

Written Testimony of  
Mark A. Willis  
Resident Research Fellow  
NYU Furman Center for Real Estate and Urban Policy  
for the hearing entitled  
**Returning Private Capital to Mortgage Markets: A Fundamental for Housing Finance Reform**  
Before the Subcommittee on Securities, Insurance and Investment  
of the Senate Committee on Banking, Housing and Urban Affairs  
Tuesday, May 14, 2013

Chairman Tester, Ranking Member Johanns, and Members of the Committee, I thank you for the opportunity to testify today on the role for private capital in reforming mortgage markets. I am Mark A. Willis, a Resident Research Fellow at the Furman Center for Real Estate and Urban Policy at New York University and an adjunct professor at the Wagner School of Public Service, also at NYU. Previous to that, I was the Executive Vice President for community development at JPMorgan Chase, having started many years earlier at one of its predecessor institutions, Chase Manhattan Bank, as president and founder of its Community Development Corporation. Before that, I served as an economist at the Federal Reserve Bank of New York and worked in New York City government.

Since 2008, I have focused much of my research work on housing finance reform and have written articles, consulted for a number of organizations, lectured, and participated on numerous panels on this topic. I am also a member of the Mortgage Finance Working Group convened by the Center for American Progress and have conducted research for the Housing Commission of the Bipartisan Policy Center. The views contained in this testimony are mine and should not be attributed to any of the organizations to which I am affiliated.

I want to make two major points in my testimony today: First, restoring private capital's historic role in the financing of home mortgages – financing jumbo mortgages – is a straightforward matter once regulatory uncertainties are resolved. Second, requiring the use of private, credit-risk-taking capital for the much larger remainder of the housing finance market is also possible, but such requirements should only be implemented after we have tested their impact on access to and affordability of mortgages for the vast majority of the homebuyer market. By test-driving different approaches, we will be better able to weigh the costs and benefits of having private capital take more of the risk and avoid unnecessarily disrupting the availability of new mortgages.

## **Background**

Before discussing the details of increasing and deepening the role private capital plays in mortgage markets, it is useful to clarify the different roles it has played in housing finance in the past. Private capital is today, and always has been, the source of all the funding of home mortgages. What we are discussing now is to what extent this private capital is insured or guaranteed by the government.

It is also useful to understand that there are two types of investors bringing private capital. First, there are those investors who are interested in taking only interest rate risk and prepayment risk (these are called “rate” investors). These investors purchase mortgage-backed securities (MBS) where there is essentially no credit risk, e.g., when the government insures against the risk of borrower default. Then, there are those who take that credit risk, either alone or in addition to interest rate and prepayment risk (these are called “credit” investors). It is generally understood that the pool of capital available from these rate investors far exceeds that for the credit investors.<sup>1</sup>

In recent decades, much of the funding for mortgages has come through the secondary market, as opposed to through financial institutions that make loans and hold them on their own books.<sup>2</sup> Many investors purchased MBS issued by Fannie Mae and Freddie Mac, which are backed by mortgages below what has been called the conforming loan limit (pre-crisis was set at \$417,000), believing that there was an implicit government guarantee of these securities. Direct investors in Fannie and Freddie also appear to have felt shielded from credit risk, despite the technical fact that these two agencies had been privatized decades ago, and it turns out that, at least for the debt investors, they were right -- the government has fully stood behind those securities. Even the equity investors in the Agencies appear not to have paid enough attention to the riskiness of the mortgages they backed or owned. In the end though, these investors did bear the cost of the financial failure of these two firms. Accordingly, most of the investors in this part of the mortgage market have in the past only had to concern themselves with interest rate and prepayment risk since the government has guaranteed timely payment of principal and interest on all securities.

Only larger loans (the so-called jumbo loans) and loans that were subprime or labeled Alt-A—the financing and regulating of these latter types of loans I take as beyond the scope of this hearing—have traditionally been financed with private, credit-risk taking capital mainly by banks<sup>3</sup> and by investors in private label mortgage-backed securities (PLS).<sup>4</sup> Before the crisis, loans larger than \$417,000 were not eligible for purchase by Fannie Mae and Freddie Mac (“Fannie” and “Freddie”—collectively the “Agencies”). Thus, investors in these securities and banks had to cover default risks.

