Bringing Housing Finance Reform over the Finish Line

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The housing finance reform debate has once again gained momentum with the goal of those involved to move forward with bipartisan legislation in 2018 that results in a safe, sound, and enduring housing finance system.

While there is no shortage of content on the topic, two different conceptual approaches to reforming the secondary mortgage market structure are motivating legislative discussions. The first is a model in which multiple guarantor firms purchase mortgages from originators and aggregators and then bundle them into mortgage-backed securities (MBS) backed by a secondary federal guarantee that pays out only after private capital arranged by each guarantor takes considerable losses (the multiple-guarantor model). This approach incorporates several elements from the 2014 Johnson-Crapo Bill¹ and a subsequent plan developed by the Mortgage Bankers Association. Fannie Mae and Freddie Mac—the government-sponsored enterprises (GSEs)—would continue as guarantors, but would face new competition and would no longer enjoy a government guarantee of their corporate debt or other government privileges and protections.

The second housing finance reform plan is based on a multiple-issuer, insurance-based model originally proposed by Ed DeMarco and Michael Bright at the Milken Institute,² and builds on the existing Ginnie Mae system (the DeMarco/Bright model). In this model, Ginnie Mae would provide a full faith and credit wrap on MBS issued by approved issuers and backed by loan pools that are credit-enhanced either by (i) a government program such as the Federal Housing Administration (FHA) or U.S. Department of Veterans Affairs (VA), or (ii) Federal Housing Finance Agency (FHFA)-approved private credit enhancers that arrange for the required amounts of private capital to take on housing credit risk ahead of the government guarantee. Fannie Mae and Freddie Mac would be


² The current professional biography for Ed DeMarco may be found at http://www.fsroundtable.org/profile/ed-demarco/ and for Michael Bright at https://www.ginniemae.gov/about_us/who_we_are/pages/leadership_bio.aspx?ParamID=21.
passed through receivership and reconstituted as credit enhancement entities mutually owned by their seller/servicers.

While the multiple guarantor and DeMarco/Bright models differ in many ways, they share important common features; both address key elements of housing finance reform that any effective legislation must embrace. In the remainder of this paper, we first identify these key reform elements. We then assess some common features of the two models that satisfy or advance these elements. The final section delves more deeply into the operational challenges of translating into legislative language specific reform elements that are shared by or unique to one of the two models. Getting housing finance reform right requires staying true to high-level critical reform elements while ensuring that technical legislative requirements make economic and operational sense.
The private sector must be the primary source of mortgage credit and bear the primary burden for credit losses. The private sector, subject to regulatory oversight, should carry out the essential functions of housing finance, including lending money, bearing credit risk, and determining how best to allocate capital. These functions should take place in a competitive setting with a range of sources for private capital that take on credit risk. Having a diverse set of mechanisms for capital to fund housing makes the future system more resilient to economic and market events that affect particular segments of financial markets, therefore impinging on the availability of funds for housing.\(^3\)

In support of a system with private capital at its core, reform efforts must incorporate the following key elements:

- **There must be an explicit federal backstop after private capital.** A properly structured government backstop will be an integral part of the future housing finance system. The government guarantee would provide catastrophic loss coverage that is explicit and paid for and apply that coverage only to the credit risk of MBS collateralized by high-quality mortgages with substantial private capital in a first-loss position. The government guarantee would ensure the timely payment of principal and interest payments to MBS investors, but would not address delinquencies on individual loans collateralizing the MBS—dealing with individual borrowers would remain the role of the private servicer and the private credit enhancer. Firms that take large losses would fail if their substantial capital base is exhausted and they are unable to meet their ongoing obligations. An explicit federal backstop would operate to support two critical components of effective housing finance reform:
Credit must remain available in times of market stress. The government backstop would help ensure continued liquidity over the economic cycle—another critical element of housing finance reform. The housing finance system must attract a broad range of investors to support the consistent availability of mortgage credit so that a creditworthy borrower can still obtain a mortgage through an efficient process, even in an economic downturn or financial market disruption.

