How Chairman Crapo's Outline for Housing Finance Reform Can Work

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Chairman Mike Crapo of the U.S. Senate Committee on Banking, Housing, and Urban Affairs released an outline for housing finance reform on February 1. While leaving much to be resolved, it offers a promising framework from which to begin. How this framework is filled in will be important, however, since a few critical structural choices yet to be made will have a dramatic impact on how the proposed system would work. We offer a summary of where this framework starts, three of the most important design issues left to be decided, and how these issues must be decided to ensure a viable path for the legislative reform we so badly need.

The system laid out in the outline

Mortgage lenders will have three options to access the secondary market through the system proposed:

1. Lenders can sell their loans to one of multiple chartered guarantors, which would issue securities through Ginnie Mae.
2. Lenders can purchase insurance from the guarantors to cover the credit risk on their pools, and issue securities themselves through Ginnie Mae, retaining master servicing.
3. Lenders can sell their loans to a loan aggregator, which would either sell them to one of the guarantors as per option 1 or issue securities themselves as per option 2.

After securing mortgage insurance on all loans with a loan-to-value of greater than 80%, lenders and aggregators must off-load all of the remaining credit risk to the chartered guarantors, whichever channel they use. Guarantors can then distribute some or all of the risk they assume through credit risk transfers, resulting in a broad dispersion of credit risk throughout global markets. Ginnie Mae will own and manage the securitization infrastructure and provide the government guarantee on the securities.[1]

To minimize market concentration, lenders cannot be guarantors and no guarantor can guarantee more than a yet-to-be-specified percentage of all outstanding mortgages guaranteed in the channel.[2]

There is indeed a good deal yet to be specified in this framework. However, three critical design issues stand out in their importance: how the lender-issuer channel will work (the second option for lenders listed above); how the new system will attract a sufficient number of new guarantors to ensure adequate competition in the secondary market; and how the system will ensure broad access to affordable credit.

How the lender-issuer channel will work

What it means to allow lenders to issue securities in this system depends on how a couple of questions are answered. The first is whether the issuer is on the hook for the failure of a guarantor from which they purchased insurance. Put differently, in the issuer channel, does Ginnie Mae step in to pay mortgage-backed securities investors after a guarantor has failed, or only after the issuer too has failed? If the latter, issuers will have counterparty risk that may compromise their ability to get true sale accounting on the loans delivered through the channel, tying up so much capital that the channel would likely be uneconomic for all lenders. And even if lenders do get true sale accounting, they would still have to hold additional capital against the risk, rendering the execution unappealing to all but big banks, which are uniquely positioned to use their scale to cover the incremental risk.

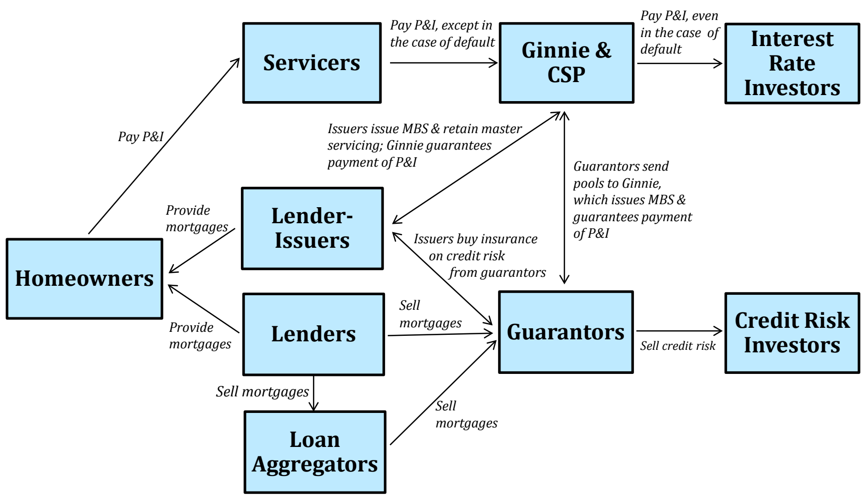
If instead Ginnie Mae steps in to cover payments to MBS investors when the guarantor fails, then this problem disappears. Issuers will not have to set aside capital to cover the counterparty risk, opening the channel up to lenders of all sizes.