---

<sup>1</sup> For example, rate investors in Fannie Mae and Freddie Mac debt and mortgage-backed securities have included sovereign funds which see the U.S. government as providing a guarantee against credit loss.

<sup>2</sup> Banks do hold some mortgages in portfolio but 1) are limited in their appetite for long duration instruments such as 30-year fixed rate mortgages, 2) look to diversify their assets to guard against sharp losses in any one sector of the economy, and 3) have only limited portfolio capacity in any case. While bank assets have grown in recent years, they still barely exceed the total value of mortgages outstanding and bank deposits fall well short of this total (See Federal Reserve Flow of Funds reports).

<sup>3</sup> Banks also buy MBSs to hold in portfolio. These securities may or may not involve credit risk depending on whether the MBS is covered by a government guarantee.

<sup>4</sup> If subprime and/or alt-A re-emerges as an asset class, then it seems likely that a secondary market to fund it will also be able to re-emerge once a healthy jumbo PLS market has been reestablished.

Following the 2007 onset of the nationwide decline in housing prices and the great recession, the government expanded the range of loans that were eligible for purchase by Fannie and Freddie by raising the size limits for eligible loans. The Economic Stimulus Act of 2008 temporarily raised the loan limit in some parts of the country with high housing prices as high as \$729,750 for them as well as for the Federal Housing Administration's (FHA) insurance program. While the limit for the Agencies has now fallen back somewhat to \$625,000, that limit still encompasses over 97% of the mortgages and almost 90% of the dollar volume originated annually for the purchase of homes.<sup>5</sup> So it is not surprising that some 90% of the mortgages for the finance of home purchases rely on the government guarantee, which means that the taxpayers remain entirely on the hook if defaults should exceed the financial capacity of Fannie and Freddie to absorb any resulting losses.<sup>6</sup>

Calls for using private, credit-risk-taking capital to decrease the risk of loss to taxpayers are made on several grounds: First, there is the simple desire to have private capital absorb some amount of the loss. Second, some argue that the private sector is better able than the public sector to price the risk,<sup>7</sup> although the latter is something of a specious argument given that the government had to bail out purely private credit risk takers whose mispricing helped fuel the subprime boom and bust. While it is a challenge for government (or anyone) to set exactly the right fee for providing a "wrap," government does have one advantage: it can cover losses out of tax revenues and even recoup those losses by raising the premium it charges going forward for providing the guarantee (as it has done through the addition of loan level price adjustments and increases in the so-call g-fees charged by Fannie and Freddie and as FDIC has done with regard to deposit insurance). A third potential benefit of having private investors take credit risk alongside the government could be an extra set of eyes to assess credit standards/underwriting criteria and monitor whether loans are being properly underwritten and serviced. Additionally, it is hoped that the active involvement of private sector actors will discourage, if not prevent, attempts by government officials to fiddle with underwriting and other standards for political gains.

In the end, it is important that America have a housing finance system that can provide mortgage products that are well-priced and accessible and safe for all borrowers who can

---

<sup>5</sup> These percentages are based on an average of the annual HMDA data for home purchase loans by owner-occupants for the years 2004 through 2011.

<sup>6</sup> The U.S. Treasury has inserted \$187.5 billion in capital into Fannie and Freddie in the form of senior preferred stock and has received back \$121 billion in dividends. As of August 2012 all of the earnings of Fannie and Freddie are being swept back into the Federal budget. Based on the amount and rate of recent payments and sweeps from Fannie and Freddie the government appears well on its way to recovering the full amount of the capital it invested.

<sup>7</sup> It is worth noting that the premiums charged by both FHA and GNMA (the Government National Mortgage Association guarantees MBS backed by FHA-insured mortgages) have been sufficient up to now to cover any losses out of the reserves they have built up over time. It is also likely that, given the rules governing FHA, a transfer of less than a \$1 billion may be triggered during the next fiscal year even though FHA has enough money to cover foreseeable losses for the next 7-10 years and can expect higher net earnings going forward since it has raised premiums while the credit quality of new loans has risen significantly.

sustain homeownership, while at the same time minimizing systemic risk to the economy as a whole.