The “to-be-announced” (TBA) market should be preserved. More than 90 percent of GSE MBS trading occurs in the TBA forward market. This market promotes overall market liquidity by helping lenders manage risk by allowing them to lock in the sales price of new loans even before those mortgages are originated, simultaneously allowing borrowers to lock in their interest rates between the time of loan application and loan closing. A government guarantee is essential to preserving the TBA market in a reformed system.

Private firms benefiting from access to a government backstop must be subject to strong oversight. The federal regulator must be empowered to ensure the maintenance of enhanced prudential underwriting standards to protect the housing finance system from non-compliant and unacceptably risky loans, and consistent capital standards to shield taxpayers from the costs of a bailout. A balanced, smart, and practical regulatory environment is a critical element of effective housing finance reform with the overall regulatory burden reflecting a thoughtful tradeoff between government mandates and the availability and pricing of credit. Proper oversight will allow the government as the regulator to perform comprehensive and diligent risk management as the catastrophic risk-holder in the reformed housing finance system.

Responsible housing sector participants are not averse to this kind of regulation. Responsible lenders recognize that it is in their best
interests to avoid a race to the bottom and the pressure to “chase volume” by loosening credit policies and underwriting practices beyond their respective comfort zones. Yet, while we must not allow mortgage products, credit policies, or underwriting practices that prey upon an aspiring homebuyer or set the borrower up to fail, the regulatory environment must still allow for flexibility and innovation in mortgage products, credit policies, and underwriting practices to prevent a credit freeze-out of qualified, homebuyer-ready applicants. To meet this challenge, we must create an environment in which rules and regulations are sensible, clearly defined, and consistently and fairly applied and enforced by a regulator that distinguishes between inadvertent underwriting mistakes and willful wrongdoing or negligence. Each of these instances must be vigilantly identified and rectified, but the implications of “one-size-fits-all” punitive enforcement ultimately can harm consumers.

There must be a level playing field for all firms engaged in housing finance. The protected GSE duopoly must end, enabling and encouraging new firms to compete with Fannie Mae and Freddie Mac (or any successors) in the securitization of conforming MBS eligible for the secondary government guarantee. Competition under proper oversight and reflecting similar pricing for the explicit government backstop would enhance innovation and reduce systemic risk by avoiding a situation in which one or two firms are linchpins of the housing finance system.⁵ A level playing field would reflect the following key elements:

• No firm should be “too big to fail.” With many firms competing in the different areas of the housing finance system, any firm—or even several firms—can fail without requiring government bailouts aimed at ensuring the continued flow of mortgage credit. This is reflected in the nature of the explicit government guarantee which would back MBS, but not individual firms (the government would support payments to MBS investors, but not the obligations of MBS issuers). Additionally, any

⁵ Firms issuing government-guaranteed MBS would be subject to similar oversight and required to fund themselves with appropriate levels of capital to take losses ahead of the government. All firms (and, ultimately, borrowers) would then pay for the government guarantee that is secondary to considerable private capital.
housing finance system reform model must provide for the orderly resolution of failed firms and the continued, seamless functioning of the system in the event of such failure.

• **Lenders of all sizes must have similar access to the secondary mortgage market.** All lenders, regardless of size or mortgage volume (including community banks) should have similar access to the secondary mortgage market on a competitive basis. The pre-crisis GSE business models featured discounts for large lenders and other favored customers, thereby disadvantaging institutions with smaller mortgage operations such as community banks. As conservator, FHFA has stopped this practice and a reformed system should do so as well. Requiring a level playing field would also help create a more competitive secondary market system, enabling more firms to enter the business, which, among other benefits, would help ensure that any inadvertent (but likely unavoidable) underpricing of the government guarantee is pushed through to homeowners in the form of lower interest rates rather than allowing MBS issuers to profit from an elevated spread between (low) interest rates on MBS and (high) interest rates on mortgages.

