S. HRG. 113–190

HOUSING FINANCE REFORM: DEVELOPING A PLAN FOR A SMOOTH TRANSITION

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING VARIOUS OPTIONS FOR A TRANSITION TO A NEW HOUSING FINANCE SYSTEM THAT ACHIEVES THE ACCESSIBILITY, AFFORDABILITY, AND STABILITY GOALS OF HOUSING FINANCE REFORM WHILE MINIMIZING DISRUPTIONS TO BOTH THE PRIMARY AND SECONDARY MORTGAGE MARKETS

NOVEMBER 22, 2013

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C O N T E N T S

FRIDAY, NOVEMBER 22, 2013

HOUSING FINANCE REFORM: DEVELOPING A PLAN FOR A SMOOTH TRANSITION

FRIDAY, NOVEMBER 22, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. The Committee will come to order. Today we continue our series of hearings to better inform the Committee's efforts to reform our housing finance system. While we have spent time examining what the different components of a new system should look like, today we focus on how to develop a credible plan that will seamlessly transition us from the current system to the new one.

This is a critical issue, especially as we consider the significance of the housing market to the overall economy. If the transition is not properly managed, or does not have enough flexibility built in, then we are asking for trouble and we could end up with potential market disruptions, which would impede economic growth. That is the last thing we want.

There are a number of transition issues worth discussing, starting with how best to wind down Fannie Mae and Freddie Mac while we build a stronger system. A key goal is ensuring taxpayers are fully repaid as we also consider what well-functioning systems and assets could be utilized in a new system. We should seek to find options that make the best use of existing resources to avoid making the transition needlessly inefficient, costly, and complex.

We also need to examine the timing and sequence of the transition plan. There should be transparency with respect to the details of the transition to provide market participants the certainty they need to make long-term plans and decide what roles they may want to play.

While there should be clear goals to make sure we eventually reach the desired outcome, we should also consider allowing for some overlap so that the new system is well-tested and fully functioning before we turn off the lights on the old system. There is simply no need to roll the dice when we are talking about nearly 20 percent of our economy.

A few other questions to contemplate: What is the best way to verify that risk-sharing structures work and sufficient private capital is able to provide mortgage credit through good times and bad? What kinds of emergency powers are needed to deal with unforeseen events during the transition and minimize market disruptions? If a common securitization platform will help deliver a single security, should the platform be fully operational before shutting down the old system? And what steps are needed to make sure legacy MBS issued by Fannie and Freddie do not become orphaned?

Given our witnesses' expertise in housing finance, as well as some of our witnesses' experiences managing other transitions, I look forward to hearing their views on these important questions and other issues. With that, I turned to Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. The issue of how we transition into a future system is one of the most important topics we will cover in this series of housing finance reform hearings. Numerous challenges will face our regulators and market participants as we move toward a new housing finance system.

These challenges are real and must be addressed. But they must also be weighed in the context of the consequences of the status quo. The status quo means Government control of nearly all of our Nation's mortgage-backed securities market, stifling financial innovation. The status quo means little, if any, reduction in the $5 trillion of outstanding mortgage debt to which the taxpayer is currently exposed.

The status quo means continued legal and market uncertainty, creating costs that we may be realizing for decades to come. These realities prove that inaction carries its own dangers in our housing market, as does action that merely gives the appearance of change without recognizing the mistakes of the past.

With that in mind, I look forward to hearing from our witnesses regarding issues we need to consider, and recommendations they have to most effectively transition to a reformed system. During yesterday's hearing, we heard recommendations on how to best equip the future regulator to meet the transitional issues it might face in preparing to assume its responsibilities.

I expect that today's hearing will give us the opportunity to pair the lessons learned yesterday with today's relevant information, particularly as it pertains to how to handle the assets of Fannie Mae and Freddie Mac. As we proceed with this discussion, there are many questions that must be considered, such as, while Fannie and Freddie are unique institutions, what do past experiences suggest are processes to maximize the return on our investment for the taxpayer, while also minimizing disruption in our markets?

How do we allow adequate time to achieve and measure the appropriate benchmarks of the transition while still ensuring accountability in the process? What is the best way of dealing with the legacy obligations of Fannie and Freddie to ensure adequate protection for both taxpayers and investors?

While these questions do not represent an exhaustive list, they do provide an insight into the complexity that we must address. S.1217 seeks to address the questions we will face through a 5-year phase-in for the future regulator, FMIC. This phase-in would coincide with the beginning of a wind down of Fannie and Freddie supervised by the Federal Housing Finance Administration, or FHFA.

Once the 5-year phase-in is complete and FMIC becomes operational, Fannie and Freddie's charters would be revoked and they would cease writing new business. However, the wind down of the companies would continue, and during that time, the obligations of Fannie and Freddie would be explicitly guaranteed by the Federal Government, offset by a continued revenue stream from the companies.

Additionally, so long as FMIC did not believe any actions interfered with its duties, FHFA would be free to sell or transfer the assets and business lines of Fannie and Freddie to aid in their resolution. One suggested use for some infrastructure of these companies is to aid in the establishment of a small bank mutual company prescribed in S.1217. Another destination for this infrastructure is likely within the common securitization platform envisioned in the bill.

There has been much discussion of these concepts and other proposals for how Fannie and Freddie's assets might best be utilized in the future housing finance system. This discussion is productive and we must consider all perspectives so that we reach an optimal solution for consumers and taxpayers.

However, the consequences of inaction far outweigh the value of comprehensive reform. The status quo is not an option. We now have momentum of both houses of Congress and the White House working toward achieving real reforms. We must build on this momentum.

I welcome the views of all who seek to aid in this effort and look forward to the testimony we will hear today. Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo. Are there any other Members who would like to give brief opening statements? I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

I would like to introduce our witnesses that are here with us today. First, Mr. James Millstein is the Chairman and CEO of Millstein and Company. Previously Mr. Millstein served as the Chief Restructuring Officer at the Treasury Department.

Next will be Mr. John Bovenzi is a Partner of Oliver Wyman. Mr. Bovenzi served over 20 years in high-level positions at the FDIC and played a key role with the Resolution Trust Corporation. Next is Dr. Mark Zandi, Chief Economist at Moody's Analytics where he directs economic research encompassing macroeconomics, financial markets, and public policy.

And Professor David Min, Assistant Professor of Law at the University of California, Irvine School of Law. Previously Professor Min served as a staff attorney at the SEC and as counsel to Senator Schumer, and he helped the lead for American Progress Working Group to develop a housing finance reform proposal.

We welcome all of you here today and thank you for your time. Mr. Millstein, you may begin your testimony.