The second question is whether lenders are able to issue securities through this channel that are backed only by their own loans. If so, then some lenders could set up vertically integrated to sell MBS backed by loans valued most highly by investors, sending ev-

1 Ginnie will also presumably manage the securitization of loans insured by the FHA, VA and USDA in the manner it does today. As we mention below, clarifying how these channels relate to each other will be an important next step in the development of the proposal.

2 The outline actually says that depositories cannot be guarantors, but we assume that the prohibition would apply to all lenders given that the reasons for prohibiting depository lenders apply in precisely the same way to non-depository lenders.

Chairman Crapo's Proposed System



Not shown: lenders must get mortgage insurance on all loans with a loan-to-value greater than 80%.

erything else through the guarantor channel. The housing finance system would then have two very different channels: one dominated by lenders selling their own premium MBS at premium pricing and another through which everyone else sells a broader mix of loans at worse pricing. This would pose a host of challenges.

Larger lenders would be better positioned to vertically integrate as issuers, given the complexity and capital involved, forcing smaller lenders into a poorer execution that makes it harder for them to offer competitive pricing to borrowers in the primary market.

Guarantors would find it difficult to compete with issuers given the latter's better execution. Guarantors would be forced to operate primarily in whatever segments of the market issuers do not want. This would make it difficult to attract capital to fund guarantors, compounding the difficult challenge of attracting new entrants to compete with Fannie and Freddie.

Finally, the fragmentation of the market would make it less liquid, less stable, and more expensive for borrowers. It would also make it difficult to ensure that all markets and communities are well served through the economic cycle, as issuers will focus on the most lucrative markets.

It is thus critical that securities issued through all three channels be collateralized by the same multi-lender pools.[3] By making the issuance fungible in this way, you would level the playing field for both lenders and guarantors, maintaining a single, deeply liquid and broadly dispersed secondary market.

If policymakers address these two open questions effectively, then the lender-issuer channel proposed could be a net gain to the system, allowing lenders to retain master servicing and thus spreading some of the associated liquidity risk beyond the guarantors, without compromising the system's competitiveness, stability or liquidity.[4]

How the system will attract new entrants

The next design issue that must be addressed is how the proposed system will create competition among guarantors. To address the too-big-to-fail problem, which is one of its central objectives, the system must ensure that enough new guarantors enter the space that any one of them can fail without bringing the entire market down.[5] While the outline includes a limit on the overall market share of any one guarantor, the system will need to make it feasible for other institutions to enter the market to compete with Fannie and Freddie.

This will be no small task. Fannie and Freddie not only have long-standing relationships with the mortgage industry that give them a formidable head start, but they have built the securitization infrastructure that the vast majority of market participants rely on to access the secondary market. The way lenders interface with the secondary market has been determined in large part by the systems that Fannie and Freddie have put into place over decades, driving everything from what information lenders collect from borrowers and how, to what underwriting processes they run and what software programs they use. Even if they are not relying on a Fannie or Freddie system for a given process, a lender is often relying on a system that was built to handle one of Fannie and Freddie's systems. The same is true for investors, with a great many of the processes, standards and expectations for how investing in MBS works arising from the systems put in place over the years by the government-sponsored enterprises.

If the only way that a new entrant can compete with Fannie and Freddie is to attract lenders and investors away from this deep, comprehensive and long-standing nexus of rules, systems and technologies, then the odds of attracting a sufficient number of guarantors for the kind of system imagined here are impossibly long. For the system to work as intended, much of this infrastructure will have to be moved into the common securitization platform, or created anew there. By making what is in some ways the highway system of the housing finance system accessible to all guarantors, it will serve to lower barriers to entry rather than make them prohibitively high.