• **The holding or taking of credit risk must be separated from the infrastructure of securitizing mortgages.** Separating the holding of credit risk from the operational process of securitizing government-guaranteed MBS prevents a situation in which entities holding credit risk also control the plumbing needed to support the MBS operation, and thus are too big or important to fail—precisely what made it necessary to bail out Fannie Mae and Freddie Mac in the financial crisis, since the two firms also owned and controlled critical securitization infrastructure that provided liquidity to the five trillion dollar conventional loan market. By separating ownership and control of the securitization infrastructure from firms taking on first-loss credit risk, a reformed system would allow individual mortgage guarantors to fail without bringing securitizations to a grinding halt.
The GSEs’ collective ability to serve as the gateway to the conventional loan secondary market by controlling the securitization infrastructure not only makes competition virtually impossible, it likely raises the cost of mortgage credit.

- **All single-family mortgages that receive a government guarantee must be securitized through a common platform.** Use of a government-owned securitization utility, accessible by all issuers under the same terms, supports the issuance of a common, single security eligible to be delivered into the capital markets with a full faith and credit government guarantee. This common infrastructure enables scale economies and maximum liquidity while lowering the barriers to entry for new participants that take credit risk since they will have to build less securitization-related infrastructure to participate in the system.

The common securitization platform would replace (or absorb) the securitization functions that the GSEs perform today. Among other functions, the utility must be able to pool loans of multiple issuers or guarantors into the same security; perform bond administration, data validation, and up-front and ongoing reporting for all securities that go through the platform; maintain relationships with MBS investors to assure the common security is trading at optimal levels; establish fees at an appropriate level that will allow the utility to continually invest in its technology; and develop the capability to offer securitization services to private label issuers who choose to use the utility for a fee. Within reason, the more functions performed by the utility, the lower the barriers to entry and the greater market competition and pricing efficiencies will be. Ensuring that all firms have access to GSE historical loan data and technology will also facilitate the entry of new guarantors.

Americans must have broad access to sustainable mortgage credit on competitive terms. Americans in all communities who have the desire to own a home, responsible credit history, and sufficient financial capacity should have access to safe and sustainable

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6 Many commenters have discussed the potential application of the common securitization platform in support of not only GSE but also Ginnie Mae and private-label securitizations. In this respect, the common securitization platform can be an effective utility that can serve the entire mortgage market. We believe these avenues should be explored in-depth.
mortgage products on competitive terms. At the same time, consumer choice is tremendously important so that homeowners can tailor their mortgage obligations in a manner best suited to their respective circumstances. For many Americans, the 30-year fixed-rate, pre-payable mortgage remains an attractive choice and must be preserved even as housing finance reform ensures access to a variety of other safe and sustainable fixed- and adjustable-rate loans that adhere to post-crisis standards. The reformed system must incorporate “lessons learned” while also enabling innovation, flexibility, and nimble course correction in the event of unintended consequences of regulatory actions that freeze out qualified homeowners or chill beneficial competition.

A reformed system must also ensure continued mortgage liquidity in the multifamily rental sector throughout the economic cycle.

New mechanisms are needed to support affordable housing. The reformed housing finance system must be able to take into account sweeping demographic, socioeconomic, income, and wealth trends, as well as their potential effects on the homeownership and rental markets. These “significant changes are being powered by fast-growing minority populations—including Hispanics, Asians, and people of two or more races—which will double in size over the next 40 years.”

Evidence of the effectiveness of the current affordable housing goals regime in increasing access to affordable housing credit is decidedly mixed. A better approach is to assess a standard, transparent, running affordable housing fee on all government-guaranteed securitizations, with the revenue used to support affordable housing with strong congressional oversight. The revenues raised from this will help ensure that the reformed system can effectively serve all Americans with the financial capacity to succeed as a homeowner. This is accomplished by, among other measures, supplementing household savings necessary for a down payment on a first home, supporting homebuyer education and counseling programs to lower

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9 We believe that a 10 basis point affordability fee is appropriate, subject to adjustment based on objective data going forward.
the risk of default, expanding the supply and access to affordable rentals, and increasing access to shelter for some of America’s most vulnerable families.