### **Taking Steps that Make Sense**

The FHFA can take a number of steps to move us down the road of housing finance reform in a measured and informed way:

#### Turn the jumbo mortgage market back to the private sector

Now that the housing market seems to have stabilized, it is time to let the jumbo market stand on its own without a government guarantee. It accounts, after all, for some quarter of the dollar volume of mortgages per year and over 8% of all mortgages by unit count.<sup>8</sup> While it may in the end make sense to trim back further the share of the market eligible for the government wrap (see discussion below), opening up the market above \$417,000 should provide a very significant opportunity to attract private, credit-risk-taking capital.

The best way to trim back is to raise the g-fee on all loans over \$417,000 until the private sector is able to capture as much of the market as it wants to. An alternative approach, which some have suggested, is to lower loan limits one step at a time to \$417,000, but this could leave parts of the market underserved or even unserved, especially if the private sector is reluctant to gear up to serve this market until it is of sufficient scale to justify the costs of setting up and running the necessary market infrastructure and to offer investors sufficient liquidity. While Project Restart<sup>9</sup> and other efforts are underway to re-think the workings of a PLS market, some remaining regulatory uncertainties, especially with regard to risk retention under Dodd-Frank, probably need to be resolved if the private sector players (e.g., investors, originators, servicers, etc.) are going to be sufficiently motivated to take the lead to reach agreement among themselves on the rules of the road necessary to be able to come back at scale. Otherwise, it may take a g-fee increase that is significantly above what pricing should be needed in the long run for the private sector to compete for the jumbo business.

#### Then evaluate whether to lower the loan limit below \$417,000

Once the jumbo private securitization market is functioning at scale, it will be possible to evaluate the impact of any further lowering of the limits for the private sector to begin to serve the vast bulk of the mortgage market which lies below \$417,000. This part of the market (74% in dollar terms and 92% of the units) has historically benefitted from a government guarantee and not relied on credit investors.

If there is no significant difference in what private, credit-risk-taking capital proves willing to finance in the jumbo market compared to the existing offerings in the conforming market, then further testing of the right level for the loan limit should be undertaken. But any expansion of

---

<sup>8</sup> These percentages are based on an average of the annual HMDA data for home purchase loans by owner-occupants for the years 2004 through 2011.

<sup>9</sup> Project Restart has been a project of the American Securitization Forum.

the non-conforming market should only be done in stages. At each stage, the goal should be to ensure that the additional market segment will continue to offer a comparable range of mortgages including, for example, long-term, fixed rate mortgages, which are well-priced and available without regard to geography or other factors that would limit access to those that now have it.<sup>10</sup> Similarly, if the jumbo market requires higher down payments and/or higher FICO scores, then extending it into the heart of the mortgage market would risk excluding many potential homebuyers, particularly first-time and lower-wealth homebuyers.<sup>11</sup>

An additional option is to consider varying the loan limits based on variations across metropolitan areas in median home prices. For example, a loan limit of \$417,000 preserves a government guarantee for only 14 % of the mortgage market in San Francisco (27% of the units) while the comparable percentages for Dallas and New York are 83% and 47% (95% and 68%) respectively.<sup>12</sup>

#### Weigh pros and cons of requiring private, credit-risk-taking capital ahead of a government guarantee on “conforming” MBS

Since these tests are likely to reveal the value of having a conforming market supported by a government guarantee on MBSs backed by qualified mortgages, FHFA should continue its current quest to determine the costs and constraints of bringing in private, credit-risk-taking capital ahead of Fannie and Freddie in that conforming market. Sharing risk does offer the potential to reduce the burden that could ultimately fall on taxpayers.

