



A Responsible Market for Housing Finance

Draft White Paper on the Future of the U.S. Secondary Market for Residential Mortgages

Prepared by the Mortgage Finance Working Group

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About the Mortgage Finance Working Group

This draft white paper is a product of the Mortgage Finance Working Group sponsored by the Center for American Progress, with the generous support of the Ford Foundation and Living Cities. The members of the Mortgage Finance Working Group, assembled in 2008 in response to the U.S. housing crisis, gathered to strengthen their understanding of the causes of the crisis and discuss possible options for public policy to shape the future of the U.S. mortgage markets. The members of the working group represent diverse perspectives, and include academics, former government officials, representatives of housing nonprofit groups, private lenders and developers of affordable housing, and other experts. This draft white paper represents the preliminary views of only those members whose names are below, although others participated in some of the discussions. The preliminary views reflect only that of the members, in their individual capacities, although affiliations are provided for identification purposes.

All are eager for comments, new information, and further discussion before finalizing any proposal.

David Abromowitz, Senior Fellow, Center for American Progress.

Conrad Egan, President and CEO, National Housing Conference.

Ellen Harnick, Senior Policy Counsel, Center for Responsible Lending.

Andrew Jakabovics, Associate Director for Housing and Economics, Center for American Progress.

Paul Leonard, Director, California Office, Center for Responsible Lending.

Adam Levitin, Associate Professor, Georgetown University Law Center.

David Min, Associate Director for Financial Markets Policy, Center for American Progress.

Shekar Narasimhan, Managing Partner, Beekman Advisors.

Janneke Ratcliffe, Associate Director and Community Development Research Associate, UNC Center for Community Capital.

Benson “Buzz” Roberts, Senior Vice President for Policy and Program Development, Local Initiatives Support Corporation.

Ellen Seidman, Senior Research Fellow, New America Foundation.

Susan Wachter, Richard B. Worley Professor of Financial Management, The Wharton School of the University of Pennsylvania.

Sarah Rosen Wartell, Executive Vice President, Center for American Progress.

Mark Willis, Visiting Scholar, Ford Foundation.

Barry Zigas, Director of Housing Policy, Consumer Federation of America.

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Executive summary

Reform of the secondary mortgage markets in the United States must start with consideration of the public purposes that the housing finance system should serve. U.S. housing finance policy has historically rested on three longstanding core principles:

- Broad and constant liquidity
- Systemic stability achieved through responsible risk oversight
- Wide and fair availability of affordable mortgage credit

We believe these goals should constitute the foundation of any reforms. This draft white paper is meant to provide a framework for addressing these goals, incorporating the lessons we have learned from the recent crisis.

Our paper differs from proposals offered by others in at least two fundamental ways.¹ First, we offer a more comprehensive vision of the housing finance system of the future, one that goes beyond only “GSE reform” (revising the government-sponsored enterprises Fannie Mae and Freddie Mac). The structural flaws exposed by the current mortgage crisis were largely—albeit not exclusively—found in the private-label mortgage securitization markets. Thus, any proposal that seeks to resolve the problems in our mortgage system must address the *entire* secondary mortgage market.

Second, while other proposals primarily aim to address the objective of liquidity—attracting investment capital sufficient to meet the housing finance needs of U.S. housing—our ideas are designed to fulfill a broader set of public purposes, including systemic stability and affordable housing finance.

Federal support for the secondary mortgage markets is not, and never has been, simply about providing liquidity. Rather, liquidity is sought in order to achieve other priorities, including the wide availability of housing credit that expands access to sustainable homeownership and affordable rental housing over time. These broader goals are part of the legacy of more than a half-century of housing finance policy.

This white paper offers a new framework in which Chartered Mortgage Issuers, or CMIIs, would enjoy some limited governmental backing for their mortgage-backed securities and take on concomitant obligations to serve public purposes. But a key feature of this white

paper is that it is concerned with the relationship between the market served by these new CMI's and the rest of the market. As a result, this white paper also suggests establishing a system of consistent oversight for all other mortgage-backed securities, or MBS issuers.

The existing system of loans insured by the federal government through the Federal Housing Administration, the Veterans Administration, and Rural Housing Administration and bundled into securities enjoying a federal Ginnie Mae guarantee would not be affected by this framework, except as described in the discussion of loan limits. The framework imagines an ongoing role for wholly public housing finance agencies providing an essential backstop and economic stabilizer as during the current crisis.

Chartered Mortgage Issuers

Under this framework, privately owned and capitalized monoline Chartered Mortgage Issuers would be given exclusive charters to issue government-guaranteed MBS in order to ensure that a deep and liquid secondary market provides capital for favored mortgages. Key features of CMI's would include:

Explicit government guarantee on MBS to ensure liquidity. The federal government would provide an explicit guarantee of the timely payment of interest and principal on MBS issued by the CMI's. Specifically:

- **The federal government would stand behind the MBS.** The federal government would ensure the timely payment of principal and interest on MBS issued by the CMI's, making MBS investors whole if the CMI's assets and a new Taxpayer Protection Insurance Fund were ever insufficient to cover MBS losses.
- **CMI's would absorb all ordinary losses on MBS.** The government guarantee would only apply if a CMI's capital were inadequate to meet its obligations to make timely payments. To reduce the likelihood of this happening, capital and reserve requirements would be established and monitored by appropriate regulatory authorities.
- **Resolution authority.** Regulators would have authority to place a CMI in conservatorship or receivership to facilitate an orderly reorganization or winding down of their assets to minimize costs to taxpayers. This authority would be modeled on the Federal Deposit Insurance Corporation's resolution authority for depository institutions. Any MBS losses would be paid first out of the failed CMI's assets at the expense of shareholders and creditors, with additional costs to be paid from our proposed Taxpayer Protection Insurance Fund.
- **Taxpayer Protection Insurance Fund.** Taxpayers would be further protected by an insurance fund, financed by a small fee levied on each guaranteed MBS transaction. Should a CMI become insolvent and unable to meet its obligations to make timely

payment of interest and principal to MBS holders, this insurance fund would be tapped, providing a buffer against taxpayer exposure. The size of the fee would be determined by regulators, and designed to provide taxpayers yet greater assurance that they are shielded from losses.

Limitations on conforming mortgages. A primary regulator would determine the specific characteristics of mortgages eligible for CMI securitization and be expressly charged with ensuring these mortgages were safe and sustainable for the homeowner, advance the goal of ensuring access to homeownership for credit-worthy borrowers or the availability of affordable rental housing, have known risk characteristics, and would not otherwise be offered consistently by private markets. An additional goal of such regulation would be to promote standardization in the interest of both transparency to mortgage borrowers and liquidity through deeper markets for MBS investors.

Regulators would determine, within parameters set by Congress, the maximum size of mortgages eligible for CMI securitization. We anticipate that loan limits on mortgages eligible for CMI securitization would decline over time as a more robust housing finance market is reestablished, so that taxpayer backing is not used to support liquidity in segments of the market that the private market can well serve alone, given the purchasing power of homebuyers at those home prices. But to the extent that housing market disruptions occur from time to time and liquidity once again is limited for mortgages for homes in higher cost areas, the regulator would have the ability to temporarily increase loan limits to address the shortage of credit.

Appropriate standards and oversight. CMIs would be subject to oversight on a range of issues in order to minimize the risks of taxpayer exposure and ensure that these entities receiving the benefits of government-backed enhancement of their obligations were acting in the public interest. Specifically:

- **Monoline institutions.** CMIs could only issue government-backed MBS and would be prohibited from issuing MBS backed by mortgages not deemed eligible for the government guarantee in order to ensure that the nature of taxpayer exposure is transparent and the benefit of public backing is in fact limited to those preferred products.
- **Risk oversight.** CMIs would be regulated for risk in a manner roughly analogous to the regulation of commercial banks, including requirements to hold significant levels of risk capital and to pay into a taxpayer protection insurance fund meant to protect against catastrophic losses.
- **Managed returns.** The profits earned by CMIs would be established through both market mechanisms and regulatory oversight. The goal would be to achieve sufficient and durable private capital investment to support socially important housing markets without allowing private investors to unduly capture the value provided by the public backing of MBS obligations or encouraging risky behavior.

Public purpose obligations. CMIs would enjoy exclusive access to a market facilitated by government backing. In return, they would be required to serve the public good, including by providing:

- **Countercyclical liquidity.** CMIs would be chartered expressly with the goal of providing mortgage liquidity during credit downturns, with reserves and other mechanisms established to they can continue to play essential functions in times of market disruption.
- **Affordable multifamily rental housing.** CMIs would be required to support affordable multifamily rental housing, through securitization activities, credit enhancements, direct investment, or a combination thereof.
- **Broad access to affordable credit.** CMIs would have an affirmative responsibility to provide affordable credit broadly and equitably and in accord with all applicable fair lending laws.
- **Affordable Housing Trust and Capital Magnet Funds.** To the extent that market pricing on the MBS issued by CMIs would allow—while still providing sufficient returns to attract private investment capital for the CMIs—the regulator would require the CMIs, like other MBS issuers, to pay a small fee on each MBS issue that would be used to finance the proposed Affordable Housing Trust and Capital Market Funds—and perhaps other vehicles—for financing affordable housing production and preservation.

Limited direct investment activities. CMI direct investment or so-called “portfolio” activities—loan or investment assets held in portfolio and not securitized—would be limited to serving certain public purposes only as approved by their primary regulator. Approved activities would include multifamily housing finance and direct investment and other activities to the extent determined necessary to allow for the provision of countercyclical liquidity.

Comprehensive and uniform oversight of other MBS issuers

Under our proposed regulatory framework, all financial institutions seeking to issue securities substantially based on U.S. residential mortgages would be subject to comprehensive regulation of risk in order to create a level playing field between CMIs and all other MBS issuers and to prevent regulatory arbitrage. This risk regulation would be designed to supplement and work in concert with any securities regulation applicable to MBS under requirements of the Securities and Exchange Commission, the Commodity Futures Trading Commission, and other regulators of securities issuers. Further analysis is required to understand the relationship between the framework approach here and those requirements in current law and as they may emerge from financial regulatory reform legislation currently pending.