Successful housing finance reform should also ensure that home purchase mortgage demand does not flow disproportionately to the FHA, institutionalizing its elevated market share and increasing taxpayer exposure as a result of the FHA’s full, loan-level government guarantee and unlimited federal line of credit. In order to foster optimal efficiency and effectiveness in meeting its historical mission of providing mortgage credit to low-wealth and underserved borrowers, it is healthy for FHA to operate in a competitive marketplace. The best way to foster innovation and improved customer service in the government sector is to provide underserved consumers with a significant measure of market choice.
The multiple-guarantor and the DeMarco/Bright models encompass, albeit in different ways, several common elements of housing finance reform that enjoy broad bipartisan support.

In both models, taxpayers would bear the cost only after a considerable amount of private capital has absorbed first losses—a construct that aligns incentives along the securitization chain and protects taxpayers from future bailouts. Both models also rely upon credit risk transfers to reduce the concentration of credit risk within a limited number of entities acting as guarantor or insurer, and provide for a full faith and credit government guarantee at the MBS level to ensure that rate investors receive principal and interest payments on a timely basis regardless of the underlying performance of the mortgage loans collateralizing the MBS.

Each model also preserves long-term fixed-rate mortgages and the TBA market in guaranteed securities that allow investors to hedge their interest rate risk and borrowers to lock in their interest rates between the time of loan application and loan closing. Additionally, each model maintains key aspects of the existing housing finance system that are familiar and attractive to borrowers, lenders, and investors, and builds upon what works in the current system. This common strategic approach minimizes potential market disruptions in the transition from GSE conservatorship to the reformed system.
The exact manner in which policymakers translate broad concepts into operational language to solve for key housing finance reform elements remains to be seen in actual legislation. Bringing housing finance reform over the finish line also requires policymakers to address other technical issues that are in some cases unique to each model and in other cases reflect shared challenges.

**Existential issues unique to each of the two models.** While each model incorporates several key housing finance reform elements, each reform model faces its own existential challenge—an issue so central to its ultimate real-world application that if left unaddressed would leave the housing finance system less well-off than it would be under a continuing GSE conservatorship.

- **Multiple-guarantor model: enabling competition.** The multiple-guarantor model’s existential challenge is creating a system that ends the current GSE duopoly. Without new entrants into the guarantor space, the reformed housing finance system could end up further entrenching Fannie Mae and Freddie Mac’s market dominance. As suggested earlier, attracting new guarantors will require broadening the functionality of the GSEs’ jointly owned common securitization platform (CSP) whose initial design is focused on serving the unique securitization needs of just the two mortgage giants.

Ensuring adequate competition is a two-fold challenge: first, determining how to provide space for new guarantors to enter the market and ramp up market share in the face of the GSEs’ current market dominance; and second, determining how the GSE market share should be sufficiently ratcheted back to create space for new guarantors before these newcomers start guaranteeing loans without adversely affecting overall market liquidity. Solving for this is vital to the viability of housing finance
reform that is based upon the multiple-guarantor model.

- **DeMarco/Bright model: true sale and consolidation.** The existential issue for the DeMarco/Bright model—which is a private insurance-based model—is finding ways to ensure that the use of private sector credit enhancers allows securitizations to achieve true sale accounting status for the issuer. This is critical or else in the event of the failure of its private credit enhancer (e.g., a Fannie Mae or Freddie Mac mutual insurer), the issuer would be responsible for covering credit losses the insolvent credit enhancer could not pay. This exposure would require the issuer to hold capital against these contingent risks, which would render the economics of securitization infeasible. Therefore, a Ginnie Mae-based legislative reform model such as DeMarco/Bright would have to reflect a chain of losses that would go from borrower equity to traditional mortgage insurance to credit risk transfer to the remaining capital of the credit enhancer and then to an insurance fund, with no contingent liability falling to the issuer for the counterparty risk of the credit enhancer. This is not an issue in the current Ginnie Mae system because all loans collateralizing Ginnie Mae securities are federally guaranteed.