However, using such private capital has drawbacks as well. Private sector investors need to be rewarded for taking risk, and they may require tighter underwriting standards (called credit overlays) than the government is willing to insure. It is simply naïve to expect private investors to adjust their expectations of an acceptable return in order to make homeownership more accessible and affordable or to put capital at risk during market downturns. Their presence may also make it harder for smaller originators to have access to the government wrap. Finally, it is important to consider any systemic risk posed by involving private capital across the board. Even if the investors in the MBS are protected by the government wrap, it is important to ensure that large losses by private capital in this position do not result in the need to once again bail out the private sector.

Shifting risk onto the private sector is also likely to raise the cost of mortgages. Government is able to provide its guarantee at lower cost because, unlike private investors, it does not have

---

<sup>10</sup> Most observers agree that broad access to a long-term (15 or 30 years), fixed rate mortgage, which have been at the core of the U.S. housing market, is critical for a healthy housing market. Many are concerned that the availability of this type of product might be put in jeopardy without the government guarantee.

<sup>11</sup> See, for example, Roberto G. Quercia, Lei Ding, and Carolina Reid, “Mortgage Underwriting and Access to Credit”, University of North Carolina, Center for Community Capital, October 6, 2011, which reports that some 40 percent of mortgages made between 2004 and 2008 were made with a down payment of less than 20%. <http://www.ccc.unc.edu/documents/Mtge.Under.Access.Credit.CFPB.10.6.11.No.2.pdf>

<sup>12</sup> These percentages are based on an average of the annual HMDA data for home purchase loans by owner-occupants for the years 2004 through 2011.

to be rewarded with a high rate of return for taking risk. Government has the ability to recover from losses by tapping other sources of revenue and so will not be put out of business if, by some unexpected set of circumstances, losses exceed the existing reserves built up by charging for the guarantee. Private capital, on the other hand, needs a high return to take on such risk and so its use will push up the rate that borrowers will have to pay. While some economists argue that the government should charge the same as the private sector to take on risk (so-called "fair value" pricing), the accounting spelled out in the Federal Credit Reform Act is designed to ensure that the government is appropriately compensated for the risk it takes, based on the government's borrowing rate.<sup>13</sup>

Moreover, reliance on private capital to take first loss will limit government's ability in times of economic stress to ensure the continued availability of mortgage financing through the conforming market, which can moderate the impact on housing prices and consequently on household wealth in the event of an economic downturn.<sup>14</sup> As we saw most recently with the housing bust and great recession, private capital can move quickly to withdraw from the mortgage market. New PLS originations disappeared and private mortgage insurance became close to unavailable. When that happened, Fannie and Freddie (along with FHA) stepped in to provide that essential countercyclical liquidity. Therefore, a requirement for private capital to be ahead of a government guarantee will make the availability of mortgages backed by the government guarantee (other than FHA) highly pro-cyclical unless a way can be found to dial back that requirement quickly.<sup>15</sup> Alternatively, the government can decide to rely just on FHA to ensure continuation of a housing market that functions well enough for both buyers as well as sellers.<sup>16</sup>

---

<sup>13</sup> Of course, every sector of the economy would like to have access to money at lower cost based on U.S. Treasuries plus a charge for risk that does reflect the government's borrowing costs and not those of risk-averse investors. Favoring the housing sector is consistent with the belief that housing provides important social benefits. For a discussion of the FCRA versus fair value, see John Griffith, "An Unfair Value for Taxpayers," Center for American Progress, February 9, 2012.

<sup>14</sup> As Mark Zandi wrote, "the FHA shows how government action during the Great Recession forestalled a much worse economic fate. If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it." See Mark Zandi, "FHA role may be bloated, but we'd be much worse off without it" *The Washington Post*, December 15, 2011, available at [http://articles.washingtonpost.com/2011-12-15/news/35285815\\_1\\_mortgage-loans-private-mortgage-mortgage-securities](http://articles.washingtonpost.com/2011-12-15/news/35285815_1_mortgage-loans-private-mortgage-mortgage-securities)

<sup>15</sup> If there is to be such a "dial", it will be necessary to determine who would make the decision, according to what criteria (e.g., would there be automatic triggers or would the decision be delegated to a government entity like Treasury, the Fed, or HUD), and what changes in procedures would need to be instituted to replace the functions that private capital was expected to perform. A similar issue exists with regard to any lifting of the loan limits for the FHA, but in this case FHA is already structured to work without relying on private capital.