Our analysis of the U.S. mortgage crisis finds that the irrational pricing in the private-label security market had a distorting and devastating effect on the conforming market. Competition for market share contributed to poor choices made by the government-sponsored enterprises Fannie Mae and Freddie Mac, which in the end have proven costly to taxpayers, well beyond even the dramatic losses one would otherwise expect from monoline housing finance firms serving the conforming market during the worst housing downturn in 80 years. Our framework, therefore, would harmonize the regulation of similar activities performed by different financial institutions in the U.S. mortgage marketplace, level the regulatory playing field, avoid a race to the bottom, and stabilize the mortgage finance system by imposing risk oversight at the secondary market level.

This comprehensive regulatory regime for other MBS issuers would be similar in key respects to the way banks and thrifts are currently regulated and would apply to all issuers of securities substantially based on U.S. residential mortgages. As in the mortgage markets of other countries, there would be far greater oversight of the form of MBS that could be issued and the types of mortgages that could be securitized, with an emphasis on ensuring the “safety” of mortgages that could be financed through the secondary market. We believe it is insufficient to rely upon origination-level consumer protection measures as the sole means of overseeing systemic risk posed by the safety of products—although clearly it is important to have coordination with origination-level regulators, such as the proposed Consumer Financial Protection Agency and state regulators.

Importantly, however, we do not contemplate that loans securitized by other MBS issuers would be subject to the specific requirements to be imposed upon the CMI—that the loans they securitize advance public objectives of affordability and broad access to credit. More exotic product types not found to be “safe” to the consumer and for the system would nonetheless be available—unless barred by primary market regulation—to the extent that mortgage lenders or investors were prepared to maintain these loans in their portfolios. Innovation could thus proceed and new products could be tested before gaining wider market acceptance.

Providing access to affordable homeownership and rental Housing

Under our proposed framework, liquidity for mortgages that would expand access to affordable housing would be provided in a number of different ways. Among them are:

- **FHA and Ginnie Mae.** Ginnie Mae would continue to securitize loans insured by the Federal Housing Administration, the Veterans Administration, and other agencies that are designed to promote affordable homeownership and mortgage financing for multi-family rental housing.

- **Affordable Housing Trust and Capital Magnet Funds.** A fee levied on all MBS issues—unless found to unduly restrict the availability of investment capital for CMIIs, which already would bear heavy public purpose and liquidity requirements—would support these funds created by legislation in 2008 to provide direct and credit subsidies for affordable housing.
- **Basic duty of broad access for all MBS issuers.** CMIIs and other MBS issuers would be required to provide broad access to affordable credit in all markets they served. A combination of quantitative and qualitative factors would be assessed to determine whether the duty to serve has been fulfilled.
- **Direct investment or “portfolio” activities of CMIIs.** As aforementioned, CMIIs would be limited in the direct investments they could make to hold in portfolio and not securitize. But to fulfill their affirmative obligations to serve public purposes, including the provision of multifamily housing finance and other efforts to provide liquidity to underserved markets, certain investments which served a public purpose would be permissible for the CMIIs—with the specific parameters and total amounts of these direct investments being articulated by the CMIIs’ primary regulator.

Better protection of taxpayers against loss

Under our proposed framework, taxpayers would be far better protected against risk of loss than in the past. Specifically:

- **Limited government guarantee.** The government guarantee would be explicit and only apply to MBS issued by the CMIIs. There would be no guarantee of the CMIIs’ debt or equity.
- **Government backing would be offered only for securities backed by loans that are deemed to be safe and sustainable.** Eligible loans must have known risk characteristics, and be safe and sustainable.
- **New Taxpayer Protection Insurance Fund.** A small fee would be levied on each new MBS offering made by the CMIIs to fund a reserve held by the Treasury that would buttress the capital reserve requirements of the CMIIs.
- **Robust risk oversight of both CMIIs and other MBS issuers.** The level playing field also reduces risk of taxpayer exposure. With competitors also subject to a consistent regime of risk regulation, the CMIIs and their regulator would not be pressured to allow them to assume higher risks to chase market share.

- **Limited portfolio activities.** A substantial portion of the losses currently being borne by the GSEs result from loans and MBS they purchased for their own portfolios, which until the onset of the current financial crisis served as major profit centers. Limiting the direct investment activities of the CMIIs to those that serve public purposes would rein in their potential losses accordingly.

Introduction

The U.S. housing and financial crisis arose in 2007 with problems in the subprime market and culminated in the complete collapse of the private secondary mortgage markets and the consequent conservatorship of the government-sponsored entities Fannie Mae and Freddie Mac.⁴ The result of this crisis could well be a comprehensive reordering of the entire U.S. system of housing finance once the currently tepid economic recovery takes hold, although not in the very near term. The priority today must be on stability as the country tries to emerge from the worst economic crisis since the 1930s, one sparked by turmoil in the housing markets.

Between the Federal Housing Administration, the Veterans Administration, and Ginnie Mae and the GSEs now under federal conservatorship, the federal government is currently providing liquidity to virtually the entire mortgage market. But it is not too soon to begin to consider what form the housing finance system that emerges should take. This will be a complex and difficult reform agenda, where the danger of unintended consequences will be great. The more robust the discussion of the options, the better will be the resulting policy. Only a careful analysis of the evidence, moving beyond ideological rhetoric, will ensure we learn the right lessons from our recent history.

In 2008, as the housing crisis was unfolding, the Center for American Progress assembled a Mortgage Finance Working Group composed of leading progressive mortgage finance experts to discuss mortgage developments and think through the implications for the future of the mortgage markets. CAP provided members of the working group with a private forum to discuss and strengthen their understanding of the causes of the crisis and possible options for public policy to shape the future of the U.S. mortgage markets. The members of this working group who have signed their name to this white paper represent diverse perspectives, and include academics, former government officials, representatives of housing nonprofit groups, private lenders and developers of affordable housing, and other key stakeholders and experts. Their affiliations are provided for identification purposes only, but they offer this draft framework in their individual capacities. All are eager for comments, new information, and further discussion before finalizing any proposal.

This white paper offers a framework that the Mortgage Finance Working Group developed as we imagined how the system of the future might be constructed. We offer it for discussion, with many issues unresolved and questions remaining. Yet we believe our framework

adds a distinct perspective to the housing finance reform debate in at least three ways. First, we offer a framework that would reform the entire secondary mortgage finance system, and not only Fannie Mae and Freddie Mac. GSE reform is a necessary but grossly insufficient step toward reforming a housing finance system in which the most significant failures stemmed from the non-GSE market. Any proposal that purports to resolve the causes of the current housing crisis must address the problems in the private-label mortgage securitization, or PLS market, where trillions of dollars in poorly underwritten mortgages were securitized with grossly misunderstood and misallocated risk.

Second, we do not believe that providing a liquid market for investors is the only public policy goal of mortgage finance reform. Other public purposes must be advanced as well. The modern U.S. housing finance system—most particularly the 30-year fixed-rate mortgage—is a creation of federal market support designed to expand homeownership and the resulting benefits of asset accumulation for individual households and community stability for all Americans. Without some federal support for this market, many homebuyers could find they have access only to short-term revolving credit that is too expensive, requires too much capital, and leaves the homeowner bearing risk that they are ill prepared to bear.

In March 2009, the Mortgage Finance Working Group disseminated “Principles to Guide Development and Regulation of a Renewed Mortgage Finance System,” in which we presented a set of public purposes that the U.S. housing finance system should serve. While liquidity is an important function of the housing finance system, it is by no means the only one. We believe that a renewed housing finance system should reflect other public priorities as well, including the appropriate regulation and management of risk—including systemic risk—and ensuring that affordable and sustainable mortgages continue to be broadly and fairly available to American households.

Finally, much of the discussion of the mortgage markets focuses on single-family homeownership. But most housing experts and stakeholders now recognize that our national policy in the past emphasized homeownership to a fault, without regard to whether it was appropriate for every household, resulting in at least some cases of encouraging homeownership for households for which it was unsustainable. This environment tolerated growing predatory and discriminatory practices in the name of expanding homeownership, while some irresponsible homebuyers took advantage, gambling that home value appreciation would bail them out of unsustainable loans. We must restore an appropriate balance between homeownership and rental housing in our housing policy, and we must make *sustainable* homeownership a cornerstone of national policy efforts.

Affordable multifamily housing will only grow in importance as the fallout from the foreclosure crisis, coupled with demographic changes, causes the demand for rental housing to soar. So in this white paper we attempt to begin a conversation around the role of government in support of finance for affordable rental housing.

In drafting this white paper, we left many issues open, choosing to focus on the issues we consider missing from the current debate. We raise questions and in some cases note key considerations and options that require further study. But some issues are left unaddressed. For instance, the white paper is limited for the most part to reform of the secondary market institutions that act as conduits for investment capital into our housing markets. It does not address the myriad primary market issues that exist, including how the delivery system for services to and by the mortgage industry should be structured, or what the role of private mortgage insurers might be in a revised system. We also do not address the question of who should be the primary regulator in a new housing finance system.

Another major issue is how to transition from the status quo to the future. In a world where 90 percent of new mortgage originations are backed by the federal government, and where Fannie Mae and Freddie Mac are being used as instruments to combat the mortgage foreclosure crisis, how can we unwind this enormously important role for the GSEs, particularly given that the losses likely to be absorbed by the GSEs look to be high and ongoing for the foreseeable future? Can policymakers discuss their future without disrupting market expectations and affecting the availability of credit in the interim?

Another related question is what role Fannie Mae and Freddie Mac or components thereof might play under our framework. Would they be eligible to continue to participate in the secondary mortgage markets or might their assets be made available to form new mortgage entities? We do not address this issue directly, although some preliminary thoughts about the transition are included. One priority, however, must be the maintenance of the GSEs' capacities during interim between now and the implementation of any reforms.

Both Fannie and Freddie have extensive infrastructure, resources, and expertise that would be extremely valuable—albeit in some new form—in sustaining a system that serves many of the public purpose objectives we argue are paramount. Both for the stability of the current system and in the interest of efficiently building a new housing finance system in the future, preservation of the human capital, intellectual property, systems, and other capacities of the GSEs is in the public interest. The lack of certainty about the GSEs' future, however, puts some of these assets at risk. When market conditions further improve, human capital retention will be an even greater problem. As much of federal mortgage market policy is currently delivered by the GSEs, policymakers should attend to the challenge of preserving these GSE assets.