**Placement of MBS issuer responsibilities and ensuring adequate liquidity.** A common issue for both models involves the placement of MBS issuer responsibilities and ensuring the adequacy of the underlying liquidity necessary to meet master servicing obligations under economic stress scenarios. These obligations include, among other responsibilities, advancing delinquent principal and interest payments to MBS investors and buying defaulted loans out of MBS trusts. A system that does not provide for adequate liquidity to meet these obligations during periods of stress when such liquidity may be costly (if available at all) is not sustainable.
**EXECUTIVE SUMMARY**

• **Multiple-guarantor model: determining liquidity rules.** The multiple-guarantor model keeps the master servicing role in the hands of the GSEs and other newly formed guarantors. Under this model, the amount and characterization of liquidity may constitute a potentially substantial barrier to entry for newer guarantors and a costly requirement for all guarantors during periods of economic stress. This is not an issue under the current GSE model because the federal guarantee of Fannie Mae and Freddie Mac extends both to the MBS they guarantee as well as to their respective corporate debt. This entity-level guarantee enables the GSEs to borrow in the capital markets at near-Treasury rates, even in times of severe economic stress, but it also leaves the taxpayers exposed to GSE bailouts, as noted earlier in this paper. In setting up the multiple-guarantor model, policymakers must determine workable liquidity rules that promote systemic safety and soundness, but are not prohibitively expensive for guarantors.12

• **DeMarco/Bright model: access to liquidity.** Under the DeMarco/Bright model, these obligations reside in the hands of hundreds of separate issuers. This model presents liquidity challenges that are particularly significant for non-bank Ginnie Mae issuers who, unlike bank issuers who have a continuing source of inexpensive funding through their deposit base, lack a ready source of added liquidity in a crisis.13 Similar to the current Ginnie Mae system, the DeMarco/Bright model provides no issuer-level federal line of credit to ensure continued liquidity during periods of significant economic stress.

With no entity-level guarantees in either the multiple-guarantor or DeMarco/Bright models, during periods of severe economic stress all guarantors (including the GSEs) and issuers will have to raise adequate levels of capital and liquidity to meet their obligations to make principal and interest payments due to investors on elevated levels of delinquent loans and to buy these loans out of MBS trusts after 120 days of delinquency. If any cannot, it is imperative that

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12 It is also likely that higher liquidity costs would be passed on to borrowers in the form of higher borrowing costs.

13 As of Fiscal Year 2017 ending on September 30, 2017, non-depositories accounted for 76 percent of Ginnie Mae single-family MBS issuance. By comparison, as the end of Fiscal Year 2010 ending on September 30, 2010, non-depositories accounted for 31 percent of Ginnie Mae single-family MBS issuance.
Additional technical issues facing any housing finance reform model.
In addition to the challenges already identified, there remain other technical issues that every model must address to create a safe, sound, and enduring housing finance system.

- **Solutions for legacy MBS.** Legislation must solve for the treatment of legacy GSE MBS. To avoid economic imbalances and market shocks, many believe that legacy GSE MBS must receive the same full faith and credit guarantee applicable to qualified conventional MBS in the reformed system. Work needs to be done on the cost of this conversion to minimize any unjust enrichment by (or unfair cost to) owners of legacy GSE MBS, as well as on the capital implications of an explicit federal backstop parity between legacy GSE MBS and Ginnie Mae MBS.

- **Clarification of the respective missions of the two guaranteed government channels.** With the prospect of having a single full faith and credit government backstop of conventional MBS and FHA-collateralized MBS, it is critical to clarify the respective missions of these two guaranteed mortgage channels. It would be sensible for the channels to act in tandem to ensure continued liquidity in the housing finance system throughout the economic cycle. Reform efforts must therefore include an analysis of eligibility requirements and underwriting standards that pertain to each channel. In addition, reform efforts should include an extensive review and implementation of upgrades necessary for the FHA, credit enhancer, and Ginnie Mae (as MBS guarantor) to fulfill their respective missions under the reformed housing finance system.