STATEMENT OF JAMES MILLSTEIN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MILLSTEIN AND COMPANY

Mr. MILLSTEIN. Chairman Johnson, Ranking Member Crapo, Senators Warner and Corker, thanks for inviting me here to testify on the transition.

I have spent the entirety of my 30-year professional career as a lawyer, investment banker, and as a public servant in doing corporate restructuring work. During the recent financial crisis, as the Chairman mentioned, I was the Chief Restructuring Officer at the Treasury Department where my primary responsibility was managing the restructuring and the exit from our substantial investment in AIG.

I also am an adjunct professor of law at Georgetown where I teach a course on the Federal regulation of financial institutions. I am here today because embedded in the task of reforming our Nation's housing finance system is a restructuring of the two largest players in that system today, Freddie Mac and Fannie Mae.

Because they are central to mortgage credit formation in the United States, winding them down, as some Members of Congress and the Administration have advocated, will have significant and, I believe, adverse consequences for mortgage credit availability and for the nascent housing and economic recovery.

Rather than winding them down, I urge you to consider a restructuring alternative that addresses the fundamental causes of the companies' insolvency, eliminates the private gain/public loss nature of their current Government charters, generates a significant profit to Treasury for supporting their solvency during the recent crisis, and most importantly, ensures a smooth transition to a new housing finance system that better protects taxpayers against future losses while providing for the continuing availability of mortgage credit to the creditworthy.

There appears to be a growing consensus in the policy community around the basic architecture of that new housing finance system. A Federal guarantee on qualified mortgage product is required to ensure the widespread availability of a 30-year fixed-rate product, and to sustain the deep and liquid mortgage securities funding markets that complement balancing lending for the banking industry.

The Government guarantee should be explicit, structured as reinsurance, priced at arm's length by an independent agency and available to reimburse investor losses only after a thick layer of private first-loss capital provided by well-capitalized mortgage insurers or subordinated capital provided by investors has been exhausted.

The Government reinsurer also needs to be a strong regulator with authority over all issuers, guarantors and servicers with whom it interacts in the new system. And I commend Senators Corker and Warner for having put together a coalition around a bill that has all of these elements in it.

However, the transition contemplated by the bill out of the conservatorships to this new system is fraught with danger and needs serious rethinking to mitigate three significant risks that any credible transition plan must address.

First, the fragile economic recovery cannot afford the risk of a significant disruption in mortgage credit availability. Second, the Government must end its ongoing backstop of Fannie Mae and Freddie Mac solvency and conservatorship in a way that minimizes the likelihood that Treasury will need to cover future losses on the $5.5 trillion of liabilities the Treasury now backstops.

While the substantial fees and net interest margin which the companies are currently earning and paying over to Treasury may look like an asset to be seized by taxpayers as the quid pro quo for the bailout, it could easily turn out to be a substantial liability if there were another significant housing downturn.

Third, there must be a credible path toward the development of the substantial layer of private first loss capital on which the functioning of the new system will depend. If you build the new Government reinsurer but the required layer of first-loss capital does not come in size or at a pace of your contemplated wind down of Fannie and Freddie, the whole system will shut down before it has a chance to start.

In my view, one fundamental choice will determine whether you successfully mitigate these risks in the transition. Do you recapitalize and privatize the guarantee businesses within Fannie Mae and Freddie Mac using their assets and operations to create a set of well-capitalized private market players who can ensure that sufficient first-loss capital is in place to allow the new system to function as contemplated?

Or do you make the bet that if you build the new reinsurance system, players yet to be named with capital yet to be raised will generate the sizable amount of first-loss capital required to make the new system function on the 5-year timetable that your bill would wind Fannie and Freddie down.

As currently drafted, 1217 chooses the latter course, and for that reason, I believe it puts the entire reform project at risk of failure. I appreciate the desire to avoid recreating the dangerous duopoly that contributed to the financial crisis and, unfortunately, I am running out of time, but I have laid out in my written testimony five or six steps that are all interrelated to avoid that outcome in connection with the privatization of the mortgage guarantee businesses, and I am happy to answer questions in the body of the hearing. Thank you very much.

Chairman JOHNSON. Thank you. Mr. Bovenzi, you may proceed.

STATEMENT OF JOHN BOVENZI, PARTNER, OLIVER WYMAN

Mr. BOVENZI. Good morning, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is John Bovenzi, a partner at Oliver Wyman, and I want to thank you for affording me the opportunity to be here to speak about housing finance reform.

My perspective draws on 28 years of experience at the FDIC and the Resolution Trust Corporation, and I would like to start with the RTC's experience in creating a new Federal agency. First, the RTC showed that it is possible to start a new Federal agency and be successful in a relatively short period of time.

However, stakeholders must have patience. The complexities of the issues that must be addressed virtually ensure that there will be bumps, missteps, and delays along the way. New agencies need governance structures, information systems, staff, policies, procedures. The FDIC was able to provide the RTC with a lot of support, but it was not nearly enough.

There was a great deal of frustration with the RTC early on, but some perspective is necessary. The RTC managed its way through those problems, saved taxpayers money, and finished its work early.

Second, the leadership is critically important. The person in charge needs to possess the skills to work effectively with a large number of stakeholders and the managerial skills to address the many operational issues faced by a new agency. Sometimes there is a tendency to focus on high-level policy issues and not give sufficient attention to the critical operational details.

Third, the employees of the two Government-sponsored enterprises in FHFA are the people who have the experience and the expertise to effectively transfer critical functions to a new agency. Their importance should not be undervalued or lost if Congress decides to move in this direction, because they are the ones who will ultimately determine success or failure.

Regarding the lessons that may be learned from the FDIC's experience, I would like to comment on three areas related to governance, financial strength, and supervision. First, independence in the system of checks and balances are two important features of the FDIC's governance structure. The FDIC's five-person Board of Directors and a strong Office of the Inspector General have served the agency well as part of an overall system of checks and balances, and those features have been included in the proposed structure for FMIC.

Second, much has been learned about what is required to maintain a strong deposit insurance fund. The FDIC's fund became insolvent during the two most recent financial crises. The agency had to substantially raise bank insurance premiums during these crisis periods when banks could least afford to pay them, and this, among other things, exacerbated the credit crunches that existed.

As a result, Congress granted the FDIC much greater premium-setting flexibility and the agency now has the authority to set the size of the deposit insurance fund high enough to withstand similar crisis periods. And FMIC would need sufficient flexibility and authority to manage the size of its fund so it, too, can protect taxpayers during economic downturns.

Third, the FDIC has a wide range of supervisory and enforcement powers. The proposed bill would grant some, but not all of these authorities to the FMIC. It is worth considering whether FMIC should be granted broader supervisory and enforcement authority.

