issue. Cross subsidization of lower-quality loans by their higher-quality counterparts has always been a part of the GSE mandate; under the Johnson-Crapo system, the flexible incentive fee was the only form of cross subsidy.

In my view, the issue is that, under a system in which private capital takes the first loss, risk-based pricing is inevitable; implicit cross subsidization is unlikely. I do not believe that an incentive fee can be structured such that it is acceptable to both the progressives who want adequate cross subsidization to encourage lending to the full extent of the new credit box and the free market folks who don’t want market prices to be distorted. Moreover, any such fee requires an explicit decision on the degree of cross subsidization, a topic that most are unwilling to explicitly address. It’s the “don’t ask, don’t tell” of GSE reform. As Ellen discusses below, the total 10 basis point fee had purposes beyond cross subsidization, but the flex part, as a matter of economics, would have been all about pricing.

A further complication: the mortgage rates produced by risk-based pricing are, by definition, considerably higher for riskier borrowers. Consequently, these borrowers would more likely opt for an FHA mortgage, where risk-based pricing is minimal. And if risk-based pricing becomes even more pronounced, these effects will be magnified, with a greater proportion of underserved borrowers finding it more economic to select an FHA mortgage.
I think it’s important to understand this is not some abstract problem: it relates to the question of how we will house an America in which many more families will reach their 30s and 40s burdened with student debt, with less-certain and lower incomes, and less family financial support than was the case for the last two generations. And if you think about homeownership as the major way the middle class—at least since World War II—has built assets, it also is part of our concern about inequality, economic growth, and social harmony.

Wall Street’s record of pricing mortgage risk has not been stellar; they clearly underpriced it wildly during the boom, and there’s a legitimate concern that the bust will lead to massive overpricing of risk that may or may not exist. If the government is going to be involved in making certain that our housing finance system works for everyone, then it’s essential to put in place the structures needed to meet that goal. Interestingly, while we’ve concentrated on the single-family owner-occupied housing finance market, there was a significant amount of agreement on how to handle the rental market, an increasingly important element of our housing and housing finance system.

Q: How much of Johnson-Crapo can be achieved administratively, and is there a will to do this?

LG: A great deal of Johnson-Crapo can be achieved through administrative channels. We can bring more private capital back into the system ahead of the GSEs’ guarantee and we can better separate the administrative functions of bond securitization from the risk-taking functions, to name but two core pieces of the bill. We do, however, need Congress for the final steps: ownership, release from conservatorship, etc. Let’s look at each point in turn.

The cornerstone of Johnson-Crapo and Corker-Warner was to bring private capital into the system ahead of the GSEs’ guarantee and we can better separate the administrative functions of bond securitization from the risk-taking functions, to name but two core pieces of the bill. We do, however, need Congress for the final steps: ownership, release from conservatorship, etc. Let’s look at each point in turn.

The GSEs have executed a series of risk-sharing transactions in which they are laying off the risk on recent-origination mortgages that are currently on their books. These back-end risk-sharing transactions ("back-end" because the loan is already on the GSE’s books) take two forms: capital market transactions such as Fannie Mae’s Connecticut Avenue Securities (CAS) and Freddie Mac’s Structured Agency Credit Risk (STACR) deals, and reinsurance deals.

One can also conceive of front-end risk-sharing arrangements, such as the one proposed by the Mortgage Bankers Association (MBA), in which, at the point of origination, the loan receives deep mortgage insurance in exchange for a meaningful reduction in guarantee fees (g-fees). One can also conceive of insurance policies on pools of loans and not just on individual loans, as was a part of the pre-conservatorship toolkit. I believe the Watt FHFA is moving toward front-end risk sharing, but first wants to make sure the mortgage insurance industry can absorb the increased demands being placed upon it.

All of these risk-sharing requirements can be ramped up over time, so that the GSEs would ultimately essentially be required to lay off most of the risk in their book of business.

JP: The forms these risk-sharing transactions take—front-end or back-end—will take on increasing importance as the enterprises scale up their transactions. If they do begin to shift to front-end transactions, then they are slipping into the role of reinsurer as Johnson-Crapo envisions the government back-stop to do. If, on the other hand, they continue to do all or even mostly back-end transactions, then they are simply solidifying their role in the market as first-loss guarantors.

So it raises an important policy question for FHFA: what are they trying to solve for? If it’s just de-risking, then perhaps it doesn’t make any difference. But if it’s laying the groundwork to ultimately shift the GSEs into the role of re-insurer that is envisioned in Johnson-Crapo, it matters a great deal.