<sup>16</sup> FHA was able to fill part of the gap opened up by the withdrawal of private capital by allowing its share of the home purchase to rise from less than 5% in 2006 to more than 30% in 2009. See U.S. Department of Housing and Urban Development, "Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2012" (2012), available at <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>

Another aspect of the current housing market that needs to be preserved is the To-Be-Announced (TBA) market, where Fannie and Freddie “pass-through” MBS<sup>17</sup> are traded today.<sup>18</sup> Most observers agree that the loss of this very deep and liquid market, which benefits from its appeal to rate investors, would likely raise the cost of mortgages and jeopardize the continued availability of well-priced, longer term, fixed rate mortgage products with rate locks from 30 to 90 days.<sup>19</sup> Unless we are prepared to do without such a market, we should consider bringing in private, credit-risk-taking capital only if it is compatible with a well-functioning TBA market.

For risk-sharing with a government wrap, focus on insurance options because they are compatible with a TBA market

Unfortunately, one of the private, credit-risk-sharing vehicles commonly discussed is incompatible with the TBA (To-Be-Announced) market and particularly with its ability to allow for rate locks. This option looks to structure an MBS into at least two tranches, one senior and one subordinate, also called A and B pieces.<sup>20</sup> The senior (“A”) piece would retain the government guarantee of timely payment of interest and principal while the “B” piece would be sold off to private investors who would stand to lose all of their investment before the GSE would take any losses.<sup>21</sup> Mortgage payments are first distributed to the investors in the “A” piece, who are thereby shielded from losses that are less than or equal to the payments owed on the “B” piece. In other words, shortfalls in payment from borrowers are absorbed first by “B” investors, and only if losses are in excess of what the “B” piece can absorb will the “A” piece suffer losses. As a result of being willing to take the first loss, investors in the “B” piece look to be paid more than those holding the “A” piece, yielding an interest-rate charge to borrowers which is a weighted average of the two interest rates plus other charges such as a servicing fee, etc.

While the “A” piece with its government wrap would be able to trade in TBA market, the “B” piece would not. Trading the “B” piece in the TBA market would violate SEC rules that prohibit the selling of securities where the underlying mortgages have not been identified in advance. The MBSs that Fannie and Freddie guarantee are specifically exempted from this requirement as are those guaranteed by GNMA.<sup>22</sup> This means that it will not be possible to use the TBA market to price the “B” piece in advance, making it a lot harder and presumably more expensive for loan originators to offer borrowers a rate lock. Also, the ability to raise capital

---

<sup>17</sup> The term “pass-through” refers to the fact that the payments made on the mortgages that back the security are simply passed through to the holders of the MBS in proportion to their investment.

<sup>18</sup> A TBA market also exists for GNMA securities but it serves only mortgages that qualify under the FHA, VA, or RHS programs.

<sup>19</sup> For example, see James Vickery and Joshua Wright, “TBA Trading and Liquidity in the Agency MBS Market,” New York: Federal Reserve Bank of New York, 2013, available at [http://www.newyorkfed.org/research/epr/2013/exesum\\_vick.html](http://www.newyorkfed.org/research/epr/2013/exesum_vick.html)

<sup>20</sup> No judgment is being made here as to the relative merits of a senior subordinate structure for the PLS market where there is no government guarantee and no TBA market.

<sup>21</sup> This structure is even now being used by Freddie Mac for some of its multifamily MBS in its K-series, but it should be noted that multifamily MBS does not trade in a TBA market.

<sup>22</sup> The Government National Mortgage Association (GNMA) guarantees securities with mortgages backed by FHA or other mortgages backed by a government agency.

using this structure is highly dependent on credit rating agencies, which will have to assess the risk inherent in the “A” piece if it is to trade without a government wrap and yet whose role in the crisis was significant and has yet to undergo reform.