Finally, I would like to make a few comments about the sales processes. The FDIC and the RTC experimented with a large variety of sales processes and learned much through trial and error. Two key principles emerged. First, virtually all sales were subject to inclusive, open, and transparent competitive bidding processes.

The RTC and the FDIC did not engage in negotiated sales with individual buyers, recognizing that open competition would maximize value and reduce the possibilities for fraud or abuse.

Second, the RTC and the FDIC partnered with the private sector in the disposition of many of their assets. Through loss-sharing transactions with healthy banks and equity partnerships with private sector investors, the agencies found they could benefit from the added value the right management could bring to those assets.

Thank you and I look forward to your questions.

Chairman JOHNSON. Thank you. Dr. Zandi, you may proceed.

STATEMENT OF MARK ZANDI, CHIEF ECONOMIST AND COFOUNDER, MOODY'S ECONOMY.COM

Mr. ZANDI. Thank you, Mr. Chairman, Ranking Member Crapo, Senators Corker and Warner, thank you for the opportunity to be here today. I am an employee of the Moody's Corporation, but my views are my own and not those of the Moody's Corporation. You should also know that I am on the Board of MGIC, the Nation's largest private mortgage insurance company. I am also on the Board of TRF, one of the Nation's largest CDFIs, so it is important for you to recognize the context of today's discussions.

Most fundamentally, a successful transition from the current housing finance system to the future system means that activities in the mortgage market cannot be disrupted. Mortgage credit must flow smoothly. This is, obviously, very key to the housing market, and by extension, the broader economic recovery. It is particularly important over the next several years as the economy continues to try to recover.

And because of the size of the U.S. mortgage market, it is key to the global financial system, and so it is very important that this all works out well; otherwise, we will disrupt a very important part of that global financial system. So this is a very important task.

Now, of course, any discussion of the transition process presupposes an end state for the future housing finance system, and I will say S.1217, the Corker-Warner legislation, has, in my view, a very good vision of where the system should go, a hybrid system with an explicit Government backstop to the system.

I think under this vision that is in the legislation, the 30-year fixed-rate, prepayable mortgage will remain a mainstay of the housing market and I think that is very important. It also ensures affordable mortgage loans to most middle income Americans through most economic times, and that is also very key.

I would like to suggest a few adjustments to S.1217 to help facilitate the transition process because it is so key, and I should say, there are a lot of moving parts here and a lot of things to consider. I am just going to consider a few things for you to contemplate.

The first is, I think there needs to be some flexibility with regard to the 5-year deadline. I think a hard and fast deadline in the context of the complexity of this process and the uncertainty involved creates some potential for disruption.

Moreover, you need to consider the economic environment and the environment in the financial system as this process unfolds. It may very well be the case that the day you want to switch on the lights to the new system the economic and financial market environment would not be conducive to that. So I think there needs to be some flexibility around this process, and I think the transition time line should be based on benchmarks, hitting certain targets, and I will mention two things that are very key.

One is a well-functioning operational common securitization platform. This is vital to any future housing finance system. If that is not up and running and working well, then the system will not operate well. So that is very important.

And I also would argue there needs to be a common security. This is becoming an increasing problem in the current—the way the system is currently designed, and this would also address some issues with regard to legacy MBS issues. So I think this is very, very important to consider in terms of transition.

The other adjustment I would make is that I think the move from the current capitalization of the system to the capitalization of the system envisaged in the future needs to be phased in over time and there needs to be some flexibility around that as well. So just based on my calculation, the current system is effectively capitalized to about a 2.5-percent loss rate. Under 1217, we envisaging a 10-percent capitalization.

Moving from 2.5 to 10, even under the best assumptions, and we have done a fair amount of calculations here, would add 40 basis points to mortgage rates, which in the grand scheme of things may not be a whole lot, but it will also be in the context of rising mortgage rates because of what the Federal Reserve Board is doing. So I think—and that is the minimum and assuming everything goes well in the transition process.

So I do think that there needs to be some flexibility with regard to how those capital levels are phased in. Also in that context, we are only talking about one part of the housing finance system. There are other parts that need to be calibrated to. You know, what is going on with regard to bank capital requirements, what is going on in the private level securities market, what are decisions being made by the FHA. So phasing in capital requirements are very important.

There are many other small adjustments I would make, but those are the two key things that I would focus on. I think they are very doable and at the end of the day, I think we will end up with a system that is meaningfully better than the one that we—certainly much better than the one we have now.

Thank you again for the opportunity to speak to you today.

Chairman JOHNSON. Thank you. Mr. Min, please proceed.

STATEMENT OF DAVID MIN, ASSISTANT PROFESSOR OF LAW, UNIVERSITY OF CALIFORNIA, IRVINE SCHOOL OF LAW

Mr. MIN. Chairman Johnson, Ranking Member Crapo, Senators Corker and Warner, thank you for the opportunity to testify today on this incredibly important topic. For the purposes of my testimony, I am going to assume that the system end state that we transition into will be some variation of S.1217, the bill proposed by Senators Corker and Warner.

I think that the Corker-Warner bill envisions a so-called hybrid system in which the Federal Government provides explicit and price reinsurance on mortgage-backed securities created by approved bond issuers in a model based loosely on the Deposit Insurance model, the FDIC. I believe that Corker-Warner provides a good framework for long-term housing finance reform, as I discuss in my written testimony, but the observations I make today hopefully hold true regardless of whether we go Corker-Warner or in some other direction.

As a threshold matter, I just want to note again, echoing some of the other panelists, how massive and complex this proposed transition will be. Fannie and Freddie currently account for more than $5 trillion in mortgages, and since the crisis, these enterprises have been responsible for more than 60 percent of new mortgage originations, about $1.7 trillion each year, an amount that is slightly more than 10 percent of GDP. These are the most systemically important companies we have ever attempted to resolve.

Now, the Federal Government has some experience in winding down large and systemically important institutions. AIG and GM are recent examples that come to mind. But here we are talking about winding down two massive and economically vital institutions, while simultaneously transitioning their core functions into a newly created set of institutions. I believe there is no precedent for this. And if we screw this transition up, we are talking about catastrophic damage to a very fragile housing sector and the broader economy.

So as a threshold matter, I believe the guiding principle for policy makers thinking about transition must be the same that governs doctors, do no harm. Avoiding the disruption in mortgage liquidity must be a paramount concern in structuring the transition from the current system to the future one.

We must also take steps to ensure that sufficient finances be available for affordable rental housing. In the aftermath of the financial crisis and housing crisis, policy makers have generally sought to deemphasize home ownership and shrink the Federal Government's footprint in housing. If we are successful in these objectives but unsuccessful in redirecting finance to rental housing, millions of working class households will pay the price.