LG: One more note on risk sharing: these transactions not only transfer the risk from the
taxpayer to private capital, they also provide price discovery. This price discovery can theoretically be used to allow the FHFA and GSEs to set market prices on g-fees and loan level pricing adjustments (LLPAs). The risk-sharing deals to date have been primarily on 60–80 loan to value (LTV) loans and combined all FICO scores, so one obtains information on the average market price for 60–80 LTV loans, and little information on LLPAs.

One recent deal used higher LTV loans, providing some indication on that pricing. The point: it is possible to construct geographically diversified pools that would provide market information for both base g-fees and LLPAs. Will risk-sharing deals be constructed to allow for market pricing by risk buckets and will the information be used in this manner? Doing so implies moving away from the cross subsidization of lower-quality loans by their higher-quality counterparts that has always been a part of the GSE mandate, and it is unclear that there is political will to change that.

Q: Laurie, you also mentioned that FHFA can begin to separate the administrative functions of bond securitization from the risk-taking functions, another core component of Johnson-Crapo.

LG: Yes, the Common Securitization Platform (CSP), as conceived by FHFA and as currently being executed by Fannie and Freddie, is intended to do exactly this. The CSP includes not only the securitization systems, but also a uniform set of standards for underwriting, disclosure, and servicing. The CSP would standardize the GSE pooling and servicing agreements. Watt made it clear in his May 14 speech that he would like to move the GSEs toward a single common security.

While developing a single security on the CSP will take years, and the mechanics of converting outstanding securities will need to be carefully considered, much of the effect of a single security could be achieved tomorrow by Freddie and Fannie agreeing that Freddie securities would be good delivery into Fannie Mae MegaPools for a very small pay-up. The common security should still be the ultimate goal; but most, though not all, of the benefits of the common security can be achieved very quickly, through an interim measure.

JP: If shifting the government into the role of re-insurer was the conceptual centerpiece of Johnson-Crapo, the CSP is its functional centerpiece. An extraordinary amount of the nuts and bolts of the current Fannie and Freddie system would ultimately go into the CSP—essentially everything but what would be needed to manage credit risk, which would go instead into the bond guarantor segment of the market. The insight behind this division makes a lot of sense: why not pull out the segments of the current system that benefit more from scale and homogeneity than competition into a utility-like entity designed entirely to provide stable scale and homogeneity? This should make the system more efficient, stable, and competitive than one in which the guarantors have control over all of the critical infrastructure that anyone trying to get to the secondary market depends upon.

Of course, what seems simple and clean in theory is anything but in practice. The components of Fannie and Freddie’s infrastructure that would ultimately make this transition are remarkably complex and arcane, and getting them into position to be pulled out of those institutions and dropped into another will be a herculean effort. So it is helpful that FHFA is already focused on the early stages of such an effort. As with the risk-sharing pilots, there is much to be learned that can inform our next run at a comprehensive legislative solution.

Q: What about the affordability pieces in Johnson-Crapo? Can anything be done to begin to move there?

LG: On affordable housing features, Johnson-Crapo called for a 10 basis point fee on the outstanding principal balance of all government-guaranteed mortgage backed securities (excluding Government National Mortgage Association (GNMA) securities) to fund the Housing Trust Fund, the Capital Magnet Fund, and a new Market Access Fund. The Housing and Economic Recovery Act of 2008 (HERA) required that a one-time fee of 4.2 basis points be imposed on every mortgage purchased by the GSEs, to be contributed 65 percent to the Housing Trust Fund and
35 percent to the Capital Magnet Fund. These contributions were suspended when the FHFA put the GSEs into conservatorship. However with the GSEs now generating profits, a case can be made that the fee be imposed, and there is pressure from many, primarily progressive groups, to do so.

**JP:** One note of caution about turning on the HERA fees. The FHFA and Treasury are embroiled in several lawsuits over whether shareholders have a right to the profits that the enterprises are now generating and that are currently being swept into the Treasury as a dividend. So the FHFA is likely to be cautious about redirecting a portion of those profits elsewhere. That’s not to say that they won’t or shouldn’t, but it’s not as simple as turning it on because they are finally making money.

**ES:** There are a few important differences between the HERA fees and the Johnson-Crapo proposal. First, the Johnson-Crapo fee would have generated a much larger stream of revenues; not only is 10 basis points more than twice 4.2, but the Johnson-Crapo fee was explicitly a “strip” to be collected as long as the loan was outstanding.