This paper focuses on policy designed to advance three high-level objectives: liquidity, risk management, and access to affordable credit on sustainable terms. After a brief overview of the history of the crisis, the body of this paper first lays out these three objectives and reviews the lessons of recent history in each area. We then describe a new framework that might advance these objectives while avoiding the problems of the past. We look forward to beginning a discussion with a wider group of interested parties about these ideas and refining them over time.

Principles for mortgage finance reform

The modern U.S. housing finance system relies upon robust government involvement to intermediate between investor demand for short-term liquid assets and borrower desire for long-term fixed-rate debt—a financial relationship dating back to the 1930s that emerged out of the housing crisis precipitated by the Great Depression. Today, a combination of direct subsidies, explicit guarantees, tax incentives, and other forms of government intervention provide significant support to the mortgage markets. In return, the mortgage markets serve certain housing-related public policy goals.

The 30-year fixed-rate mortgage, which did not exist as a mass market product until the federal government provided public policy support, is the best example of our housing market at work. Until the recent regulatory policy failings allowed market distortions to irrationally inflate home values, the long-term, fixed-rate, 30-year mortgage was a solid building block for affordable homeownership—and for most households the single most important tool for building wealth and advancing up the socioeconomic ladder—for many generations of Americans.

Any discussion of reforming the housing finance system should start with a clear understanding of what we want the system as a whole to accomplish in the wake of the Great Recession. We must clarify what public policy goals the system is designed to serve in order to articulate how a reformed system can meet those goals. To this end, the Mortgage Finance Working Group developed “Principles to Guide Development and Regulation of a Renewed Mortgage Finance System,” published by CAP in March 2009. This document describes eight principles meant to guide the discussion of mortgage finance reform.⁶ Those principles fall generally into the following three categories: liquidity, risk management, and broad access to affordable credit.

Liquidity

Investors’ interests demand short-term investments offering maximum flexibility, but most borrowers require long-term, illiquid loans, offering them an opportunity to build equity and a predictable obligation whose payments can be anticipated. In the existing mortgage finance system, intermediation between these demands is largely accomplished by a robust and liquid secondary market for mortgage-backed securities. In the last decades of the last

century, mortgage markets in the United States did a remarkable job of intermediating between those different needs. No other housing finance system in the world has done as well as the U.S. system in providing these types of mortgages.

One key to ensuring a strong flow of liquidity is standardization of investment vehicles, which allows for deeper and more liquid trading in the secondary markets. Any proposed mortgage finance system must also be judged by whether it results in the availability of long-term fixed-rate credit. And two aspects of liquidity are important: breadth and consistency.

Regarding breadth, a wide range of communities and housing types require capital, thus requiring liquid markets for investments in products serving those markets. It is especially important to create liquidity to serve markets and products that are otherwise underserved. Case in point: to attract private capital to multifamily housing finance there must be a liquid secondary market for these investments—which may be in whole loan sales as well as in securities. Similarly, breadth refers to the array of investors available to buy and sell assets backed by mortgages that provide finance for all appropriate forms of housing. To attract many investors there must be liquid, transparent, and deep markets for mortgage-backed securities.

Investors are also drawn to U.S. mortgage markets because of its *consistency* through booms and busts. And from the perspective of the consumer and the larger U.S. economy, consistent access to housing finance during credit contractions, as well as expansions, is essential. Any proposed mortgage finance system must be judged by how well it will provide liquidity during downturns, when private lenders are typically reluctant to take on credit risk.

Given the extent to which U.S. housing finance has grown to rely upon the secondary markets for capital, it is essential to have both a government- and nongovernment-backed mortgage securitization market to ensure sufficiently broad and deep liquidity, as we have grown accustomed to in this country. Measures to bolster both areas are necessary.

Risk management, including systemic risk

Another key goal for any mortgage finance system must be to appropriately manage and disperse risk—an inherent part of lending. A mortgage finance system that seeks to eliminate or even excessively minimize risk will serve only a small fraction of the demand for credit with adverse social consequences. The goal instead should be to appropriately understand and price risk, and allocate it to those with the capacity to bear it. Investors should be matched with products with the risk-reward characteristics—duration, credit risk, interest rate risk—that they desire and can afford to hold. The result will be systemic stability, limited volatility, and widespread availability of capital for reasonable credit risks—rather than the misallocated capital, wealth destruction, and market volatility of recent years.

Where there is significant government intervention in the marketplace or there exists a number of “too big to fail” financial institutions, taxpayers inevitably bear the greatest risk from misalignment of incentives, misallocated risk, and moral hazard. To minimize taxpayer exposure, there must be a framework in place to ensure there is adequate transparency, market discipline, and oversight of risk across all actors whose participation in the market—individually or collectively—is systemically significant.

This new system of risk management should be based on strong underwriting standards and robust oversight of capital adequacy and risk. The origination of sustainable mortgages to informed consumers is also a critical first step in reducing risk and restoring stability to the secondary mortgage markets, although it alone is insufficient to manage risk in the secondary markets. Finally, the new system should offer consistency regardless of the regulatory agency charged with oversight. All financial institutions providing similar products or services should be subject to parallel requirements—a level playing field—to prevent the possibility of regulatory arbitrage and the resulting “race to the bottom.”

Access to affordable and sustainable credit

There is a strong social interest in providing broad access to affordable mortgage credit on fair, nondiscriminatory, and sustainable terms. Homeownership is historically the primary vehicle for accumulating wealth for most Americans, allowing them to save for education, retirement, and small business formation, and climb the socioeconomic ladder. A system that provides affordable mortgages only to more affluent borrowers is therefore insufficient.

In the wake of the foreclosure crisis, it is tempting to pull credit back from all but the strongest borrowers. But as housing markets normalize, we must not go back to the old days where entire communities were shut out from access to the best financing. Homeowners at the higher end of the socioeconomic ladder already enjoy significant governmental subsidies,⁷ and there is ample evidence that many households that may not fit the perfect mortgage model for private lenders—“20 percent down, established credit, 31 percent debt-to-income ratio”—can become successful, long-term homeowners, when well underwritten and given access to affordable, fixed-rate financing.

Thanks to the government, the wide availability of affordable, long-term fixed-rate mortgages is a unique feature of U.S. housing finance and the principal means by which many generations of lower- and middle-class Americans have entered the ranks of homeownership. Without access to affordable mortgage credit, most Americans would not be able to buy their homes, let alone build up their financial security through them. Moreover, unlike adjustable-rate mortgages, these loans shift interest rate risk away from homeowners, the party with the least ability to manage that risk, onto institutions and individuals with greater risk-management capacity.

Prudent loans with low down payments that reduce the upfront homebuyer funds needed to close on a home purchase have also played an important role in expanding homeownership, but such loans pose greater risk of lender loss and foreclosure for the homeowner. Appropriate mechanisms to reduce that risk were developed by sophisticated nonprofit lenders and some financial institutions, but these products could not compete in recent years with low down-payment products with no commensurate effort to mitigate risk.

A key standard against which any proposed reform should be measured is in how well the system would provide access to fair and affordable mortgage credit in all communities, including underserved communities, on terms that are *sustainable* for the homebuyer. Without that, parts of society would be denied access to the wealth-building benefits of homeownership, making it even harder for them to seize economic opportunity. And the communities most painfully affected by the subprime crisis will be left starved of credit and unable to rebuild. Historically underserved communities should receive access to credit on terms that reflect their actual, not perceived, credit risk, and not on predatory terms. These are the communities that have been among the hardest hit by the housing and economic crisis and will need the most capital to rebuild.

In order to promote sufficient liquidity in these areas, it is important that any mortgage finance system foster “good” innovation to promote the development and “mainstreaming” of new mortgage products with the potential of extending affordable and sustainable homeownership.

Notwithstanding the benefits for many when credit is extended on responsible terms to responsible homebuyers, not everyone can or should be a homeowner. Our nation’s housing finance policy should refocus on supporting good quality affordable multifamily rental housing. As many households transition out of homeownership, and do so with badly damaged credit, the demand for quality rental housing will grow. Demographic trends also suggest rising demand and a continued gap between incomes and the rents those incomes can afford. A housing finance system must support the full spectrum of needs for mortgage credit.

Finally, the crisis highlights the high cost to all when communities are underserved and underinvested and capital is scarce—in a global economy where housing markets and the capital that finances them are all interconnected, weaknesses in one area spread all too easily to others. This recognition forms the basis for policies that call on federally supported financial institutions to serve lower-income and minority communities within the constraints of safe and sound practices. True reform needs to take into account the potential of housing-related investment to strengthen entire communities.

Background

The recent housing bubble and its consequent bursting have revealed numerous flaws in our housing finance system. A global abundance of capital chasing yield, coupled with a blind faith in the primacy of unregulated markets and an outdated regulatory framework, led to a dramatic shift in the way that mortgages were financed. Credit liquidity moved away from supporting regulated financial institutions such as commercial banks, thrifts, and the GSEs to the issuers of private-label mortgage-backed securities.

Before dissecting how the housing finance crisis occurred, it is worth emphasizing a few points about the structure of the U.S. housing finance system. At its core is the affordable, 30-year fixed-rate mortgage, found in only a few other nations. This mortgage, which most of us take for granted, is actually an affordable housing finance product created by government policy. Since 1934, when the FHA was established to restore a mortgage market crippled by the Great Depression, U.S. housing finance policy has offered incentives and support to attract more capital more efficiently so that more U.S. households could build financial security through home ownership.

Prior to the 1930s, mortgages were almost exclusively short-term, nonamortizing balloon loans. At the time, the federal government began to finance homeowners into stable, long-term mortgages with lower down payments. The idea of government support for affordable homeownership became a fixture of American housing policy. The government's support of multifamily housing finance began later, but dating back to at least 1963 there has been a concerted effort to use government direct subsidies and credit enhancement to support a liquid secondary mortgage market for multifamily loans through FHA insurance, interest rate subsidies and so called Section 8 rental assistance, Low Income Housing Tax Credits, the Federal Home Loan Banks' affordable housing goals, and the GSEs' affordable housing goals, all of which encouraged multifamily finance.

