

## Housing Finance Reform: Step-by-Step

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May 15, 2014 is the high-water mark to-date for housing finance reform legislation. On that day, a bipartisan vote in the Senate Banking Committee approved the Crapo-Johnson bill, which would have wound down Fannie Mae and Freddie Mac and established a new legal and operational infrastructure for mortgage securitization.

Whatever one's views of that particular legislation, I expect that most of us here share some disappointment that the legislative process has since stalled. Still, housing finance reform itself has not stalled, even if the pace seems rather slow.

I would like to briefly summarize the progress made since the halt of Crapo-Johnson and then offer my current perspective on where we could go from here.

### Key Progress

Each of the recent legislative proposals to modernize our housing finance system, including the Johnson-Crapo bill, share the following elements:

- Wind down Fannie Mae and Freddie Mac,
- Build a common securitization infrastructure to serve as the backbone for mortgage securitization in a post-conservatorship world, and
- Shift mortgage credit risk from taxpayers back to market participants.

Although these bills have stalled, progress in each of these areas has continued.

### ***Winding Down Fannie and Freddie***

The wind-down of Fannie and Freddie has a mixed record the past two years, but on balance has moved forward. Importantly, each company's retained portfolio continues to shrink. On a combined basis, these portfolios declined \$130 billion in 2015 and nearly \$1 trillion since early 2009. The other developments I am about to review, such as the common securitization platform, also represent progress towards winding down Fannie and Freddie.

### ***Building a Common Securitization Infrastructure***

In 2013, the Federal Housing Finance Agency (FHFA) established Common Securitization Solutions (CSS) as a corporate entity jointly owned by Fannie and Freddie. CSS is moving closer to becoming operational as a new securitization platform. FHFA recently announced that Freddie Mac will begin using CSS before the end of this year for certain activities relating to its single-family mortgage-backed securities. FHFA further announced that it expects CSS to be ready to issue a common GSE security by 2018—just two years from now.

This is very important to housing finance reform. As I've already noted, every major housing finance reform bill envisioned some form of a common securitization platform. Even without legislation, such a platform is becoming close to a reality today. We are two years away from having a modern securitization infrastructure that ultimately can replace Fannie and Freddie's outdated and proprietary infrastructures.

### ***Shifting Mortgage Credit Risk***

We have also seen important progress on shifting mortgage credit risk from taxpayers back to market participants. During the financial crisis, the Fannie and Freddie conservatorships, backed by the Treasury support agreements, kept the secondary mortgage market functioning but shifted to taxpayers the burden of backstopping the credit risk on Fannie and Freddie-guaranteed mortgages. Since 2013, important strides have been taken to begin shifting some of this risk back to market participants.

Credit risk transfers (CRT)—the transfer of some portion of mortgage default risk away from Fannie and Freddie to private investors—have grown steadily in size, depth, and variety. FHFA shifted to percentage-of-business requirements for risk transfers in 2016 and announced it will be soliciting additional public input.

While we are approaching a time where the market is going to want these transfers to become more standardized and predictable, the progress to-date must be acknowledged. Indeed, interest in these transactions has been strong despite certain legal and regulatory headwinds. This is very encouraging for the long-term prospects for housing finance reform because it allows a proof of concept in a redeveloped market for mortgage credit risk rather than arguing about it as a theoretical exercise.

## ***Other Developments***

While each of these developments is significant, and each moves towards accomplishing the legislative intent expressed in the major housing finance reform bills, other developments have also moved the market towards a new, more resilient structure. Let me list a few of these:

- Fannie and Freddie's rep and warrant framework has been overhauled, with the most problematic elements of the old system having been eliminated;
- Data standards continue to be upgraded substantially. Rather than proprietary data systems at each company, the past several years has seen the development of standardized data definitions covering loan originations and appraisals, as well as standardized technology for collecting and reporting these data. Developments in this area are ongoing, including the expected completion this year of a new uniform loan application dataset.
- Data disclosures continue to progress with the release of a large volume of historical loan level data and most recently an announcement by Freddie Mac regarding ongoing loan level disclosures for loans in certain credit risk transfer deals.
- FHFA, Fannie and Freddie are actively developing a common security. While such a security for now is aimed at making Fannie and Freddie mortgage-backed securities fungible, this work also paves the way for a single security defining a post-conservatorship world.
- Mortgage insurance improvements are now in place, with both new master policies and updated financial eligibility standards.

## ***Building Confidence in Housing Finance Reform***

The sum and substance of these administrative and marketplace developments is that the challenge and uncertainty associated with housing finance legislation is lessened. Rather than assuming that a market for credit risk can be built, it is being built. Rather than assuming a securitization platform can be built to replace Fannie and Freddie, it is being built.