With that in mind, I want to talk about the Corker-Warner transition plan which lays out a few detailed steps. The Corker-Warner bill contemplates a transition period of no more than 5 years following its enactment, during which time Fannie and Freddie would be phased out and the infrastructure for the new system, including the FMIC at the heart of the framework, would be established.

Upon enactment, Corker-Warner would eliminate the affordable housing goals currently in place and begin to gradually reduce the loan limits over time, along with their GSE portfolios. Once the FMIC is certified as operational, an event that must occur again within 5 years of enactment, Fannie and Freddie are to be dechartered on their outstanding legacy obligations explicitly guaranteed with full fit and credit of the United States.

At a high level, I think this plan provides a thoughtful template for transition, but leaves certain issues unresolved, several of which I identify in my written testimony. Like Dr. Zandi, I have a few recommendations I think that could help improve this transition.

First, I think we should delegate more responsibility to regulators and remove some of the predesignated timetables in place. In a number of ways, I think this transition plan in place seeks to micromanage the transition process. Specific timeframes are put in place for winding down the GSEs, lowering loan limits, and getting the FMIC up and running.

What we have seen, of course, is that, you know, the best laid plans do not always work the way we planned. Capital requirements are highly detailed in this plan, but I think that all of these things are highly complex and technical issues that are best resolved by regulators looking closely at accumulated data, rather than by legislation based on assumptions that may or may not turn out to be true.

Second, I think transition should be phased in over time, echoing Dr. Zandi, rather than through the on/off model currently contemplated. As recent events may highlight, unanticipated problems can and do arise, particularly with any transition as complex as moving trillions of dollars in mortgage origination finance from one platform to another.

We may end up flipping the switch on the new system, only to discover that the lights do not turn on. I believe a preferable approach is to adopt a phased-in approach or piecemeal approach to transition, turning over small, but increasingly larger parts of the mortgage markets to the new infrastructure.

For example, rather than preparing the CSP, Common Securitization Platform, to handle all the mortgage financed by GSE securitization, we could start with a dedicated subset, like 15-year fixed-rate mortgages or high-cost conforming mortgages. Such an approach, I believe, would allow regulators to test the new system in a meaningful way and develop that data that can help them perfect the new architecture. I think it would also help build investor liquidity in the MBS which is critically important.

Third, convert legacy securities into the new MBS. Make this an option. You obviously cannot force investors to do this. Fourth, preapprove the new MBS for use in markets like TBA, for use as collateral in markets like the Fed discount window lending, repo, and derivatives markets.

And finally, I think that the regulators need to be given more tools to prepare for another countercyclical downturn like we have today. Obviously, the role that Fannie and Freddie are playing today is critically important. I think regulators need more power to be able to deal with situations like these. I am out of time, so I apologize.

Chairman JOHNSON. Thank you all for your testimony. As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member. This is a question for Mr. Millstein, Dr. Zandi, and Professor Min. Mr. Millstein, what are the most important elements of wind down of Fannie Mae and Freddie Mac? And should the charters be repealed prior to the new system being fully tested and operational? Should it be a target-based or time line-based approach?

Mr. MILLSTEIN. I think it should be a target-based, not a time line-based approach, and as I said in my opening remarks, I think the wind down—I think you have two problems, and the biggest problem here is, you have got a new system you are building that requires a lot of first-loss capital. You cannot issue a new guarantee unless you have your first-loss capital in place. So there will be no guarantees in the absence of that capital being there.

Today, six out of ten mortgages in America are being provided by these two entities you are proposing to wind down. Getting the timing of that wind down right with the wind up of your new system, to me, is a very, very—you have made this more complex than it needs to be.

So what I have urged and what the plan I proposed suggests is, take the guts of the mortgage guarantee businesses of the two entities, capitalize them so they can play the role of first-loss provider in your system, and when they are properly capitalized—because today they have no capital other than the backstop from Treasury.

When they are properly capitalized, turn your system on, because now you have got your two—at least two, maybe four if you do it with the multifamily businesses as separated from the single family—you have four separate entities who can play the role of first-loss provider.

In that context, tear up their charters. They are no longer Government-sponsored enterprises. They are just private mortgage insurers competing with MGIC, Dr. Zandi's company, and every other private mortgage insurer for the business of acquiring and pooling mortgage loans into conforming MBS, and buying reinsurance from the Government.

Chairman JOHNSON. Dr. Zandi, do you agree?

Mr. ZANDI. I agree it should be a target-based time line or transition, not a time line-based transition. I mentioned a couple of benchmarks and targets that I would focus on, the common securitization platform being very important. That is key to allowing for bringing down the barriers of entry to allow more private capital to come in. So that needs to be operational, working well, and functioning properly before we can transition to the new system.

I mentioned the common security. I think that is also going to be quite important. That helps address also bringing down barriers to entry. It allows smaller lenders to participate in the system and that is going to be very key to this all working out well. And there are others, other key benchmarks. So I think it needs to be target-based.

I do think it would be, to answer your question explicitly about the charter, I think the approach I would take is to put the two institutions into receivership, take their assets, put them into a limited life regulated entity. This is a structure that was designed as part of the HERA legislation for this purpose. It allows the institutions to operate normally. Liquidity would continue to flow to the mortgage market. The market would not be disrupted, but the assets could then be deployed in a way to allow for a greater competition in the mortgage guarantee market.

The concern I have is that if we just take Fannie Mae and Freddie Mac, restructure them and throw them out into the world, that the world will be dominated by the entities that follow Fannie Mae and Freddie Mac. Nothing will change. It will be a duopoly or potentially even a monopoly and I do not think that is appropriate.

So I think we should take those assets and we should allow 1,000 flowers to bloom, allow other guarantors to come in, more private capital to come in, and they can license those assets in their own functions and it would create greater competition and ultimately a more resilient, better, stronger market at a lower cost to taxpayers and to mortgage borrowers.

Chairman JOHNSON. Mr. Min.

Mr. MIN. To answer your questions, I think it should be target-based. I am a little reluctant to say their charters should be repealed until we know there is enough liquidity in the rest of the system. We are in the aftermath, of course, of a 100-year flood. We are in a credit downturn.

It is not clear to me where the sources of private mortgage funding are going to come from right now. As I detail in my written testimony, bank deposits do not appear to be a likely source. Private label securitization, which was responsible for so much mortgage financing in the mid-2000s, has scaled back completely.

So I do not know where this is going to come from. I do not know how long it will take. I think we need to achieve those liquidity benchmarks. Just to give one anecdote on sort of the target-based versus time line, you know, the securitization platform, the common CSP, which Dr. Zandi described, is at the heart of this new plan.