To achieve sufficient liquidity for affordable housing finance, the federal government has taken numerous steps to attract capital, including the creation of FHA, Ginnie Mae, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system, to name a few. The government fostered the creation of liquid mortgage capital markets and provided support both direct and indirect to the vast majority of mortgages originated in this country.

This government support is not intended to maximize profits for investors or simply to keep the mortgage banking system functioning, but rather to ensure broad-based financing is accessible to facilitate homeownership as a vehicle for earned prosperity and encourage creation and retention of affordable rental housing. As a result of these governmental efforts, affordable long-term mortgages are widely available, and to a large extent pooled and securitized in the secondary markets, shifting the risks of capital market fluctuations to institutions and investors and away from homeowners who are less able to manage their finances to adjust to market changes.

Until the recent regulatory failures led to a crisis, the U.S. policy of promoting homeownership could largely be considered a success, as two-thirds of American households own their homes, compared to just 40 percent in 1940. Affordable homeownership became a gateway to the middle class for countless Americans. So where did things go wrong?

The “shadow banking system” of purely private mortgage securitization, which when first developed several decades ago served only small market niches, grew explosively from the early to mid 2000s—fed by a global oversupply of capital and a regulatory playing field that was heavily tilted in its favor. Risk in the private-label mortgage-backed securities, or PLS market, was mispriced and misallocated based on a presumption of unending house-price appreciation, which the market was itself fueling through loose underwriting, the mass origination of unsustainable loans, other predatory and sometimes discriminatory practices, and low barriers to entry for some irresponsible investors and homeowners. Enormous growth in PLS market share distorted the secondary mortgage market overall, driving safer, fairer, and better-underwritten loan products out.

Regulators and politicians stood by idly as these practices metastasized. The PLS issuers were largely free of direct safety and soundness oversight, but policymakers were reluctant to intervene in a market that seemed to be creating great wealth, even as it was driving an enormous housing bubble. From 2000 to 2005, private-label MBS experienced a nearly nine-fold expansion; their market share rose from 12 percent in 2002 to nearly 50 percent in 2006. Correspondingly, the share of the secondary mortgage market represented by FHA loans shrank to low single digits, and that of conforming, conventional mortgages originated into the Fannie Mae and Freddie Mac securitization pipeline—which had once dominated the market—shrank to less than 30 percent in 2006.

The GSEs, compelled by competition and interested in reaping some of the apparent gains associated with private-label MBS, were eventually successful in convincing their regulator to allow them to purchase investment-grade PLS beginning in 2006, heating these markets even more. The combination of low interest rates targeted by the Federal Reserve and the rise of the PLS market drove massive home-price appreciation that was unsupported by the underlying economic trends. By the end of 2007, U.S. housing prices experienced an inflation-adjusted 86 percent increase since 1996, even as household income stagnated.

As we all now know, risk management failed at all levels of the unregulated private-label mortgage-backed securities markets. As a result, once the music stopped in late 2007, mortgages that were originated for private securitization began to fail at historically unprecedented levels, causing enormous losses to the holders of these private-label securities, including Fannie and Freddie.

The costs of this downturn are astronomical. Trillions of dollars in family—or household—wealth evaporated. Trillions of dollars more were committed to propping up the global financial system. The ensuing Great Recession led to unemployment rates in the United States of more than 10 percent and home price declines of more than 30 percent, triggering further defaults, with more shocks expected to come.

Fannie Mae and Freddie Mac, facing significant losses for the foreseeable future, fell into conservatorship in 2008, ending their status as quasi-private entities. Private mortgage securitization has all but disappeared, and the mortgage markets are surviving only through the extensive countercyclical liquidity provided by the federal government through FHA and the postconservatorship GSEs. If our housing finance system is to continue serving the roles it has historically played, policymakers must make reforms to revitalize the markets for both government-backed and nongovernment-backed markets MBS.

Lessons for reform from the crisis

The housing bubble and bust exposed some major structural flaws in our current housing finance system and its ability to meet the goals of providing liquidity, stability, and access to affordable credit. Liquidity in the secondary mortgage marketplace, stability in the housing finance system because of a liquid secondary market, and access to affordable credit on sustainable terms because of steady capital flows into our housing finance system are now all at risk. We consider each of these in turn.

Liquidity

Going forward, it is clear that purely private markets alone cannot provide broad and constant liquidity due to their inherent procyclical tendencies. The PLS market arguably supplied too much liquidity during the recent boom, intensifying the housing bubble, and inarguably is failing to provide sufficient liquidity during the current downturn. The federal government is currently backing about 90 percent of all new mortgage originations.

Nor did the purely private markets even manage to provide truly broad liquidity during the credit expansion. To the extent they provided credit to the underserved and more vulnerable parts of the market, they too often did so with wealth-depleting high-risk, high-cost products that could only be considered sustainable in a world of infinite home price appreciation.

What's more, global investors have completely lost confidence in the PLS market after its collapse. Opaque mortgage products deemed to be investment grade by the rating agencies burned investors around the world. As a result, it is difficult to imagine that U.S. housing finance will be able to attract sufficient capital to meet its needs, even during credit expansions, without a significant government role.

Stability

Obviously, the U.S. housing finance system failed on a number of fronts when it came to the governance of risk. Many policymakers are now appropriately focused on ensuring systemic stability through strong risk oversight, but those who focus primarily on GSE reform to achieve systemic stability are missing the bigger picture. After all, one

root cause of this crisis was the unexpectedly high default rates on mortgages originated for the private securitization markets, which we know suffered from poor underwriting and misaligned incentives across the board. The resulting loss rates on “toxic MBS” were the primary reason that our financial system nearly collapsed in late 2008. Any efforts to reform the housing finance system that ignore the private securitization markets are destined for failure.

The first step in this process is to recognize that certain types of mortgage products are inherently safer for consumers and investors than others. There is ample evidence that fixed-rate 30-year mortgages default at a fraction of the rate of more exotic mortgages such as 2/28 option adjustable-rate mortgages when held by similar borrowers.

Another lesson is that a lack of transparency and standardization fosters complexity and information asymmetries that increase the likelihood of bad decision making by borrowers and investors alike. Many of the mortgage products offered during the housing boom were opaque and complex. As a result, consumers and investors relied excessively on “expert” third parties with misaligned incentives—mortgage brokers and rating agencies, respectively—to provide insight into the products they were buying. Increased standardization and transparency would serve to make comparison shopping easier and reduce the need for reliance on outside parties whose interests might not be properly aligned.

Misaligned incentives were endemic throughout the housing finance system during the housing boom. Issuers, brokers, rating agencies, and most other actors involved in the intermediation of risk in the private securitization markets all had excessive incentives to produce short-term volume without any regard to—and occasionally perverse incentives against—the long-term viability of the loans they were helping to make. The lack of “skin in the game” was designed to minimize the amount of capital required and thus reduce the cost of lending, but ultimately it served to raise costs substantially.

Capital flooded the private-label securities market, we now know, in part due to the absence of any meaningful regime of risk regulation and capital adequacy oversight, such as that which governed banks and thrifts. Off-balance-sheet vehicles helped to make opaque the risk assumed by even these more heavily regulated financial institutions; the uneven playing field between regulatory regimes made it even more difficult for already reluctant regulators to limit these off-balance-sheet activities.

The systemic consequences of misallocated capital hit taxpayers and consumers alike, particularly in an age of interconnected markets and “too-big-to-fail” financial institutions. A clear lesson is that we must ensure a level playing field over all secondary market providers of mortgage finance with robust oversight.

Finally, while our framework is focused on reform of the secondary markets, measures that improve the ability of consumers to evaluate their options and reduce the likelihood of predatory lending practices would improve the long-term sustainability of those loans and

thus reduce systemic risk in the secondary markets. Consumer protection is an integral part of reducing systemic risk.

Access to affordable credit on sustainable terms

Today's lingering housing crisis makes clear that the most basic of affordable mortgage products, the widely available 30-year fixed-rate mortgage, is unlikely to exist in the absence of a government backstop. Any reform of the system must account for this fact.

Equally important, affordable homeownership is advanced and preserved through both expanding markets and protecting borrowers from predatory lenders. The expansion of the PLS market led to a proliferation of new types of toxic mortgage products that were superficially affordable but actually much more expensive and likely to default. Even worse, the toxic mortgages packaged up and sold in the relatively unregulated PLS market drove out the safer and more sustainable mortgage products offered by FHA and the GSEs—products that had long served this market.

Case in point: 55 percent of the borrowers who tapped subprime loans in 2005 were eligible for prime loans at the time of origination.⁸ Good affordable lending was driven out—a perfect example of Gresham's law: "Bad money drives out good." As a result, while the explosion in new mortgage finance provided by the PLS markets initially led to some increases in the overall U.S. homeownership rate, these increases were short lived and the equity of many borrowers, especially minority borrowers, was effectively destroyed when the housing market collapsed.

If the U.S. mortgage finance system is to serve its longstanding goal of promoting affordable homeownership, then policymakers must understand this will not occur in the private markets without a mix of carrots and sticks to encourage it alongside the continuation of the tradition of targeted government support of housing finance. Similarly, public policy and support will be necessary to ensure the sufficient availability of affordable rental housing for those Americans who are not capable of homeownership.

The GSEs today serve a disproportionate share of the affordable multifamily finance market. That market took a significant beating when Fannie and Freddie went into conservatorship—underwriting standards tightened dramatically, and they sought to liquidate assets to reduce losses. Some parts of the affordable multifamily housing market, such as smaller buildings, have long lacked access to the credit needed for maintenance and upgrades—including for energy efficiency. If the system is to continue to provide credit for affordable rental housing, some mechanism of government support will likely be required for a long time to come.