3 It would function much as Ginnie II functions today.

4 An interesting question is whether guarantors will price loans they purchase more favorably than those for which they only provide insurance, as in the former they will maintain master servicing, making it easier for them to manage the risk they have assumed.

5 Allowing privately owned institutions to play a role so critical to the system that they cannot be allowed to fail gives them an incentive to take on excessive risk, knowing that taxpayers will bail them out if these risks do not pay off. Policymakers can address this problem in one of three ways: They can attempt to regulate the behavior of the privately owned oligopoly, as has been recommended most recently by the National Association of Realtors; they can put these critical functions into a governmental or quasi-governmental institution, as several of us have advocated; or they can create a market in which enough privately owned entities own and manage that infrastructure that any one can be allowed to fail, as is envisioned in the Crapo proposal. Simply re-privatizing them with a few modest reforms, as some have advocated, will leave the too-big-to-fail problem firmly in place.

The most realistic way to do this is to build on the work that the Federal Housing Finance Agency, Fannie, and Freddie are doing already with the common securitization platform. Once the CSP is effectively supporting issuance by both Fannie and Freddie, it should be well positioned to handle additional issuers. Unlike the initial effort of synthesizing two very different securitization systems in Fannie and Freddie, new issuers will be able to join by designing their de novo systems to sync up with the existing systems of the CSP, a much less daunting undertaking.

However, the CSP is limited in which securitization processes it supports, focusing exclusively on the bond administration functions. Here too it can and should be expanded. For instance, it should take on more loan-level data, so that market participants have access to the kinds of data that allow Fannie and Freddie to automate appraisals and other critical processes. Most useful here would be sharing the data and processes that drive Fannie and Freddie's automated underwriting systems, which together form one of their most formidable barriers to entry. By opening up their AUS to the market, at least for some brief period, other guarantors would be able to develop their own automated underwriting systems more readily, helping them to begin on terms more level with Fannie and Freddie. Policymakers could take this one step further by requiring the CSP to intermediate between lenders and the guarantors' automated underwriting systems. Guarantors could be required to provide a portal to their AUS on the platform, so that lenders would submit information on a given loan for approval and pricing from all guarantors at once. This would dramatically reduce the prohibitive advantage that Fannie and Freddie would otherwise enjoy from the market's adoption of their AUS.

How the system will ensure broad, consistent access to affordable lending

And finally, another critical design issue that must be addressed is how the system will provide broad, consistent access to affordable mortgage credit, particularly in areas that the market may be less inclined to serve well when left on its own. Chairman Crapo's outline states that the affordability goals and duty to serve will be replaced by a market access fund, which will be funded by an annual 10-basis point fee on all securities issued through the channel.[6] While that would generate more than $5 billion a year to lower housing costs for low- and moderate-income borrowers, which is more than the current system provides, a great deal more about how this will be allocated and how the system as a whole will work will need to be developed in the right way to ensure that it provides adequate support for communities that need it.

First, it will be important that all guarantors have a national footprint, so that they cannot simply serve those markets that happen to be most profitable. Allowing guarantors to cherry-pick markets could lead to regional or demographic gaps in the secondary market, segments in which lenders have little to no places to sell their loans. This, in turn, would lead to gaps in the primary market that would be difficult if not impossible for the market access fund to overcome. It would also lead to volatility in liquidity as guarantors move from one market to another depending on the inevitable variations in profitability that will come with the economic cycle.

It will also be important to develop a means of allocating the funds that cannot be captured by intermediaries. The current system does this relatively well. By delivering its cross-subsidy through a simple, largely level guarantee fee—whereby lower credit risk borrowers are overcharged so that higher credit risk borrowers can be undercharged—it avoids the expense of sorting out who is to receive which kinds of benefit and paying others to deliver that benefit. Whatever means are used to deliver the cross-subsidy in the new system, the benefits should similarly flow to the beneficiaries in as automated and simple a way as possible.