  - **FHA and Ginnie Mae upgrades.** Both legislative and administrative actions are necessary to enable FHA to attract and retain high-quality staff, pay for upgrading critical systems and infrastructure, and eliminate lender

14 Ginnie Mae MBS also include loans covered by the (ii) U.S. Department of Veterans Affairs, (iii) U.S. Department of Agriculture’s Rural Housing Service, and (iii) U.S. Department of Housing and Urban Development’s Office of Public and Indian Housing loan guarantee programs, but these programs generally have designated constituencies that derive from their respective missions.
exposure to massive litigation risk for errors that have no bearing on loan performance. These have all been cited over the last several years as areas of challenge for the FHA, and it is time to address these critical needs. Reform legislation should also address the additional powers Ginnie Mae needs to perform its current and future critical role in the housing finance system. Additional flexibility is needed to protect the nearly two trillion dollars in guarantees that Ginnie Mae manages and to properly maintain its common securitization platform, which currently tracks 11 million mortgages used as collateral for MBS. Areas that should be evaluated include the pay structure under which Ginnie Mae has to operate, which has made recruiting and retaining qualified staff very difficult. Also, removing Ginnie Mae from the appropriations process will allow for the timely management of staffing levels as market conditions change. The normal budgeting cycle is two years, which is an eternity in a rapidly changing market environment. It is also important to evaluate the hiring process to make sure Ginnie Mae can hire qualified staff in a timely manner and to evaluate the contracting process to assure contracts can be finalized in a timely manner and at a good value to the government. Congress should also review the legal authority Ginnie Mae needs to properly manage the risk of its diverse and increasingly complex issuer base.

- **Selection of a common securitization platform for the reformed conventional housing finance system.** Congress must decide whether the shared securitization plumbing for the reformed system should be Ginnie Mae’s platform or the GSE’s CSP and whether the new system should continue with two operating platforms under two different regulatory and policy regimes. To maximize market liquidity, it is important that a conventional loan sold into the secondary market and an FHA loan sold into the secondary market should not have different prices solely
because of different platforms from which they were issued or administered.

- **Structural and technological improvements must be an integral part of reform.** Finally, housing finance reform is about more than just the GSEs. It is time to take a hard look at other public and private structural elements of housing finance and how we can improve and strengthen the safety, soundness, and sustainability of the entire system. This includes an analysis of many of the legal and operational facets that define or reflect the interaction among lenders, servicers, borrowers, and other stakeholders and the efficiency and effectiveness of these relationships. Some of these additional components include lending regulations and practices, borrower access to credit and readiness for homeownership, and loss mitigation tools and efforts. We believe there are ways to improve these elements in innovative, forward-looking ways that could revolutionize the housing finance system. A reformed housing finance system should encourage and accommodate these structural and technological improvements.

These structural and technological components also pertain to private label securitization (PLS), the largest source of funding for the housing finance system just prior to the financial crisis. While the role of the PLS market in the crisis is well known, PLS can and should play a meaningful role in a reformed system—but only if it is itself a product of reform.

New issue PLS re-emerged post-crisis in 2011, but since then continues to represent only a sliver of the overall MBS market. A combination of legislative and regulatory measures and industry practices have improved the safety and soundness of PLS in general, but not all post-crisis standards—or methods of implementing them—represent best practices or provide sufficient investor protections to support a sizeable PLS market. While several post-crisis standards resolve critical deficiencies
identified in pre-crisis PLS transactions, other deficiencies remain unaddressed. Furthermore, in a few cases, post-crisis issuers have established transaction standards that arguably constitute weaker investor protections vis-à-vis pre-crisis transactions. To date, mortgage industry participants have engaged deeply in PLS reform work; this work must continue to evolve and serve as a benchmark for or practitioner’s guide to actual PLS transactions if PLS is to re-emerge as a safe, sound, and sizeable source of private capital in the future housing finance system.

Within the coming weeks and months, the respective committees of jurisdiction in the Senate and House will translate their broad reform principles into legislative language. We look forward to helping inform the ensuing legislative debate, using our independent voice and unique expertise to address unresolved issues within the respective measures and to help find common ground that can lead to a bipartisan consensus and broad support in both chambers.

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15 In particular, the Structured Finance Industry Group’s “RMBS 3.0” task force, established in 2013, published the 6th Edition of its Green Papers in November 2017 and continues to engage in comprehensive PLS reform efforts. Eric Kaplan, the director of the Housing Finance Program within the Milken Institute Center for Financial Markets, and one of the authors of this paper, is chairperson of SFIG’s RMBS 3.0 task force. More information is available at: www.sfindustry.org/advocacy/categories/C48.
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