A possible framework for reform

To fulfill the public policy objectives outlined in this paper, our framework would create a mortgage finance system characterized by “level playing field” risk regulation for all MBS issuers in tandem with explicit government backing for certain preferred products. Specifically, this framework would:

- **Ensure liquidity through government-guaranteed MBS.** Chartered Mortgage Issuers would be allowed to issue government-backed MBS to ensure sufficient liquidity for favored products that serve defined public policy goals.
- **Improve systemic stability through strict and uniform oversight of MBS issuers.** To address the problems with risk management and misaligned incentives that distorted the housing markets and the financial system, *all* institutions—CMIs as well as other MBS issuers—seeking to issue securities backed by mortgage loans⁹ would be subject to comprehensive regulatory oversight. MBS issuers would be regulated for risk and capital, including stringent oversight of their products and acceptable mortgages, with only certain “safe” mortgage products allowed to be securitized.
- **Provide access to affordable credit through a variety of approaches.** Affordable homeownership would be promoted through a number of different ways, including:
 - Ginnie Mae, which would continue in its role of securitizing FHA loans designed to promote affordable homeownership and multifamily rental housing for lower-income households.¹⁰
 - Affordable Housing Trust and Capital Magnet Fund, which would be financed through a small fee levied on all new mortgage issues to be used to fund various affordable housing initiatives.
 - Direct investment by CMIs, which would be allowed to directly invest in certain products, authorized by their regulator and meant to serve certain public purposes, including the provision of countercyclical liquidity and liquidity for multifamily housing.
 - Requirements to provide broad access to affordable credit—which all MBS issuers would have to follow—tailored to their specific securitization activities, in order to

provide broad and nondiscriminatory access to affordable credit. For instance, an MBS issuer that was active in securitizing multifamily housing finance or home equity lines of credit would have a duty to provide such finance across communities.

- Other approaches—which would address failures in our current housing finance system—primarily the major gaps in its ability to safely promote affordable homeownership. There is significant room to advance new proposals in this regard, and we embrace such efforts.

As the above points make clear, we share the conclusion of some industry voices that any reform of the mortgage finance system must have a mechanism in place to ensure ample credit liquidity—including countercyclical liquidity—to meet the needs of U.S. housing markets. But our framework also seeks to address two other key issues that we have not yet seen addressed. First, a reformed housing finance system should provide liquidity to those areas where it is economically viable but which are not otherwise being served. There are a significant number of underserved Americans for whom the benefits of homeownership are attainable and sustainable—provided they have access to credit on fair and sustainable terms. And there are of course many Americans for whom homeownership is not a feasible option, and so there must be mechanisms in place to ensure the sufficient flow of credit to building and sustaining affordable rental housing. Any reforms of the mortgage finance system must address these credit needs.

Second, we believe that strong risk oversight is absolutely critical and must extend to the private mortgage securitization process that generated the exotic subprime and low-documentation or no-documentation mortgages that led the housing market meltdown. Any mortgage finance reform proposal that does not envision a robust regulatory system for private label mortgage securitization ignores the fundamental issue that led us to this market collapse. At the same time, this risk regulation must be uniform and consistent across different types of institutions, so as to mitigate the possibility of arbitrage and a race to the bottom, as we saw happen during the recent housing bubble.

The recent crisis revealed how integral housing finance—a \$12 trillion mortgage market—is to the broader economy and global macroeconomic system, yet too little housing finance expertise was resident in economic policymaking and regulatory bodies and thus there was no systemic view of the housing markets. One possible way to address this issue might be the creation of a Housing Markets Coordinating Council that brought together the financial markets and financial institution regulators with the Departments of Housing and Urban Development and Treasury, the VA, and other housing-focused agencies to periodically examine housing-specific market issues and their relationship to the economy and report to Congress and the president on the state of the housing markets. Whether such a council should be created, and in what form, needs to be considered in the context of other inter-agency structures, including those being developed as part of financial services reform.

Chartered Mortgage Issuers of government-guaranteed mortgage-backed securities

An important part of our framework for reform is the creation of financial institutions that can ensure the U.S. mortgage finance system provides—and continues to provide—sufficient liquidity to meet the needs of the housing markets. As a number of industry groups point out, it appears highly unlikely that such liquidity will be provided by the private markets in the absence of some government support.

Toward that end, much like the proposal laid out by the Mortgage Bankers Association and Credit Suisse, this framework would include an explicit two-tier government guarantee on qualifying MBS, with the issuer bearing the first loss. But our framework further contemplates that the guarantee be limited to the MBS issued by fully private Chartered Mortgage Issuers, which would be regulated across a number of areas, including risk and product offerings.

Furthermore, the guarantee would be limited in other ways by the CMI's primary regulator, which would define the standards for acceptable mortgages and MBS, including loan limits and product types—with an emphasis on promoting long-term fixed rate mortgages and other products that would safely expand affordable homeownership and would otherwise not be served by the private markets. Below is a summary of key details relating to these CMIs:

Chartered Mortgage Issuers would be regulated across a number of areas

Profits would be managed to attract capital but protect against undue private gain, and strong risk and product oversight would be mandatory. Specifically:

- **CMIs could only issue government-guaranteed MBS.** CMI's regulator would determine what kinds of MBS and mortgages would be eligible for the guarantee, with an emphasis on safe affordable mortgage products that safely expand homeownership, and which would not be made available without a public backing, with an emphasis on long-term fixed-rate mortgages. Among the loan characteristics the regulator would determine would be loan limits on the size of mortgages that can be securitized with the government guarantee.
- **Risk regulation harmonized with risk regulation of non-CMI issuers.** This would include resolution authority—similar to that enjoyed by the FDIC with respect to depository institutions—allowing regulators to place troubled CMIs into conservatorship or receivership as a means of facilitating an orderly reorganization or winding down of their assets, with the goal of minimizing costs to the taxpayer. Leverage requirements

would be determined by the regulators. And CMIs would be required to hold risk capital designed to protect taxpayers from any future losses, and pay into a Taxpayer Protection Insurance Fund.

Chartered Mortgage Insurers would boast limited government guarantees

Chartered institutions would have access to an explicit government guarantee on qualifying MBS that they issued alongside an explicit non-guarantee on their own finances. Specifically:

CMIs' own equity and debt would explicitly not be guaranteed.¹¹ CMIs' investors (debt and equity) would stand in the first loss position, with the government guarantee standing behind them (we agree with the general approach outlined in the Mortgage Bankers Association's proposal, which would limit the government guarantee to the MBS and explicitly disavow—in a credible way—any guarantee of corporate debt or equity). The specific criteria determining whether MBS qualified for this government guarantee would be determined by the CMIs' primary regulator. These criteria would encompass certain requirements for the underlying mortgages, including:

- Loan values under a specified conforming loan limit.
- Measures to drive standardization, among them standardized underwriting and origination standards. These standards would augment the consumer protection and underwriting standards created by origination-level regulatory reform.
- Limited number of products. Only a few types of products would receive the government backing, which would help to drive standardization and liquidity in the secondary markets.

CMIs would be subject to a duty to serve all markets at all times in a fair and equitable manner. This would include—as appropriate—the securitization of products with well understood risk characteristics to advance this goal, including the securitization of certain multifamily products. This duty would be greater than that imposed on other MBS issuers. Specifically:

- In addition to the general duty to serve imposed on all other MBS issuers, the CMIs would have a more specific duty to serve all markets, all areas, and to provide a counter-cyclical source of liquidity in the time of private sector withdrawal.
- Consistent with the obligations imposed on other MBS issuers, CMIs would be required to pay a small fee (millage) on each new MBS issue, which would fund an Affordable

Housing Trust Fund and perhaps other public purposes. (One potential issue with this fee—as applied to our CMIs—is that it might serve as a deterrent to investment capital. While this is an empirical question that is difficult to answer, we believe this concern is potentially a valid one, and would suggest that regulators should have the flexibility to reduce this fee for CMIs, should it prove to be a hurdle to obtaining necessary capital.)¹²

A limited portfolio would be maintained by CMIs, to the extent it served certain public purposes. These public purposes would be defined by the CMIs’ primary regulator, and would include the following:

- Activities in support of affordable multifamily housing—including mixed-income and mixed-use development and small multifamily—would be expressly permitted. In the current housing finance system, multifamily housing is largely financed by the GSEs. In the absence of any similar source of financing in a reformed system, this critically important area of housing is likely to be severely underfunded.
- Some amount of additional portfolio activity would be permissible to maintain capacity for crises and for incidental purposes.

Capitalization of the Chartered Mortgage Insurers

The success of our framework would rely in large part upon the ability of the new CMIs to attract sufficient levels of private investment capital. While the GSEs were always able to attract ample amounts of capital, our proposed CMIs could experience more difficulty in this regard, for a number of reasons.

First, while the CMIs would receive an explicit government guarantee, this would be limited to the MBS they issued, and would explicitly not apply to their debt and equity. Second, in exchange for this limited backing, CMIs would assume certain public purpose obligations, such as the duty to remain in markets when economic conditions deteriorate, that would limit their profitability. Third, CMIs would be required to maintain both regulatory capital reserves and pay into a Taxpayer Protection Insurance Fund to limit taxpayer exposure to losses. Finally, CMIs would see regulated returns, which obviously cap the expectations of investors.

Because our framework contemplates that the CMIs’ regulator would be charged with ensuring that CMIs earn sufficient profits to attract the necessary private investment capital, and provides flexibility to adjust specific regulations achieve that result, our expectation is that the combination of the government guarantee of MBS—which would be available only to MBS issued by the CMIs—the increased regulation of other MBS issuers, and a reasonable rate of return will attract sufficient capital to support at least two CMIs. Assuming that some portion of the \$5.4 trillion in assets held by Fannie Mae and Freddie

Mac are available to help capitalize new CMI, we have some confidence that sufficient capital will be available to allow a robust origination and securitization system to emerge.

That said, we offer this framework to begin a discussion. We are eager to learn from capital market participants about the feasibility of this aspect of the framework and what conditions would be essential to attract private capital.

Uniform comprehensive oversight of all MBS issuers

Our framework is predicated on the principle that the regulation of similar activities performed by different mortgage market players must be harmonized. We believe that any regulatory reform of the mortgage finance system should include uniform comprehensive regulation for any institution that seeks to securitize U.S. mortgages. This framework implies a comprehensive risk regulation regime, similar in some ways to the way that banks are regulated, for all issuers of securities substantially based on U.S. residential mortgages.