It is necessary either for Corker-Warner or for the PATH Act; and yet, if you are following what is going on, it has been a year and a half after the FHFA first announced its plans to develop the CSP. We have had literally no movement. The last press release they issue announced that they had leased some office space. It does not appear that they have had a lot development toward that goal.

If that is the sort of timeframe we are looking at, we have to be cautious about proceeding ahead based on assumptions that things will happen that may take more time.

Chairman JOHNSON. Mr. Bovenzi, based on your RTC experience, to what extent should flexibility be built into the transition process to allow a regulator to address potential problems and to avoid market disruptions?

Mr. BOVENZI. Well, like the other speakers, I believe you need to build in a great deal of flexibility. Congress can set the basic parameters, but you cannot anticipate everything, and even if Congress could, facts change, markets do not stay the same and there will be new issues to address that could not really have been foreseen.

So I think the RTC experience shows that need for flexibility. They tried out some different things that did not work before finding out what did work for them. And it was not a smooth path for awhile, but it got to the right place. That flexibility was critical in getting there.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. Dr. Zandi and Mr. Millstein, the two of you have differing perspectives on how to best capitalize and establish a reformed market. But it seems to me, as I read your testimony, that there is an agreement between you that any current revenues of Fannie and Freddie should only be used to, either, one, repay the taxpayers or make the taxpayers whole, or two, offset the cost of backstopping and capitalizing a new system.

If I am correct about that, we have already seen this money used to offset a temporary tax cut and there are now other proposals out there advocating its use for other initiatives. I would like both of you to please elaborate on your views. Do I understand your testimony correct? Do you believe we should limit the utilization of these assets to either making the taxpayers whole and utilizing the necessary assets to capitalize a new system?

Mr. ZANDI. You have characterized my view accurately. I do not believe that it is appropriate to use these resources for other purposes, and I think they should be used to ultimately repay taxpayers. That is an open question, exactly what that means and how much that will cost.

And moreover, I do think it is undesirable to use Fannie Mae and Freddie Mac to generate revenues for other Government functions. The best example of that, of course, was the 10 basis point increase in the G-fee to help pay for the payroll tax holiday. I view that as a mistake, and hopefully we do not go down that same path again.

So I do not think that is the appropriate use of these institutions and the profits they are now generating. It should be used to repay taxpayers and used to help facilitate whatever future housing finance system we evolve to.

Senator CRAPO. Thank you.

Mr. MILLSTEIN. I agree with that. I think the alternative to the system we currently have where all of their profits are being swept into the Federal Treasury is, in effect, you are taxing the mortgage market to pay for other things. And here you are embarked upon a great legislative reform effort. These entities are producing $25 billion to $30 billion a year of cash-flow that can be used to recapitalize a grossly undercapitalized housing finance system.

It seems to me that as part of your reform effort, you should seize those revenues and use them for this public purpose of fixing the housing market.

Senator CRAPO. Thank you. And, Dr. Zandi, I noted in my opening statement that we cannot allow our legitimate concerns about unknowns to cause us to forget the equally legitimate concerns about the status quo. In your testimony, you laid out several of those concerns. Could you further expand on why you believe that inaction carries its own dangers?

Mr. ZANDI. Yeah. I think the current system is a real problem. You know, clearly, what we just discussed is an issue. As Fannie and Freddie continue to generate profits, the inclination will be to use that for other Government purposes, and again, I do not think that is appropriate. So that is clearly a risk.

And also, over time, with those profits getting incorporated into the budget and the budget process, that will make it more difficult to actually address the reform of Fannie Mae and Freddie Mac. So the longer it takes us to do this, the more difficult it will become.

Moreover, you know, the fact that Fannie Mae and Freddie Mac are in this limbo status is creating its own set of issues and problems. You know, increasingly over time, this will become more apparent. I will just give you an example of what I mean.

Right now, mortgage credit is very tight for potential first-time home buyers. The average credit score for someone selling a loan or purchasing a loan to Fannie Mae is 760. That means you have to be in the top third of the distribution of credit scores. That is not consistent with a first-time home buyer.

One of the reasons for that is because of rep and warranty policies between Fannie, Freddie, and the lenders, and this is not getting resolved, certainly not quickly enough, and one of the reasons I would proffer is because of this limbo status. So that is just an example of what I mean. There are many others that will become more evident going forward.

And then finally, there is no reason for it. Right? I mean, there is plenty of private capital out there. They are all very interested in participating in this market. It is clearly obvious in lots of different places and there is no reason why taxpayers should be taking credit risk on mortgage loans.

Senator CRAPO. Thank you. And, Mr. Bovenzi, you noted many valuable lessons learned from a positive nature about the RTC that could provide insight into our decision making as we approach Fannie Mae and Freddie Mac. Are there any cautionary lessons that we should also glean from the history of the RTC? Were there actions corrected at the time or merely thought you had gained through your benefit of hindsight?

Mr. BOVENZI. There are probably many cautionary lessons given that it was not, you know, a smooth path. I mean, there was a time when the RTC was accused of ruining the housing markets in the United States, but looking back with some perspective, they are now viewed as having been a success in terms of straightening it out.

So I think, you know, there is a danger to everybody having a very short-term perspective of what needs to be done versus a longer-term perspective. As we are hearing, this is not a simple matter either way. You make changes and there will be some disruption; you do not make changes and you have issues as well.

So I think what I have tried to lay out were things to think about if Congress goes down this route that are cautionary to think about, like how do we treat the employees in the GSEs who have the expertise to help make a smoother transition and issues like that from the RTC's and FDIC's experience.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. First of all, I just want to thank you and Ranking Member Crapo for the attention you have given this issue. I believe this is our ninth hearing this fall, and while there is a lot of other activities going on in the body that are showing, perhaps, disruption, I think your leadership of this Committee has shown a real focus and attention on this issue, and even during these challenging weeks, continuing to advance the process forward. I think it is very helpful, one.

Two, I think this is about our 20th housing finance hearing we have had since 2011, and again, I think you and your team have built a very solid record here. A couple of comments before I get to my question. I think Dr. Zandi has pointed out some of the challenges around 1217 and the legislation we have worked on.

We do think there needs to be high, solid capital standards. I do think that at some point, though, the comparison to the status quo, which is right now no private capital risk, this is purely a public sector socialized risk, it is really not even an apples-to-apples comparison. Any system, even Mr. Millstein's system, would have higher costs involved because there would be additional private capital.

I also wanted to comment to Dr. Min. I think one of the comments you made about the notion that any future market rental housing, other kind of first-time home buyer access, perhaps not completely eloquently put together, but are market access fund, recognizing there is that appropriate role, I think, is something that we have taken a pretty good stab at.

