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U.S. Senate

"Chairman's Housing Reform Outline"

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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. As an outline it leaves much to be resolved, but it does offer a promising framework from which to begin. How this framework is filled in will be important, since a few critical structural choices yet to be made will have a dramatic impact on how the proposed system would work.

My testimony offers a summary of where Chairman Crapo's 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.[1] Before this, I consider the critical criteria that must be met for housing finance reform to succeed.

Defining successful reform

The success of any housing finance reform depends on its ability to satisfy six essential criteria, including ending too-big-to-fail, fully protecting taxpayers, providing equal access to the system for underserved communities and lenders of all sizes, maintaining affordable mortgage rates for borrowers under all market conditions, promoting competition, and easing the transition from the current system to the future system.

The future housing finance system must end the reliance on too-big-to-fail financial institutions. Fannie Mae and Freddie Mac were too big to fail, and the cost to taxpayers of forestalling their failure during the financial crisis was considerable. In the future system, no private institutions should be indispensable to a healthy, well-functioning secondary mortgage market, or be able to dominate the market by controlling its infrastructure or taking a significant share of the system's credit risk.

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[1] My testimony is largely based on "How Chairman Crapo's Outline of Housing Finance Reform Can Work," Jim Parrott, Dave Stevens and Mark Zandi, white paper, February 1, 2019, but the views expressed in this testimony are my own.

Taxpayers must be fully protected from suffering any losses in the future system. This requires that there is substantial private capital in the system, sufficient to withstand losses in all but the most catastrophic economic scenarios. The federal government should stand behind the system, backstopping it against these dark scenarios, but mortgage borrowers should pay taxpayers for the cost of this backstop. Taxpayers should also have the ability to claw back from borrowers any costs they incur in backstopping the system.

Maintaining broad access to mortgage credit for those in a position to become sustainable homeowners is one of the most important and widely supported objectives of housing finance reform. For this to mean anything, though, not only must borrowers be able to find a lender willing to make them a loan, they must be able to find one willing to make them a loan on terms that they can afford. Equal access for lenders of all sizes is also necessary to ensure sufficient competition in the future system.

The future system must not result in significantly higher mortgage rates while still providing the necessary capital buffer to protect taxpayers and the appropriate access for underserved borrowers. The system must also be flexible enough to ease the impact on mortgage rates and credit availability during tough economic times when private sources of capital will either be unwilling to provide capital or require such a high return that it would cause rates to spike. This requires a catastrophic government backstop.

Competition in the future system is necessary to ensure that mortgage borrowers are offered innovative loan products with attractive terms and interest rates. This includes promoting competition in the primary lending market, the markets for taking credit risk, and the secondary market. It is also critical that competition in the system is not based on inappropriate underwriting standards, which will result in unsustainable lending and an unstable system.

Finally, and arguably most important to successfully achieving legislative reform, the transition from the current system to a future one must occur with as little disruption, uncertainty and risk as possible, building upon steps already under way. This includes Fannie and Freddie's current work to build a common securitization platform, or CSP, and the government-sponsored enterprises' current risk-transfer efforts. It is critical to move in an incremental fashion because the deep structural reform called for will require significant change to a complex and critically important system. The process of transition should be approached with an appropriate level of humility and flexibility in the face of the difficulty and importance of the challenge.

Chairman Crapo's system laid out in the outline

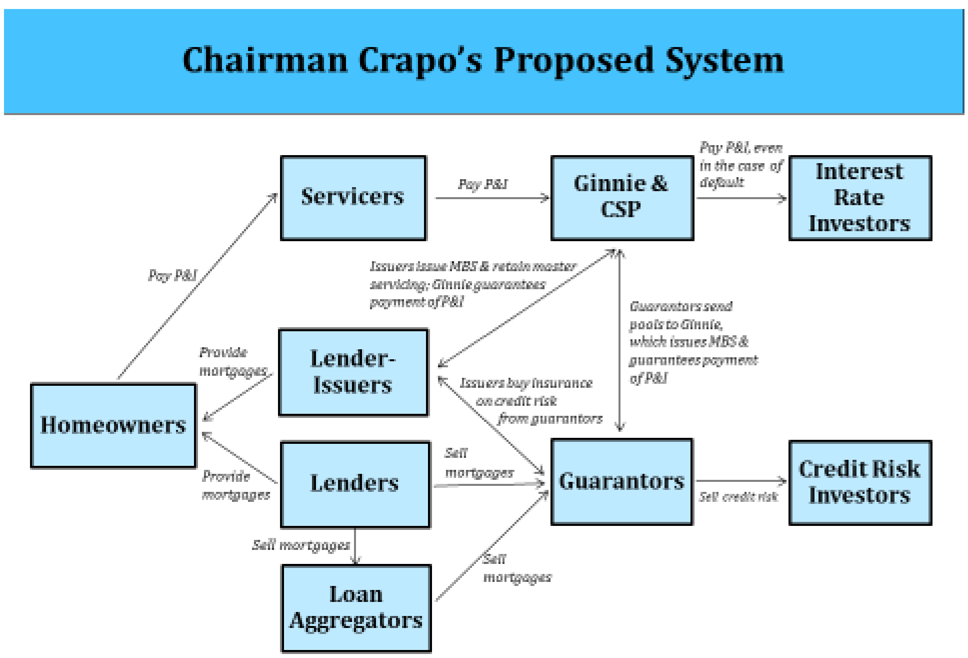
Chairman Crapo's outline for housing reform goes a significant way toward meeting these criteria for successful reform. In the proposed system, mortgage lenders will have three options:

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 loans, 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.

Lenders and aggregators must off-load all of the credit risk on their loans to the chartered guarantors, whichever channel they use, after the risk assumed by mortgage insurers on loans with a loan-to-value of greater than 80%. 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 (see Chart).[2]



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

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.[3]

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[2] 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.

[3] 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.

There is 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 the issuers' 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. 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 in the system lenders are able to issue securities backed only by their own loans. If so, then some lenders could set up vertically integrated channels to sell MBS backed by loans valued most highly by investors, sending everything 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 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 multilender pools.[4] By making the issuance fungible in this way, it 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.[5]

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.[6] Although 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

[4] It would function much as Ginnie II functions today.

[5] 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.

[6] 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 anyone 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.

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.

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 since it focuses 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 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.[7] 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 few 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 fund 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.

Last, it will be important to target the market access fund to those borrowers who actually need the help and to provide 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 rate. Some 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.[8]

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[7] It is worth noting that the Crapo outline retains both the Housing Trust Fund and Capital Magnet Fund, which are focused on addressing the inadequate supply of affordable housing.

[8] 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. As 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.

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 Federal Housing Administration, Veterans Affairs, and the U.S. Department of Agriculture into a more seamless, coherent system of government support for the mortgage market.[9] But if policymakers can effectively address the more foundational issues discussed above, I 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.

[9] 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.