Instead, FHFA should focus on insurance type options for that extra layer of protection for taxpayers. Insurance can work with traditional, pass-through MBSs that, with a government wrap, should be able to trade the same as Fannie and Freddie Mac MBS now do in a TBA market.

There are two main types of insurance that are most often mentioned for this purpose. One type is provided through mono-line insurance companies that are in business solely to insure mortgage risk. A variant of this approach is the private mortgage insurance (PMI) business that was a response to the statutory requirement that Fannie and Freddie obtain third-party coverage on loans with a LTV ratio above 80%. On a number of accounts, the PMI model evidenced major shortcomings when hit by the latest housing bubble and bust. However, with changes in rescission rules, tighter capital-to-risk rules, and enhanced regulation and supervision at the state and federal levels<sup>23</sup> it may be possible to come up with a design that would be acceptable to the customers of their product, e.g., Fannie and Freddie, and to the regulators and credit rating agencies.<sup>24</sup>

An alternative way to insure first loss would be to use credit-linked notes (CLNs)—a type of security which can be bought and sold in the public credit markets.<sup>25</sup> With CLNs, private investors put their capital at risk by purchasing the notes. These CLN investors advance the full amount of the note, and these funds are held in trust (thus this is described as a “funded” insurance model).<sup>26</sup> If a loss occurs, the funds go to cover the losses; if no loss occurs, the funds are returned to the CLN investor. In the meantime, the CLN investors receive regular payments which provide them with a return on their capital. Compared to the Senior-Sub or the traditional mortgage insurance model, this structure is more flexible as to what risks can be covered. Rather than covering an individual loan, or a single security, a draw on the CLN can be triggered by performance of a so-called “reference pool.” This reference pool can be as simple as the specific mortgages backing that MBS, or a broader group of mortgages, or a cross section of a GSE’s entire book of business, or other even broader economic indicators such as the unemployment rate or house price index.

A key factor in the choice among these alternative forms of insurance comes down to the overall cost imposed on borrowers for a given amount of protection. While in theory, the cost

---

<sup>23</sup> In general, insurance companies are subject to state regulation with no federal oversight bodies comparable to those that exist for banks.

<sup>24</sup> Even with risk-sharing ahead of the government wrap at the MBS level, requiring PMI might still make sense at the loan level for loans with LTV greater than 80%. Alternatively, a risk-sharing system could be built on a strengthened PMI model but with first-loss coverage much deeper than 30-35%.

<sup>25</sup> CLNs have been used previously by Freddie Mac under a program called Freddie Moderns

<sup>26</sup> It is a separate matter if the investors themselves can absorb the losses without becoming insolvent or potentially creating systemic risk across a broader segment of the financial system.



of the private capital to cover a given amount of risk should be the same regardless of the institutional form, these two types of insurance are subject to very different regulatory regimes which can affect the relative costs of providing the coverage. Moreover, there are other differences that should also be taken into account such as impact on small originators, on the widespread availability of mortgages across geographies and all segments of our society, scalability, ability to modify and restructure loans, etc.

Investors in CLNs, for example, may be more restrictive in the types of loans they are willing to insure and in dealing with smaller originators and originators that work in only a limited number of geographies. Investors in CLNs may prefer to work with originators that have been rated for the quality of their origination and servicing systems or have large, diversified pools of mortgages while insurance companies may find that working with as many originators as possible over time may help them diversify their risk, rather than seek to diversify one MBS at a time. At least in theory, though, a large enough “reference pool” could accomplish the same thing for CLNs. Insurance companies may also be more motivated and capable than the principals in the CLN to provide a second set of eyes to monitor the origination and servicing systems to minimize loss and be more flexible in allowing for loan modifications and refinancing.

As for scalability, both approaches would seem to be able to scale up, assuming that there is sufficient private capital willing to invest in the stock of the insurance company or buy the CLNs. The insurance companies also have access to re-insurers which can add to their capacity to take on risk. For CLNs, a critical element for them to be able to compete effectively may be sufficient scale to provide liquidity for the trading of these securities.