I concur with a lot of the folks on the panel, that we have got to get this right in this transition period. The only hesitancy—one of the hesitancies I have, if you move simply from a target versus time line, those targets always can slide. We have seen that constantly.

I think Dr. Zandi's comments about, you know, how quickly FHFA is moving toward the common securitization platform is trying to get this judgment right, and I would welcome from all on the panel, and really appreciate your testimonies, you know, what are those speed bumps, metrics, hurdles, whatever we want to call it, along the way so that we do not have this simple moment where we flip on the switch.

There has got to be these points, and I think again, Dr. Zandi—well, Professor Min, you have got a number of those, but clearly, getting the securitization platform right and the common security right is very important.

I guess what I would hope as well is, Dr. Min, to make sure that we do not try to recreate the wheel, you know, a lot of the activity going on at FHFA right now, I think, are efforts to make sure that we transfer over the assets.

I want to agree with Mr. Millstein. I think it is really important that we keep the people and intellectual capital assets from Fannie and Freddie, for a variety of reasons, including the fact that a lot of those folks live in Virginia. So I guess what I would ask is, how do we make sure—let us take, for example, the question around the starting up an issuer.

Do you, Professor Min or Dr. Zandi, want to make a couple comments on what should be some of those gating things we should look at?

Mr. MIN. I will leave you some time. I think obviously you need capital. As I point out in my written testimony, I think that there is a lot of capital. It obviously depends on the cost of capital, reverses return analysis that you are well familiar with. But I think on top of that, there needs to be some sense that there is going to be investor liquidity in this market, and so for that reason alone, the CSP and the single security are important.

I think as Dr. Zandi and I both point out in our testimonies, right now there is significant pricing differences between Fannies and Freddies. If you simply do not have a single security, those differences in pricing liquidity will be greatly exacerbated as you add a third, fourth, or more issuers.

That is why that particular product is so important. I think at the same time, you want to make sure that a lot of the agency investors, the agency liquidity that is there transfers over, because I think that itself will be a very important calculation for investors.

Is there a market key? Will it be there when we startup the operation for that switch? And that is why I have recommended some of the steps I have about getting liquidity in place.

Mr. ZANDI. Senator, so when you say issuer, I take that to be issuer guarantor, and that is a matter of some discussion and debate as well, but I am just going to assume that. You know, I do think that it will be very important in the transition process that the Government is helping to stand up additional guarantors. I mean, we have got Fannie and Freddie and the infrastructure is there and we can make this work so that they go out into the marketplace and liquidity is sustained and everything is working properly.

But to really make this a well-functioning system for the future, we need to be able to have more than two guarantors out there. We need many. It depends on the structure of the market and what the scale economies are, but my guess is that the market could reasonably support four or five, six guarantors, and that would be competitive market.

But that is not going to happen, I do not think, on its own. It certainly is not going to happen if we just throw Fannie Mae and Freddie Mac, whoever we turn them into, out into the marketplace. That is just going to shut down the market to competition.

Even if you do the common securitization platform, even if you have a common security that will help bring down various entry, even if you stipulate that these new entities are SIFI institutions and they have higher capital requirements and raise their cost of capital, I still fear that given these legacy relationships they have, it will be very difficult to generate a competitive market.

So it is going to be important, in the transition process, that we have a clearly articulated means for standing up, helping stand up new guarantors into the marketplace to make this a competitive market. And we can talk about how to do that, but that is key to this all working out in the end.

Senator WARNER. Thank you, Mr. Chairman. I just want a final quick comment. It is just that I also want to echo and appreciate Senator Crapo's comments about the challenges of the status quo and the very real threat. Even though I think the majority of us all feel very strongly, we ought to keep the G-fees in this industry, there remains that threat. So I appreciate your comments as well.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I appreciate you having all of these hearings, and Ranking Member Crapo, and working with him to make that happen, and all of you for coming to them still trying to adjust to having all my rights stripped away yesterday by people I have worked with for a long, long time to solve issues in a bipartisan way without any discussion.

But anyway, Mr. Min, I want to tell you, I do appreciate some of the concerns you raised about mortgage-backed securities and legacy mortgage-backed securities. The notion that you mentioned about basically turning them into FMIC-backed mortgage-backed securities is exactly what 1217 envisions. So I appreciate the contribution you made to this hearing in stating that, and it is exactly what we would like to do.

Dr. Zandi, I know we have worked together for a long, long time to try to figure out a way to move past the system that we have, and I know that you know we have had people on the left, on the right, in the center. I think you attended a dinner about 15 months that had multiple kinds of folks there to try to figure out how we begin to look at this system.

I think there is no question that you agree, as someone who spent a lot of time in this world, that we need to move past the system we have now where private sector investors do really, really well when the market is good, and then the taxpayers do really bad when things go wrong. You agree with that, is that correct?

Mr. ZANDI. Yes, sir, I do.

Senator CORKER. And I know that we have looked a lot at capital and, you know, how much capital is necessary. Today, in a $5 trillion market, which 90 percent of new loans today are coming through some Government entity, but under the 1217 bill, there would need to be about $500 billion in capital, is that correct, under the 1217 arrangements?

Mr. ZANDI. Yeah, 5 percent of the $5 trillion.

Senator CORKER. No, 10 percent of that.

Mr. ZANDI. Excuse me, 10 percent of the $5 trillion.

Senator CORKER. I know that was a Freudian slip.

Mr. ZANDI. Yeah, that was Freudian. I am sorry. I am just trying to slip down——

Senator CORKER. I am not my normal energetic self. I apologize.

Mr. ZANDI. As you could tell, neither am I.

Senator CORKER. And I know that you and I looked at a chart that actually looked at nonagency capital returns over the last few days about $636 billion coming over the next 7 years back into the system. So the notion of trying to have about $500 billion, quote, quote, quote, is that is what we build back up to, does not seem in any way to be farfetched, does it?

Mr. ZANDI. I think we can do it. I think there is, as we can tell from what is going on in the marketplace in recent months, a great deal of interest and participating in taking on mortgage credit risk. We can see it from the proposals that have come forward in the last couple weeks.

Senator CORKER. Yes.

Mr. ZANDI. We can see it in my world, in the PMI world that I am a board member of MGIC. So there is clearly a great deal of interest in private capital coming into this marketplace, yes.

Senator CORKER. I noticed, over the last couple of weeks, we had an offer from a gentleman named Berkowitz from down near Florida to buy actually the credit risk portion of the remnants of Fannie and Freddie, and while the offer likely will be rejected because of the amount, in talking with people that are related to that type of offer, in many ways, does that not give us hope that there are people out there that are willing to invest in the credit risk portion only and it is a matter of just getting the economics right?