Moreover, these developments address other concerns as well. For example, some have argued that any private market for mortgage credit risk will be pro-cyclical, active when times are good and barren during market downturns. By transforming the market with standardized data, robust data disclosures, and standardized security structures, investors will have far greater understanding of and confidence in market outcomes in the future. This will encourage investors to remain committed to this sector through the cycle.

## **Next Steps**

Rather than thinking about housing finance reform as something that happens from a 2000-page piece of legislation that takes many years to implement, we are actually bringing about reform in the reverse order. As I have just described, critical, foundational changes that take years to develop are well underway. Looking forward, FHFA, market participants, and Congress each has a meaningful role to play in ensuring continued progress.

In the near-term, Congress can help by encouraging and guiding these developments. Legislators do not need to agree on all final outcomes but instead focus on areas where they do agree on the need for market structures to develop.

For example, all major reform bills envision a common securitization platform. While development of CSS continues, Congress could take its development a step further by legislating a process for CSS to be separated from Fannie and Freddie. This could lead to CSS operating as a pure market utility capable of serving other issuers, not just an operating subsidiary of Fannie and Freddie.

Credit risk transfers have bipartisan support. Congress could encourage the continued development of this market by signaling its support for risk transfer to become standard. Going a step further, it could encourage development of risk transfers at the front-end, that is, executed without the involvement of Fannie and Freddie. It could also encourage deepening the actual loss transfer, or even experiment with reinsuring a portion of the risk still retained by Fannie and Freddie. Of course, FHFA continues to direct progress in many of these areas and market participants are contributing new and refined approaches for credit risk transfer.

There are many reasons the private label securities market has not restarted in a meaningful way, and one of them is lack of volume. Congress could encourage this market and prevent taxpayers' risk exposure from growing by capping the conforming loan limits. While I believe that the loan limits should be reduced, at least Congress could direct that they not be increased. There is simply no public policy reason to extend taxpayer backing of mortgages greater than \$625,00 in high cost areas and \$417,000 in the rest of the country.

Congress could also take up some of the barriers to broader participation in the emerging market for mortgage credit risk. In particular, real estate investment trusts are limited in their involvement in credit risk transfers, something that Congress can and should address.

A final push for housing finance reform will require certain regulatory and structural changes, some of which lack consensus today or lack a common understanding of the issues and options. For these matters, Congress could direct further study that could inform future legislation or the regulators or the Administration could initiate such reviews. Some issues are narrow or technical such as:

- How many zip code digits should be released to identify the location of a property as part of loan level disclosures, or
- What rights should senior lien holders have with regard to simultaneous or future subordinate liens on the same property?

Some are broad, such as:

- Do we have appropriate and consistent capital requirements across all mortgage financing structures, or

- What component parts of Fannie Mae and Freddie Mac could be organized for being put back into the market upon the end of the conservatorships? For instance, should we prepare to separate multifamily from single-family? Should the master servicing and loss mitigation functions be separated to compete in and serve the entire market, including private-label?

These questions would benefit from further study.

There are also important developments awaiting action by market participants, including those of you here.

In particular, to-date, front-end risk transfers have been executed by a handful of large players. But there is no reason to think that such transfers cannot be constructed for smaller lenders as well. Indeed, the Federal Home Loan Bank System's Mortgage Partnership Finance Program was the original CRT structure, and it focused almost exclusively on risk transfer for community banks. A market opportunity awaits those that creatively develop risk transfer structures for smaller lenders. And, it could give those lenders the ability to monetize what they have long argued is their comparative advantage in assessing borrower and collateral risk.

## Conclusion

I remain optimistic that our long and winding road to housing finance reform can produce a robust system that benefits homebuyers, taxpayers and markets. We are building a resilient new system in steps, testing and experimenting along the way. Building data standards and disclosures, a new securitization platform and new security structures takes time. We have been investing that time while we all await Congress and Congress benefits from these developments, which should give lawmakers confidence in legislating an end to the conservatorships.

It also provides policymakers time to wrestle with housing policy's unresolved issues. I will end by urging that those deliberations include a thoughtful review of FHA and Ginnie Mae's role in housing finance and a reconsideration of our policy emphasis on encouraging homebuyer's leverage rather than their equity-building.

## **About the Author**

Mr. DeMarco is a senior fellow at the Milken Institute's Center for Financial Markets. He served as acting director of the Federal Housing Finance Agency and the conservator for Fannie Mae and Freddie Mac (2009-14).

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