#### Test for the optimal allocation of risk-sharing versus cost to the borrower

In addition to testing the cost and viability of different options, it is important to keep in mind that any incremental costs will have to be borne by borrowers. Since, as noted earlier, the government does not need to charge as high a premium for taking on a given amount of risk as private capital requires, the higher the degree of risk-sharing, the higher the likely cost to borrowers.

In order to sort out the tradeoff between the cost to the borrower and the degree of risk sharing, the government needs to be explicit in how much to charge to build up an appropriately sized reserve to protect itself and thus the taxpayer from having to call on tax dollars. The amount it needs to charge (and the size of the reserve it needs to build up) depends on how much risk it is taking. The amount of risk, in turn, depends on how much it lays off on the private sector as well as the underwriting and servicing standards it sets.

At one extreme, government can require enough private capital to be able to absorb all expected loss with a high degree of certainty. In this case, the government would only need to impose a very small charge to cover the *de minimis* probability of the tail risk that it retains. Alternatively, the amount of first loss placed on the private capital can be limited or none at all,

leaving the government with more of the risk, which it can cover at lower cost than the private sector would likely be willing to do.

In evaluating its risk, the government will also need to take into account counterparty risk, that is, whether the insuring entity will be able to come up with the money it has promised. For CLNs, this issue may not arise if the notes are fully funded. However, once the full amount of the notes has been paid out, the government must make up any difference. In contrast, insurance companies may be able to pay out more but they are regulated based on risk-to-capital which means that, at any point in time, there is a limit to the losses that they can cover. However, if desired, there is a way to structure an insurance contract similar to the protection provided by a CLN and that would be to set a cap on total payout, i.e., include a stop-loss provision.

Insurance companies also could have more discretion to allow loans to be modified or refinanced if the buyers of the CLNs require highly prescriptive rules for the treatment of any mortgages that are in the “reference pool.” Similarly, insurance companies would seem to have more ability to rescind coverage in the case of defects in the origination process, but this is technically an issue of the language in the insurance contract requiring payment contrasted with the language in a CLN as to when it also must pay out.

To determine the tradeoff between more risk-taking by the private sector and the cost of mortgages, it makes sense to test some different structures with varying amounts of risk being laid off on the private sector. The challenge in designing these tests will be to choose which levels of protection to test in order to get a good idea of the parameters of the tradeoff. To do this, it is essential for the government to determine the appropriate premiums it needs to charge for different levels of residual risk.

#### Ensure cost savings are passed on to borrowers

Regardless of the final structure chosen, it is critical to ensure that the borrower benefits from the lower cost of funds made possible by the government wrap. Many have argued that the duopoly of Fannie and Freddie allowed them to capture for their shareholders and senior management excess profits that limited the benefit of the implicit government guarantee from flowing to borrowers. Going forward, this means that all the players – from the originators to the servicers to the securitizers to the private, credit-risk-sharers (if there are any) – provide their services based on a competitive price. If any of these markets lack sufficient competition, then it will be essential for government to intercede in some way to prevent monopoly-like profits at the expense of the borrower. One proposal that has been put forth to deal with this possibility is set up a cooperative to securitize the MBSs and retain first-loss risk with the originators putting up the capital and being themselves members.<sup>27</sup> I leave it to others to identify other alternatives that would also help ensure the savings are passed on to borrowers.

---

<sup>27</sup> See Toni Dechario, Patricia Mosser, Joseph Tracy, James Vickery, and Joshua Wright, “A Private Lender Cooperative Model for Residential Mortgage Finance” Staff Report No. 466 (Federal Reserve Bank of New York,

## Transition

Separate out the provision of the government wrap from Fannie and Freddie for “conforming” MBS and re-launch Fannie and Freddie without any government guarantee, either implicit or explicit

Once a determination is made as to the degree of risk-sharing that it considers optimal (that share could be zero), the provision of the government wrap can be moved to another entity such as the Government National Mortgage Association (GNMA/Ginnie Mae).<sup>28</sup> The remaining functions in Fannie and Freddie could then continue in a new legal entity or entities. New entrants should also be allowed, if not encouraged, to compete with the successors to Fannie and Freddie in securitizing mortgages.