But it does show that there is interest out there for people to participate as buying guarantors in a new system. Is that correct?

Mr. ZANDI. Yeah, that is exactly right. I mean, if you look at the proposal, there are $17 billion of real capital in the proposal, at least that is the number he put forward, and by my calculation, $17 billion gets you pretty close to what you need to get to that 10-percent capital in year one of the new system.

So immediately I saw that, I go, Oh, OK. So there is private capital out there willing to participate in this marketplace and it gets you pretty close to where you want to be in year one. So I took a great deal of solace in that. And I agree, I would not go with the proposed structure that he has, but certainly, you know——

Senator CORKER. But my sense is, and I have read some quotes since those discussions matured a little bit and developed, it seems to me that the offer that he made was very exactly in line with 1217. In other words, you would have to have 1217 pass to create this modular competitive system for that type of offer to even work.

So it seems to me that what we are already seeing out there is hedge funds and private equity and other folks who are willing to capitalize this system in such a way as to make it competitive and modular. Is that correct?

Mr. ZANDI. Exactly right. I mean, when I was talking about those new guarantors coming into the marketplace, you could envisage what he is proposing as, in fact, one of those new guarantors. So it fits exactly in with the vision you have that is in 1217.

Senator CORKER. Mr. Millstein, I know we have had a number of meetings in our office. I know that you were in the public sector and now are out in the private sector over the last couple of years with your firm. I know that when you are in the public sector, you learn about just sort of the way Government works and you can figure out ways of, you know there is a degree of incompetence and people are afraid of change and there are ways of sort of making money off of that.

I know that—I appreciate your testimony today, but I do want the Committee to know that unless Mr. Millstein is willing to, under oath, say differently, he does benefit personally in the event, if we have the fear and inability to move beyond the system that we have, in other words, if we were to do what he espoused, he and his family would benefit greatly personally. I just think that——

Mr. MILLSTEIN. Senator, let me interrupt you just so we do not waste any more time on that. I no longer——

Senator CORKER. Well, actually——

Mr. MILLSTEIN. I no longer——

Senator CORKER. ——I am just making a statement——

Mr. MILLSTEIN. I know, but I want to make sure you are——

Senator CORKER. ——less of a statement of fact and you are willing to——

Mr. MILLSTEIN. So I am going to tell you right now, that I do not own those securities any longer. I do own a home and I am a small-time real estate developer, so I have a deep interest in how you do this, to make sure you do it right, but I am no longer a stockholder.

Senator CORKER. So I guess—well, very good. That is good to hear. Right.

Chairman JOHNSON. Professor Min, in addition to single family, could you elaborate and what key issues should we consider in structuring an orderly transition for multifamily housing reform?

Mr. MIN. Thank you for that question. I did not have a chance to get into in my oral testimony. I think that—so as it is structured now, I think that the Corker-Warner plan envisages the market access fund, which is actually made up of several discrete funds receiving or being responsible for the bulk of multifamily.

In addition to that, I think you all received at least one or two proposals, thinking about ways to create multifamily specific guarantor issuers under the new system envisioned by Corker-Warner. So I think those would be the two main engines for multifamily, and I think that in theory, as I have researched this issue, that should actually work.

But the sort of issues I raised in my testimony, my written testimony, are about getting from Point A to Point B. I think these are the segments, particularly in the affordable rental space, that are most likely to experience a vacuum as we reduce the footprint of the GSEs and try to transition to that Point B where these institutions will be responsible for filling that space.

So what I propose in my testimony is, is two steps. Basically, let us try to get a running start for multifamily housing for institutions that are dedicated for this affordable rental space, including starting prefunding the market access fund now, siphoning off a little bit of the G-fee, which is fairly ample at this point, and start to prefund that so that it really is in place and operational when that transition happens.

The second step is to go along with the plan proposed by former Assistant Secretary Dr. Bostick of trying to create multifamily subsidiaries of Fannie and Freddie and allowing them a head start so that they can be operational again as we get into this transition period.

I think the concern is that this is a space that purely private capital has not always gone into and it has been—it is an increasingly important part of the system, particularly as I mentioned, as we think about pulling back from single family and pulling back the Federal Government's footprint. So those are the steps I would outline.

Chairman JOHNSON. Senator Crapo, do you have any follow-up?

Senator CRAPO. Yes, just one last question, Mr. Chairman. And I guess I will direct this to Dr. Zandi, but any of the others who would like to jump in on it, feel welcome.

On this question related to the Chairman's earlier question about whether we needed to have a target focus like achieving benchmarks before we actually pull the trigger and move forward with the finalization, or whether we needed time lines as Senate Bill 1217 currently has, and I know Senator Warner got into this.

I understand the comments that all of you have already made about the fact that this is complicated and a rigid time line might not be sufficiently flexible to allow us to get it right. That being said, I kind of want to focus on the other side of that, and that is, if you just continue to try to look at benchmarks, I look at the—I am an opponent of quantitative easing, and I look at it the way that we are trying to get out of quantitative easing right now with benchmark targets that we are not meeting.

And we just seem to always stay where we are. I know that may not be a perfect example, but my point is, how do we ultimately have some accountability here in the sense that we get there if we start focusing on a benchmark process in order to implement the legislation? Dr. Zandi.

Mr. ZANDI. Yeah, an excellent point and it is a tension that Senator Warner highlighted as well. I think the approach would be to have very explicit benchmarks and then to make sure that there is clear oversight with regard to how those benchmarks are achieved or not achieved and why.

So if you come up to a certain—it is not that we should not have a time line. We should have a time line, but with benchmarks in the time line, and as we approach them, then if we are not achieving them, then we need—there should be oversight and there should be accountability with regard to why and using that as a mechanism for ensuring we get back on the time line.

But there may be reasons why you might want to delay, because there are things that are completely out of our control. I will give you just a blue sky example, but it is very possible. You get up to the point where you want to turn on the light switch and 2 weeks before, there was a financial event in Europe and the financial markets are in turmoil.

Now, do you really want to turn on the light switch at that point? The answer is probably not. Nobody would really want to do that. So you need to have some flexibility with regard to how you do this.

Senator CRAPO. All right. Thank you.

Mr. MILLSTEIN. Can I answer that, though?

Senator CRAPO. Yes.

Mr. MILLSTEIN. Look, the system that Senators Warner and Corker have designed is one that requires a good deal of first-loss capital. And we here can speculate on how much there is and when it will come and how much appetite there is. But at the end of the day, your legislation is depending upon the investment decisions of tens of thousands of investment managers, and you cannot command them to show up on cue.