And then it will be important to target the market access fund to those borrowers who actually need the help, with the kind of help they actually need. Here, the current system does not perform as well. Although much of the cross-subsidy is driven by the duty to serve and affordability goals to serve to low- and moderate-income borrowers, a significant portion is not. As most of the cross-subsidy is provided through the level guarantee fee paid by all Fannie and Freddie borrowers, almost a quarter of the cross-subsidy goes to those who are not low- or moderate-income borrowers, but benefit simply because they have poorer credit. Moreover, not all borrowers need help in the form of a modest reduction in their mortgage rates, yet desperately need it in another form, such as down-payment assistance. The future system could thus do a better job channeling funding from those who can afford to pay to those who need the help and in the form that they can actually use.[7]

Conclusion

There are, of course, other critical choices to be made, including what capital and regulatory regime to impose on guarantors to ensure that they are protecting the taxpayers standing behind the system rather than arbitraging the government's backstop; how to give whatever institution owns and operates the securitization platform the flexibility and autonomy it needs to be an effective market utility; and how to integrate the FHA, VA and USDA into a more seamless, coherent system of government support for the mortgage market.[8] But if policymakers can effectively address the more foundational issues discussed above, we think the remaining challenges are manageable. Chairman Crapo's outline thus holds significant promise, making it a worthy place to renew the much delayed, but still badly needed, effort to overhaul the housing finance system.

6 It is worth noting that the outline retains both the Housing Trust Fund and Capital Magnet Fund. So they are proposing to replace the components of the subsidy focused on expanding access to credit, but not those focused on addressing the inadequate supply of affordable housing.

7 Some have expressed concern that applying a conservative income cap on who can receive the subsidy would leave out some families that need and deserve help, particularly middle-class families of color whose ability to get a mortgage has been impacted by a legacy of discrimination. The answer, though, is more thoughtful targeting, not giving up on targeting altogether. Challenging as targeting may be, without it we are giving money to the wrong people and those who really need it are getting less, or none at all, as a result.

8 The long list of issues to be addressed is a reminder of how challenging legislative reform will ultimately be: how guarantee pricing should be regulated; what the process for resolving a failing guarantor will be; how to handle transition; how to handle multifamily, and on and on.

About the Authors

Jim Parrott is a nonresident fellow at the Urban Institute and owner of Falling Creek Advisors, which provides strategic advice on housing finance issues to financial institutions active in the primary and secondary markets. Jim spent several years in the White House as a senior advisor on the National Economic Council, where he led the team of advisors 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. Prior to his time with the NEC, Jim was counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development. He has a JD from Columbia University School of Law, an MA from the University of Washington, and a BA from the University of North Carolina. He also served in Sri Lanka with the Peace Corps and lives now with his family in Chapel Hill, NC.

Dave Stevens, CMB, a housing policy consultant, has been involved in the mortgage banking industry for 35 years, most recently serving as President and CEO of the Mortgage Bankers Association from 2011-2018. Prior to the MBA, he was nominated by President Obama and served as the U.S. Assistant Secretary of Housing and Federal Housing Commissioner at the Department of Housing and Urban Development, where he worked on an interagency team focused on the administration's housing efforts during the peak of the great recession. Mr. Stevens has held several key leadership positions in the industry, including EVP of Wholesale Lending at Wells Fargo Home Mortgage, SVP of Single Family Lending at Freddie Mac, and President and COO of Long & Foster Real Estate, Inc. Mr. Stevens was named 2018 Mortgage Professional of the Year by National Mortgage Professional Magazine, and has been included on Bloomberg's 50 Most Powerful People in U.S. Real Estate and Inman's 100 Most Influential Real Estate Leaders. He has appeared frequently on CNBC, PBS, and Bloomberg TV, and continues to influence policymakers in Washington. Mr. Stevens currently serves on the board of directors of Dynex Inc., a publicly traded Real Estate Investment Trust, and serves as a Senior Advisor to Mortgage Media, along with consulting for other real estate industry companies. A graduate of the University of Colorado, he and his wife, Mary, live in Washington DC.

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