Coordinate any changes with attention to the role of FHA and the single securitization platform being developed by FHFA

While this hearing does not directly concern what role the Federal Housing Administration (FHA) should play in a reformed housing finance system, it is worth noting why its continuation is important and, in particular, what changes should be made now to enhance its ability to protect both taxpayers and future borrowers from being exposed to unnecessary risk. FHA has three roles to play: First, FHA needs to ensure that all those who can sustain homeownership have access to reasonably priced long-term, fixed-rate mortgages. Second, FHA needs to prevent the collapse of local, regional, or national housing markets when the private sector pulls back from offering mortgages. Third, FHA needs to promote innovation by piloting new products and underwriting and servicing practices.

All three roles are important, but the provision of countercyclical support to the new mortgage market is probably most relevant to this hearing. If it is concluded that private capital should be brought in ahead of the government wrap and if there is no mechanism devised to dial it back in the face of a withdrawal of private capital has withdrawn, then it is essential to preserve FHA’s ability to scale up even more than it did during the most recent fall in housing prices and the great recession. Even with Fannie and Freddie still originating loans (although with limited support from the PMI industry to do loans with LTV’s in excess of 80%), FHA alone provided as much as 40% of mortgages for home purchase with over 70% of these loans going to first time homebuyers.<sup>29</sup>

It is worth noting that FHA also needs to pull back from the jumbo market. As part of the response to the fall in house prices and the financial crisis, the FHA was permitted to

---

2010), available at [http://www.newyorkfed.org/research/staff\\_reports/sr466.pdf](http://www.newyorkfed.org/research/staff_reports/sr466.pdf). A similar proposal has been put forth by Andy Davidson.

<sup>28</sup> The Housing Commission of the Bipartisan Policy Center has proposed that the role of “public guarantor) be performed by GNMA or by a newly created government entity.

<sup>29</sup> U.S. Department of Housing and Urban Development, “Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2012” (2012), available at <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>

dramatically increase the size of loans that it could offer. With the stabilization of the housing market and the desire to crowd in private capital to the jumbo market, the loan limit for FHA should be lowered to \$417,000 if not to the lower levels that prevailed earlier.

#### Impact of a single securitization platform

FHFA has announced plans to develop a single securitization platform to replace the back office functions of the Agencies. While its creation will not necessarily inhibit the ability to implement the steps outlined above, it might be just as easy, if not easier, to modify existing systems to accommodate the necessary changes. As originally announced, the plans for this platform were very ambitious, especially given the intention to design it with sufficient flexibility to accommodate the wide variety of originators and originating platforms beyond those of Fannie/Freddie. However, regardless of how flexible and all inclusive the final product, it needs to incorporate the possibility of providing first-loss protection either directly or through third-party entities.

#### **Conclusion**

In exploring how to bring more private capital into the housing finance system, there are a number of steps that FHFA should undertake. One path is to restore private capital's historic role in the financing of the mortgages bigger than \$417,000. This should be able to be done in a straightforward matter, once regulatory uncertainties are resolved, by raising the g-fee until the private sector takes over that part of the market. With actual information on the cost of and product mix of loans being offered in the jumbo market, we will be better able to evaluate the benefits of having a government guarantee supporting MBSs in a conforming market. Many housing market experts worry about loss of a TBA market and of a well-price, fixed rate mortgage with 15 and 30 year maturities. By taking one step at a time, we will be able to see for ourselves if lowering loan limits further will limit access and affordability of mortgages. By doing it in stages, it will be possible to prevent unnecessarily harming the bulk of the housing market.

Given the skepticism that a purely private mortgage market would work well for the vast bulk of the housing market (save for the portion served by FHA), FHFA should also continue to pursue its exploration of the cost and structure for requiring private capital to take first loss ahead of a government guarantee. By test-driving different approaches, we will be better able to weigh the costs and benefits of having private capital take more of the risk and avoid unnecessarily disrupting the availability and affordability of new mortgages.