This regulation would include strict limitations on the types of MBS that could be issued and the types of mortgages that could be securitized, with an emphasis on only allowing “safe” mortgages to have access to the secondary markets. Importantly, this is distinct from the products that the CMIs would be allowed to issue, where the predominant considerations would be not only safety, but also affordability and public purpose. Similar to the prudential regulatory regime currently in place for banks, any private institution seeking to issue securities based substantially on single-family home mortgages would be subject to comprehensive regulation. Specifically:

- Regulation would apply to securitization of all mortgage types and amounts.
- Approval would be required to issue all mortgage securitization—including jumbo mortgage-backed securities—to level the playing field and eliminates any potential competition from unregulated actors.
- A strong prudential risk oversight regime would be paramount, including rigorous capital and risk standards requiring risk-based capital levels to be harmonized with those of the Chartered Mortgage Issuers to avoid the “race-to-the-bottom” problem alongside robust product regulation so that only a limited number of safe product types would be allowed to be securitized. This might also bolster liquidity by providing a measure of standardization and promoting investor confidence in the integrity of both the instruments and the issuers, thus allowing deeper trading in the secondary markets.
- Some form of “skin in the game,” or a retained risk requirement, for all mortgage originators.

- Standards for acceptable underwriting and mortgage characteristics, perhaps developed in conjunction with regulators at the origination level—including the proposed Consumer Finance Protection Agency. These standards would require a limited and tailored obligation to provide broad and non-discriminatory access to credit, based on the products being securitized by the issuer. This would also level the playing fields between MBS issuers, CMI, and portfolio lenders—banks and thrifts—since the latter two also have a similar affirmative obligation under our framework.
- A small fee on each MBS issue would be accrued and allocated to support the Affordable Housing Trust and Capital Magnet Funds to provide subsidies for affordable housing efforts, and perhaps for other purposes.

Providing access to affordable credit through a variety of approaches

Under our framework, affordable homeownership would be promoted through a number of different channels, including Ginnie Mae. This government agency would continue in its role of securitizing FHA and other government insured loans designed to promote affordable homeownership and multifamily housing for lower-income and underserved households and as a countercyclical backstop.

Another avenue for providing affordable housing finance would be a requirement, imposed on all MBS issuers,¹³ to demonstrate that they are providing broad access to credit—specifically that they are securitizing mortgages, both nationally and in the majority of states in which they operate, in a manner that equitably serves underserved areas, including lower income, rural and minority areas. This obligation is meant to complement and enhance, rather than replace, the obligations of banks and thrifts under the Community Reinvestment Act. An obligation of participants at the secondary market level to provide a market for primary market products serving underserved communities would amplify the effectiveness of the obligations in primary market.

At the same time, we expect there to be few situations in which a single entity would be subject to both CRA requirements—CRA applies to banks and thrifts (and their subsidiaries). Based on prior experience, we expect that most registered MBS issuers will be neither banks nor thrifts nor their subsidiaries. If such situations exist, the relevant regulator will be expected to administer the regulations in a complementary manner.

Another way we envision providing affordable credit to the mortgage market is through direct investment by CMIs for their portfolios. We propose that CMIs be allowed to directly invest in and retain certain products, authorized by their regulator and meant to serve certain public purposes, including the provision of countercyclical liquidity and liquidity for multifamily housing.

Importantly, unlike for the GSEs in the past—up until they were placed into conservatorship—the CMIs would not have an implicit guarantee on their debt, thus limiting both the scope of their potential direct investment activities and the risk from these, but also the potential public benefits. Further analysis of this mechanism is required.

Finally, we propose that a fee be levied on every MBS transaction, which would be used to fund the Affordable Housing Trust and Capital Magnet Funds or to finance different affordable housing initiatives.¹⁴

Measuring efforts to serve underserved communities

Our proposed framework envisions that all MBS issuers would be subject to a general duty to serve underserved communities. Beyond this obligation, CMIIs would be required to undertake certain enhanced duties in return for receiving a government guarantee on their MBS, providing them with a cost advantage in the capital markets, and access to a market limited to other firms similarly situated with high barriers to entry. This section first lays out some early thinking on how to determine whether other MBS issues are satisfactorily meeting the more limited duty, and then examines the differences between these general obligations and the additional duties imposed on CMIIs under our proposal.

As an alternative to the strictly numerical benchmarks that currently determine whether the GSEs meet their obligations to provide broad access to credit, our framework suggests an analysis that would be both quantitative and qualitative. Central to this analysis would be a quantitative evaluation of how an issuer's share of underserved markets compares to its shares in the rest of the market, taking into account any differences among issuers. No firm would flunk based on quantitative measures alone, and no firm would be required to carry out any activities that would jeopardize its safety and soundness. Our analysis would include the following considerations.

- **First order assessment of compliance.** We assume at the outset that mortgages originated for securitization will meet any guidelines set by regulators of the origination process—including a Consumer Financial Protection Agency—and that the primary responsibility of enforcing origination-level standards will rest with those regulators. But should an MBS issuer habitually or seriously violate origination-level rules prohibiting discrimination, unfair and deceptive marketing practices, unsafe products, or other requirements that protect underserved communities, then we would consider that issuer to have failed this duty to serve analysis.
- **Quantitative consideration.** Here we would examine how the issuer's securitization activities in underserved areas compare to the national average (for non-CMI issuers).¹⁵ We would look at what percentage of the issuer's overall securitization activities (by number of mortgages securitized, not dollar amount) fall into underserved markets (both nationally and in each state) and how this compares to the underserved share of the market for all other non-CMI issuers.

- **Qualitative consideration.** If the issuer’s securitization activities are insufficient from a purely quantitative measurement in broadly serving underserved markets, then we would examine whether the issuer is enhancing access to credit in underserved markets in other ways, such as through developing securitization techniques that are particularly effective in serving these markets or through its support—via participation in deals, investments and grants—of other organizations that effectively serve these markets. Providing financing for affordable multifamily housing or financing or other support for third parties such as Community Development Financial Institutions that serve the multifamily housing market would also receive favorable attention with extra weight given to below-market-rate funding.
- **Qualitative consideration.** If the MBS issuer has fallen short on both a quantitative and qualitative measurement in meeting its obligation to provide credit to underserved markets, we would examine other factors that perhaps should be taken into account. Acceptable explanations may include an issuer’s product mix or a lack of profitable market opportunity, but the burden of proof should fall on the issuer.

If an MBS issuer were to “fail” this evaluation, it would be penalized with heightened requirements to serve underserved communities, including through grants, volunteering, counseling, and/or the payment of substantial additional fees into the Affordable Housing Trust or Capital Magnet Funds. In egregious cases, the issuer could be barred from issuing MBS. Substantial penalties for failure would be designed to discourage firms from electing to pay penalties rather than strive to satisfy the duty to broadly serve mortgage markets.

Transitioning to a new housing finance system

Once a framework is established for the housing finance system of the future, policymakers must determine how to transition from the current system of intensive government support through FHA and the GSEs in conservatorship to the new framework. There are many separate transition issues, but in this section we examine only a few of the key issues that must be addressed during the transition, including loan limits and market demarcations.

Transition issues

First, policymakers should ensure that their discussion of possible future arrangements does not have a destabilizing effect upon the current system, reducing investor demand and the broad liquidity provided by the housing finance market. The GSEs are currently essential tools of federal policy, providing an enormous amount of liquidity in support of the federal government's efforts to stabilize the housing markets. Investor appetite for the MBS issued by Fannie Mae and Freddie Mac helps to finance the significant borrowing of overseas' capital by the U.S. government, providing an outlet for foreign investors to invest the excess dollars accrued by our significant current account deficit. Any abrupt disruptions could affect the balance of payments and global macroeconomic stability. Policymakers must take special care in debating policy options to avoid unsettling markets which are still fragile during the ongoing housing market weakness.

Another priority should be the maintenance of the GSEs' capacities during any transition to a new housing finance system. Both Fannie and Freddie have extensive infrastructure, resources, and expertise that would be extremely valuable in sustaining a system that serves many of the public purpose objectives we argue are paramount. For the stability of the housing finance markets, as tools of public policy in the current conditions, and in the interest of efficiently building a new system in the future, preservation of the human capital, intellectual property, systems, and other capacities of the GSEs is in the public interest. The lack of certainty about the GSEs' future, however, puts some of these assets at risk. When market conditions further improve, human capital retention will be an even greater problem. As much of federal mortgage market policy is currently delivered by the GSEs, policymakers should attend to the challenge of preserving these GSE assets.

The second question involves the role of Fannie Mae and Freddie Mac in the system of the future. Both GSEs have significant experience at the intermediation between the conforming mortgage markets and the investor community, promoting affordable homeownership, and investing in multifamily housing equity and debt—all priorities under our proposed reforms. Fannie and Freddie could eventually be unwound, as many experts have suggested, through a “good bank” “bad bank” model, although this has many limitations.

Alternatively, the assets of the companies could be made available to new CMIIs and other MBS issuers in a future system. Another possibility is that of Fannie and Freddie emerging under new governance and charter obligations to assume a role as CMI, as described above. In any of these visions, great care must be taken to transition from the status quo to the future without significant disruption to the availability of mortgage credit.

In an October 2009 analysis, Credit Suisse argued that a restructured Fannie Mae and Freddie Mac should be relied on as principal participants in any reformed housing finance system because of their resources in these areas, and the need to maintain continuity to promote investor confidence and market liquidity. Alternatively, the Mortgage Bankers Association’s Council on Ensuring Mortgage Liquidity proposed that Ginnie Mae or a similar agency provide a government guarantee on MBS issued by private institutions in the conforming market.

The issue of the future of the GSEs is made even more complicated by the political debate surrounding their role in causing the housing crisis. The primary focus of our Mortgage Finance Working Group is on ensuring the new housing finance system provides not just liquidity but affordable access to credit and systemic risk-taxpayer risk reduction. To the extent the GSEs can be retooled and redirected to meet the future system objectives while correcting some of the governance and risk management infirmities of the system of the past, then it is worth considering some continuing role under different ground rules for the GSEs or their successor firms as CMIIs.

Loan limits and market demarcation

Within the larger issue of how to transition from the status quo to a new and reformed housing finance system lies the question of what the proper loan limits for what were once called “conforming” loans should be in a future, more stable, residential finance market. As part of its efforts to combat the housing crisis, the federal government significantly raised the loan limits for mortgages that could be insured by FHA and securitized by Fannie Mae and Freddie Mac to provide liquidity for higher-priced mortgages that are currently not being supported by private markets.