Second, HERA does not include the Market Access Fund, which would have competitively supported research and development and commercial-size market testing of products and services designed to meet the new needs of both the ownership and rental markets. (The Housing Trust Fund and Capital Magnet Fund are focused on rental housing for low-income households.)

Finally, as discussed a bit earlier, under Johnson-Crapo the 10 basis point fee was not going to be applied uniformly to all entities. The amounts charged would vary: guarantors and aggregators that served a higher share of underserved populations would pay less, others would pay more. The hope was that part of the differential would be passed back to the borrower, reducing some of the impact of the higher mortgage rates the new system is likely to produce. (Laurie and I proposed a different form for the incentive fee, as we did not think in its form in Johnson-Crapo the fee was likely to be passed through to the borrower.) And Johnson-Crapo had neither affordable housing goals nor an enforceable “duty to serve.” Both are present in the current system, as established in HERA, and FHFA is in the process of writing 2015 goals and implementing the “duty to serve.” However, without a Market Access Fund, it’s unclear that capital-constrained Fannie and Freddie will go back to doing some of the creative work needed to serve a changing population, no matter what the FHFA does on duty to serve.

While not directly on point, the Request for Input on Guarantee Fees the FHFA put out on June 5 raises a series of questions that implicate the role of the GSEs in providing access to affordable credit. These include appropriate putative capital levels; the interplay between risk-based pricing and access to credit; and the impact of g-fees on the size of the market and the GSE, FHA, portfolio, and private label securities (PLS) shares.

**Q:** Of the work that needs to be done, what has to be done by Congress?

**LG:** Only Congress can clarify the distinction between public and private; the current system started out muddled with an implicit government guarantee, and became more muddled when the institutions entered conservatorship. Under Johnson-Crapo, the distinction between private and public is clear: the platform is public, the first-loss capital is private, the catastrophic guarantee is public. Under the present system, the CSP is a separate company, jointly owned by Fannie and Freddie, who are themselves in conservatorship. The guarantees are provided by entities in conservatorship, which are currently unable to build capital. The catastrophic insurance is implicitly provided by the government—it has never been made explicit. Congress will be needed to clarify these issues.

**Q:** So how do you all feel about the prospects for legislative reform going forward?

**LG:** I know I am the least optimistic of the three of us that we will get GSE reform through legislation, at least in my professional life. And I must say,
reading this over reaffirms my view. I expect the FHFA and the GSEs to evolve to a state that incorporates many of the principles that legislative GSE reform would have brought. But, as Jim has pointed out, the final fate of the GSEs does require legislative action. And this is unlikely in the near term, leaving the GSEs—and the United States housing finance system—in a long period of limbo.

**JP:** I struggle with predicting where this is going, to be honest. I worry that as the housing market continues to recover (knock on wood) and memories of the crisis and Fannie and Freddie’s role in it grow more distant, Congress will be less and less interested in taking this on in any comprehensive and structural way. If that is what happens, then I fear that we are stuck in this dysfunctional limbo until something dramatic happens—a bump in the market that forces the undercapitalized enterprises to begin to draw on Treasury again, say, or a lower court decision or two in favor of shareholders that call the current arrangement into question. Then we’ll dust off Johnson-Crapo and all go scrambling back to the table. I hope it’s sooner, but I do worry.

**ES:** Well, it’s certainly not looking good, and time is definitely running out this session. But sometimes budget scoring and politics can work in strange ways. Jim covered politics earlier in the discussion about who might get dug in and why. That can also work in reverse: for example, a Democratic hold in the Senate in November might convince Republicans that they’ll get a better deal in 2015 than after 2016.

Budget scoring is more arcane. But if the Congressional Budget Office (CBO) scores Johnson-Crapo in a manner that suggests GSE reform could pay for other things Members want, some who are not currently interested may become so. Less powerfully, if the CBO began to issue warnings that leaving the GSEs in conservatorship was going to start costing the government a good deal of money, that could also add some pressure for reform. Similarly, a change in the status quo with respect to the shareholder lawsuits could generate some movement. But I think the better bet is on stalemate on the Hill.

**JP:** And of course we shouldn’t lose focus on how much we can do to improve the status quo while we wait for Congress. We can do a great many things administratively that will both improve life in the conservatorship and begin to prepare for life after. Hopefully this is something we all begin to focus on next.