In setting loan limits at any time, policymakers should aim to restrict government backing to those areas and activities that serve an articulated public purpose, while limiting excessive risk to the federal balance sheet. Government involvement in housing finance was

never intended to subsidize housing finance across the entire market, but rather to support liquidity in certain areas and products that serve the goal of expanding affordable homeownership—to the extent that private markets are not already providing such liquidity.¹⁶ At the same time, protecting taxpayers from risk is an important consideration.

Given the current illiquidity in the private MBS markets, a temporary increase in the loan limits is appropriate because it serves the public purpose of preventing a broad collapse in housing markets and supporting the fragile housing finance system. But when liquidity returns to the private markets, government support should be scaled back to those areas where it serves public purposes so that taxpayer backing for larger mortgage levels except in higher cost areas should be scaled back as well.

We envision an eventual reduction in loan limits for FHA and for the GSEs—or their successors— so that these institutions return to serving their historical share of the market. FHA loan limits should therefore decline to a lower level than the GSE (or CMI) limit, with that level to be determined keeping in mind the need to ensure the overall risk borne by FHA. Simply put, once the liquidity crisis ends, we do not believe there is a convincing argument that a public purpose is served by continued government support of the highest priced segments of the mortgage markets.

In addition to the inconsistency of having the government support affordable housing finance for high-priced homes, during normal times, this spectrum of the housing market has historically not suffered from illiquidity. Traditionally, the areas of the market now being served by the expanded loan limits for FHA and the GSEs functioned effectively without government backing. Private lenders were able to lucratively fill this market niche. Moreover, the high end of the housing market already enjoys significant benefits from interest and property tax deductibility.

There are also important considerations of risk exposure that argue for the eventual reduction of loan limits, once we emerge from the current downturn. As some have argued, government backing in the higher end of the mortgage market may well expose taxpayers to greater risk because of the greater price volatility, the higher potential loss severity and because such activity leads to greater concentration of risk in more expensive homes and in certain geographic areas. While there is insufficient data at this point to definitively know whether these claims have merit, at the very least operating in the higher end of the market carries with it a great deal of uncertainty, which seems problematic given that this uncertainty is related to taxpayer exposure.

Lower loan limits over time should not prevent the CMIs and FHA-Ginnie Mae to play traditional countercyclical roles that have proven so important to macroeconomic stability. Putting this determination in the hands of regulators based on prescribed market conditions might also provide some market confidence. So to the extent that housing market disruptions occur and liquidity once again is limited for mortgages for homes in higher

cost areas, the framework envisions that a regulator would have emergency authority to raise loan limits upon a declaration that a public benefit would be achieved by temporary increases.

A variant of this idea would be a loan limit that floats with market liquidity conditions. We assume, however, that a broader market will evolve if the structure of the mortgages that are securitized is more consistent over time, rising significantly only in times of housing market stress. The emergency authority to increase loan limits would apply to limits for both FHA and the CMLs and could be exercised only when regional or national credit market conditions deteriorate significantly, such as during the current severe downturn

Avoiding mistakes of the past, protecting taxpayers

Our proposed framework is designed to ensure that taxpayers are not subject to loss from the government's role in support of the housing markets, except in the event of truly catastrophic housing market conditions. Taxpayer risk is addressed through a number of different mechanisms, among them:

- Reducing the risk of a future housing bubble and mass mortgage defaults.
- Implementing greater protections where the taxpayer has exposure.
- Realigning the incentives of lenders.

We consider each of these in turn.

Measures to reduce the risk of a future housing bubble and mass mortgage defaults

Taxpayer exposure in the current mortgage crisis has primarily arisen out of losses at financial institutions deemed too systemically important to be allowed to fail as well as at the GSEs, Fannie Mae and Freddie Mac. Both sets of institutions suffered heavy losses from their high levels of exposure to privately securitized MBS. As monoline mortgage enterprises, Fannie and Freddie also suffered outsized losses because of their concentrated exposure to the U.S. mortgage markets, which saw asset values collapse rapidly across the board as the bubble burst. In short, taxpayer bailouts were the result of the mass origination of unsustainable loans and a related housing bubble of inflated housing prices fueled by easy credit.

The framework we propose would mitigate against the problem of housing bubbles, first and foremost by bringing the unregulated sector of the mortgage markets—the private label securitization process that was the primary driver for the mass origination of unsustainable credit—under the same regulatory umbrella as other sources of housing finance. Leveling the regulatory playing field would prevent a flood of investor capital to unregulated areas of the market.

Our framework also would reduce the likelihood of housing bubbles by limiting access to the secondary markets to safe mortgage products. Mortgage products that did not meet

this criterion could only be made by banks, thrifts, and others who held whole loans for their own portfolio. As a result, mortgage lenders would be more judicious in evaluating risk and conducting underwriting than they have been with mortgages originated for the securitization pipeline.

Implementing greater protections where the taxpayer has exposure

The combination of regulating private issuers of MBS and implementing a new systemic risk oversight regime—as the Obama administration proposes—should reduce the taxpayer’s exposure to systemically significant financial institutions—except when there is a federal guarantee provided, such as would be enjoyed by our proposed CMIs. Our framework would limit taxpayer exposure on CMI losses in four important ways that the current regulatory framework does not currently do with respect to the GSEs.

First, our framework would limit CMIs to securitizing loans that were safe and sustainable—with known risk characteristics—and which advanced the goal of expanding homeownership or the availability of affordable rental housing.

Second, a small fee would be levied on each new MBS offering made by the CMIs, which would go towards a Taxpayer Protection Insurance Fund. This fund would buttress the capital reserve requirements of the CMIs, limiting potential taxpayer risk.

Third, the portfolio activities of the CMIs would be limited. A substantial portion of the losses currently being borne by the GSEs is the result of losses on loans and MBS they purchased for their own portfolios; limiting portfolio investment for the CMIs would reduce their potential losses accordingly.

Finally, the government guarantee would be explicit and only apply to MBS issued by the CMIs. It would not cover their debt or equity. As such, the government’s exposure would be limited to the MBS issued by the CMIs.

Realigning the incentives of lenders

Finally, we believe that our framework also serves to realign the basic incentives of key financial institutions in the secondary markets, including the CMIs and other MBS issuers, reducing risk across the board. CMIs would see regulated returns, and as a result they would not have the same incentives to maximize yield, meet market earnings expectations, and compete for market share, which led the GSEs to take excessive risk during the height of the credit bubble.

On the contrary, we believe that the combination of regulated returns with strict product regulation would motivate CMI managers to place much greater emphasis on long-term sustainability, so as to limit risk and the possibility of large losses that could jeopardize their standing. Given the benefits of an explicit government guarantee, we believe that such a change in incentives is appropriate.

The basic incentive structure would also change for other mortgage issuers, who also would be limited to securitizing safe and sustainable mortgages—again, it should be noted that this is a broader set of mortgages than the CMIs could securitize. As a result, MBS offerings could not once again become a source of high-risk, high-yield profits. Riskier mortgage products would be confined to the portfolios of lenders willing to absorb their risk, a prospect we believe would lead to more appropriate standards of underwriting and risk evaluation than the current *laissez faire* approach to mortgage securitization encourages. As a result of these realigned incentives, our framework would lead to the origination of more sustainable loans across the mortgage finance system, reducing the risks of gross imbalance that fueled the last crisis.

Conclusion

This draft white paper presents a framework that is designed to advance some policy goals that the participants in our Mortgage Finance Working Group believe must play a greater role in the public discussion than they have to date. But the framework is nonetheless a work in progress. We circulate this draft for initial comment and then will reconvene to consider what we learn before finalizing and publishing any proposal or recommendations. We hope our contributions today and in the future will advance the deliberations of policymakers that must follow greater normalization of economic conditions and the housing markets.

Membership of the Mortgage Finance Working Group

David Abromowitz, Senior Fellow, Center for American Progress. David, a partner at the law firm Goulston & Storrs, has received numerous awards for his housing work, and recently co-chaired the Housing Policy Working Group for Governor-elect Deval Patrick of Massachusetts. He serves on a number of key advisory boards, including the National Housing and Rehabilitation Association and the National Association of Homebuilder's Multifamily Leadership Board.

Conrad Egan, President and CEO, National Housing Conference. Conrad has held numerous positions with the U.S. Department of Housing and Urban Development dating back to 1969, most recently as special assistant to Clinton administration HUD Secretary Henry Cisneros, and was also executive vice president at NHP Inc., at the time one of the nation's largest multifamily enterprises. From 2001-2002, Conrad served as executive director for the Congressionally-created Millennial Housing Commission.

Ellen Harnick, Senior Policy Counsel, Center for Responsible Lending. Prior to joining CRL, Ellen was a commercial litigation partner in the New York law firm of Friedman Kaplan Seiler & Adelman LLP. She has a wide array of other leadership positions, particularly in the area of international law and economics, including a consulting position with the U.S. Agency for International Development to develop the mortgage market in Bosnia and Herzegovina.

Andrew Jakabovics, Associate Director for Housing and Economics, Center for American Progress. Andrew is well known for his work on housing and economics, most recently for his research on the effects of the current mortgage crisis and potential policy solutions. Prior to joining CAP, he served as the research chief of staff for the Center for Real Estate's Housing Affordability Initiative at the Massachusetts Institute of Technology.

Paul Leonard, Director, California Office, Center for Responsible Lending. Paul has had a distinguished career in housing, community development and social welfare policy, having held leadership positions at the Alameda County Social Services Agency in California and the U.S. Department of Housing and Urban Development, as well as working as an independent policy consultant immediately prior to joining CRL.

Adam Levitin, Associate Professor, Georgetown University Law Center. Adam's academic work focuses on the role of financial institutions in the business and credit economy. He also serves as Special Counsel for the Congressional Oversight Panel, and as Robert Zinman Resident Scholar at the American Bankruptcy Institute. Before joining the Georgetown faculty, he practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges LLP, and as law clerk to the Honorable Jane Richards Roth on the United States Court of Appeals for the Third Circuit.

David Min, Associate Director for Financial Markets Policy, Center for American Progress. Before coming to CAP, David served as Senior Policy Advisor for the Joint Economic Committee of Congress and Banking Committee Counsel to Sen. Charles Schumer (D-NY). He previously worked as an associate at the law firm Wilmer Hale LLP and as a staff attorney in the Enforcement Division of the Securities and Exchange Commission.

Shekar Narasimhan, Managing Partner, Beekman Advisors. Shekar was formerly managing director for Agency and Funds Management at Prudential Mortgage Capital Company, and chairman and CEO of The WMF Group, Ltd., a commercial mortgage company. He currently serves as treasurer for the National Housing Conference and on a number of advisory Boards, and was formerly chair of the Mortgage Bankers Association's Commercial/ Multifamily Board of Governors and the Campaign for Affordable Housing.

Janneke Ratcliffe, Associate Director and Community Development Research Associate, UNC Center for Community Capital. Before coming to the Center, Janneke was executive director of a small business lending nonprofit, and previously spent 10 years in GE Capital's mortgage subsidiary and seven years at one of the country's leading community development financial institutions, helping to launch a multibillion dollar secondary market for affordable home loans and other initiatives under the innovative New Markets Tax Credit Program.

Benson "Buzz" Roberts, Senior Vice President for Policy and Program Development, Local Initiatives Support Corporation. Buzz directs LISC's activities in public policy and research, and was involved in the creation of such federal policies as the Low Income Housing Tax Credit, the New Markets Tax Credit, and the HOME housing development program. He is a board member of the National Association of Affordable Housing Lenders, the National Housing Conference, and the New Markets Tax Credit Coalition.

Ellen Seidman, Senior Research Fellow in the Asset Building Program at the New America Foundation. Ellen is also executive vice president at the ShoreBank Corporation's National Program and Partnership Development. From 1997 to 2001, Seidman served as director of the Office of Thrift Supervision, and has also been a director of the Federal Deposit Insurance Corporation, chairman of the Board of the Neighborhood Reinvestment Corporation, and senior counsel to the Democratic staff of the House Financial Services Committee. From 1993 to 1997 Ellen was special assistant for Economic Policy to President Bill Clinton, on the staff of the National Economic Council. She has also held senior positions at the U.S. Treasury and Transportation Departments, and at Fannie Mae.

Susan Wachter, Richard B. Worley Professor of Financial Management, The Wharton School of the University of Pennsylvania. Susan is internationally renowned for her academic work in mortgage finance, having published over 150 articles. Under President Clinton, she served as assistant secretary for Policy Development and Research at the Department of

Housing and Urban Development. She has also served as chair of Penn's Real Estate Department and as Co-Director of the Penn Institute for Urban Research.

Sarah Rosen Wartell, Executive Vice President, Center for American Progress. In the Clinton administration, Sarah served as deputy assistant to the president for Economic Policy and deputy director of the National Economic Council, and earlier as deputy assistant secretary of the Federal Housing Administration, U.S. Department of Housing and Urban Development. She also has served as a consultant to the Millennial Housing Commission and the William J. Clinton Presidential Foundation.

Mark Willis, Visiting Scholar, Ford Foundation. Mark spent 19 years at JP Morgan Chase & Co. overseeing its community development banking programs, time during which he founded the Chase Community Development Corporation, and served as president of the Chase Manhattan Foundation. Before joining JP Morgan Chase, he was Deputy Commissioner for New York City's Department of Housing Preservation and Development. Mark co-chairs Housing First! and has previously chaired the New York Community Investment Company and Consumer Bankers Association's Community Reinvestment Committee.

Barry Zigas, Director of Housing Policy, Consumer Federation of America. Barry, who also consults with foundations, nonprofits and others through his firm Zigas and Associates LLC, previously spent over a decade working at Fannie Mae, most recently as senior vice president, where he led the company's community lending initiatives. He has also served as president of the National Low Income Housing Coalition, and played a key role in passing the low-income housing tax credit and the National Affordable Housing of 1990. Barry serves as a Trustee of Enterprise Community Partners and on the boards of the National Housing Trust and the National Housing Conference.

Endnotes

- 1 To date, the Mortgage Bankers Association and Credit Suisse have issued public recommendations on reforming the housing finance system. See “MBA’s Recommendations for the Future Government Role in the Core Secondary Mortgage Market,” Mortgage Bankers Association, August 2009, available at <http://www.mbaa.org/files/Advocacy/2009/RecommendationsfortheFutureGovernmentRole.pdf>; and “Mortgage Market Comment: GSEs—Still the best answer for housing finance,” Credit Suisse Fixed Income Research, October 6, 2009 (only available to clients).
- 2 We use the term “government-sponsored entities” or “GSEs” in this document exclusively to describe Fannie Mae and Freddie Mac, while noting that there are other entities that fit this description, including the housing GSEs that constitute the Federal Home Loan Bank system. Our framework focuses primarily on the secondary markets, where the FHLBs play a lesser albeit significant role—insofar as they issue debt that enjoys an implied government guarantee to finance their liquidity activities—and so we have not directly addressed the question of what, if anything, should be done to reform the FHLBs or how this framework might affect their activities indirectly. The Center for American Progress expects to release a related paper describing the role played by the FHLBs in residential mortgage finance in early 2010.
- 3 These eight principles are: access to credit and liquidity; countercyclical; risk management and oversight; standardization; transparency and accountability; systemic stability; enhanced consumer protection; and equitable and fair access to credit for consumers and communities. These principles are described in greater detail at http://www.americanprogress.org/issues/2009/03/mortgage_finance_principles.html.
- 4 Of the more than \$400 billion a year in tax expenditure that supports homeownership, retirement savings, and investment, 90 percent goes to families in the top 20 percent of the income distribution, while less than 3 percent goes to families in the bottom 60 percent. See Lillian Woo and David Buchholz, “Subsidies for Assets: A New Look at the Federal Budget,” CFED, Washington, DC, February 2007, available at <http://www.community-wealth.com/pdfs/articles-publications/individuals/paper-woo-buchholz07.pdf>.
- 5 Rick Brooks and Ruth Simon, “Subprime Debacle Traps Even Very Credit-Worthy,” *The New York Times*, December 3, 2007, available at <http://online.wsj.com/article/SB119662974358911035.html>.
- 6 This is intended to be interpreted broadly, and include not just mortgage-backed securities, but other financial products predominantly based on mortgages. The goal of such broad coverage is to ensure that mortgage financing in the secondary markets is regulated uniformly, and does not result in a “race to the bottom.” We are seeking to prevent a situation where MBS are overseen appropriately for risk, but CDOs and CDSs or other instruments are not, leading to distortions as in the recent crisis.
- 7 Ginnie Mae also securitizes other government loans, such as mortgages backed by the Veterans Administration and the Office of Public and Indian Housing.
- 8 As acting FHFA Director Edward DeMarco noted before the Senate Banking Committee recently, the question of how to structure the role of government guarantees in the housing finance market is of paramount importance. One approach that Director DeMarco suggested was that of “having the government take a more limited catastrophic credit insurance position backing mortgage assets.”
- 9 Some suggestions made by members of our working group include possibly offsetting the CMI’s millage; to the extent they have provided affordable housing through other means; or gradually reducing the millage as the loan limits are reduced.
- 10 CMIs would have a heightened duty to broadly serve the markets.
- 11 Note that the CMIs’ obligation to pay these fees might need to be reduced, given their broad duty to provide liquidity and the need to raise sufficient private equity and debt to fund their operations.
- 12 Because CMIs will enjoy a heightened duty to serve, we would only consider non-CMI issuers, to allow for an apples-to-apples comparison.
- 13 The wide availability of the 30-year fixed-rate mortgage is one notable and successful product of such limited government support.
- 14 It is important to remember that in the absence of countervailing efforts by FHA, originating lenders have incentives to operate in the higher end of the FHA loan ranges, because their fees are earned on the basis of loan size and because small loans and big loans take roughly the same amount of effort to originate and service, resulting in higher earnings for larger loans. FHA balanced the scaled by allowing originating lenders to earn higher fees on loans originated at the lower end of the scale, and incentives such as these must not be lost sight of when considering the question of loan limits; The FHA’s explicit government backing was historically confined to lower loan limits, to ensure that it served the low and middle end of the market where its explicit government backing was most needed. The implied government backing of the GSEs Fannie Mae and Freddie Mac was similarly limited, to avoid having the government subsidize the purchase of high-priced homes.
- 15 FHA provides a 100-percent loan by loan guarantee, buffered by a Mutual Mortgage Insurance Fund designed to protect the taxpayer from losses. As outlined in our framework, the government would provide a 100-percent guarantee on the timely payment of interest and principal on CMI-issued MBS, with CMI capital and a systemic risk fund serving as a buffer against taxpayer exposure.
- 16 Comparing OFHEO/FHFA price index to Case-Shiller finds that OFHEO index is much less volatile. One big difference is that OFHEO/FHFA index is based on conforming loans acquired by Fannie/Freddie, while Case-Shiller includes higher cost loans as well as more exotic loans. The Case-Shiller index is also “value-weighted” so that larger value homes have more relative influence on the index. See picture attached at end of this report.

Notably, when the Federal Reserve switched revised total real estate holdings for U.S. households in its Flow of Funds report B.100 by switching from using the OFHEO index to using an alternative that encompasses non-conforming loans as well as loans within the Fannie/Freddie limits, the changes were substantial (See <http://www.federalreserve.gov/releases/z1/20081211/z1r-1.pdf>, revision note #7). In the original reports, based on OFHEO’s index, household real estate values were calculated to peak at \$20.16 trillion in Q22007, and to have fallen by \$730 billion by a year later to \$19.43 trillion. The revised calculations show an earlier and much higher peak (\$21.89 trillion, in 2006), and a much bigger fall of \$2.23 trillion by Q22008, and continued total declines into the first quarter of 2009 of 4.4 trillion (to 17.94 trillion).

Also informative, is a paper by Ambrose, Buttimer and Thibodeau, *A New Spin on the Conforming/Jumbo Loan Rate Differential* (2001 Journal of Real Estate Finance and Economics). Following a single market (Dallas) from 1980 to 1997, they find nonconforming real estate values to be more volatile than conforming property values. Though the relative volatility fluctuated considerable over that time period, for the entire period, “House prices for properties typically financed with non-conforming loans were 25% more volatile than properties typically financed with conforming loans,” p.320.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is “of the people, by the people, and for the people.”