They are going to have to see the new system design and see it operate a little bit before they are going to start coming in droves. Today, with all due respect to my colleague, Mr. Zandi, today there is $8 billion of capital in the private mortgage insurance business.

Yes, Mr. Berkowitz has shown up with an offer that says he will put $17 billion in, but there is a long way between that offer and a closing. A lot of other things have to happen. But the most important lesson, I think, in terms of this benchmark versus time line is, you are trying to design a system that will induce people to put capital into new mortgage insurers and into new first-loss securities that do not exist today, in a system with a guarantee that does not exist today, for a market of new securities that does not exist today.

It is going to take time and you are depending on tens of thousands of individual investment managers to play with you, to shake your hand and say, Yes, I will help you build this market. They may come on a 5-year timetable, but if they do not, when you flip your switch, your system is going to shut mortgage availability down, nothing any of you want to do.

So that is the risk, to me, of having a very hard time line built into this, and that is the risk, to me, of taking the assets under your control today, that you could recapitalize today, to make sure that this system functions. The risk of just saying, "No," in order to preserve the possibility that MGIC will be able to raise $125 billion of capital in order to play my first-loss role, I am going to trash the assets that are currently doing this for me in this market. That, to me, is crazy, crazy.

Mr. BOVENZI. If I could make one comment? There may be some precedents for finding something in between. I think when the FDIC sets up a bridge bank for a failed institution, there is a set timeframe for how long the Government should own that bank before it has been sold or restructured.

But because of the public policy issue of not having nationalized banks, if there are reasons why that life of the bridge bank should extend, I think the FDIC Board of Directors could, you know, do that and have flexibility to have it come forward for, you know, a board to say, OK, there are certain reasons why we need to extend this beyond.

So maybe there is some areas where there may be precedents where you can try to set some form of timeframe with benchmarks, but flexibility to extend if necessary.

Chairman JOHNSON. Dr. Zandi, do you care to respond?

Mr. ZANDI. Thank you. I agree that there is a lot of moving parts here and there is a lot of uncertainty. A lot of the uncertainty revolve around issues of private capital and what cost will the private capital come into the system. And there is a lot of codependencies here.

I mean, how much capital comes in depends on how much clarity you provide and oversight you provide. So there is a lot of reasons to be nervous about the process. But let me say that this is very doable. It is not like we cannot do this, and we can, and the economics of this are such that there will be investors and there will be private capital. It will come in. And this can work out very, very gracefully. We just have to be very careful about how we do this and articulate it.

Chairman JOHNSON. Does Senator Warner have any follow-up?

Senator WARNER. I just really appreciate the conversation back and forth here. I saw one of the groups who are interested in this issue this week and they were talking about how the housing market has recovered a bit, but there are still challenges.

And I pressed this particular group, there was like, you know, when are you ever going to hit that magic time? I mean, if we could predict when that total solidness is there, that may just be an unobtainable goal. I would reflect that we are 5 years after the crisis now. Obviously the housing market's recovery has not been to that whole 5 years.

I would point out that in the wild and wooly final days of Dodd-Frank, there were efforts to, on the floor of the Senate, to unwind the GSEs with no transition on a 2-year basis and completely zero them out that got a lot of votes. And, you know, I think we have, in a broadly bipartisan way, directionally set a path for reform that the Chairman and the Ranking Member are improving upon.

And if there are moments along the way during this 5-year period where we will have—I am not sure what the right term is—a speed bump or indicators, you know, such as the common securitization platform that is independent of—I think the appropriate questions Mr. Millstein has raised about private capital showing up.

You have got FHFA trying risk-sharing models now. We have had testimony at these hearings about trying to create kind of blended securities during the interim that would again give us, I think, better indices. And, you know, my point is, you have got to start this process, and, you know, waiting for the perfect moment leaves also a huge amount of uncertainty over this market that is terribly important to our economy.

And as we have perhaps repeatedly shown, as well intentioned as we may be on this panel about not using G-fees or other fees for other purposes, locking in a reform basis may be one of the best ways to ensure that we do not do that.

I would also make a comment, as one of the things that I think was an area that needed a great deal of improvement in 1217 was multifamily. I think there are a lot of Members on this panel from both sides who are working on improving that. And, frankly, in that area more than ever, the do no harm mantra is important because they did not create the challenges. That part of the business did not create the challenges.

So I guess it is not as much a question other than the fact that I think I would at least take your admonitions to heart, but not to the point of saying—as an excuse to say we have got to spend another months, years, whatever, studying this issue. I think it is time to proceed.

And again, I am going to close by simply thanking the Chair and the Ranking Member because you have brought an attention and focus to this that I think has really advanced the debate greatly.

Mr. ZANDI. Can I make one quick comment just to reinforce something the Senator said about timing? You could make a very good case that timing is incredibly good right now. Right? I mean, the credit environment is excellent. The number of mortgage loans that are 30-day delinquent is as low as it has been in the data that I have back into the 1980s.

Sixty-day delinquency, that is 2 months late, is as low as it has been, and even 90-day delinquencies are approaching a record low. And private capital is very interested in participating now. And you also have very low yields and, you know, here is an opportunity to get the yield.

So I would echo that this is a—you know, there are challenges in the environment that we exist and we have a 7-percent unemployment rate and we have got to make sure that this all works out well. But I would argue that there is no better time for doing this than literally right now.

Senator WARNER. Right.

Mr. ZANDI. And then I would say, simply to add, that if Senator Crapo, thinking along the continuum, but QE is going to end at some point. Interest rates are turning back to kind of more normal levels would make it even harder to make this transition. If not now, when?

Chairman JOHNSON. Mr. Millstein, do you have any closing comments?

Mr. MILLSTEIN. Well, I want to join with Senator Warner in saying that I agree, the most important thing we could do for private capital beginning to come back into this market is to pass legislation telling the markets where the Government is going to move with regard to Fannie and Freddie and ending of the conservatorships. They are at the center of the housing market today.

They are operating with no capital and not seeking a capital return, making the pricing of their guarantees, I think, a discount to what private parties would do. And clarifying the future state of Fannie and Freddie to the market is critically important for private capital formation to return.

My caution, despite what Senator Corker may have characterized my remarks to be, my caution is not about legislating. My caution is about having a mechanical line down of the two entities that are providing almost all credit formation in the conforming market today.

You have run significant risks, but telling the markets through your legislation where you are going and what your objectives are, competitive, first-loss, mortgage guarantee industry providing substantial capital in front of a new Government regulator who is strong, but guaranteeing qualified product, that is an important signal.

It will allow private capital to start developing plans around your new structure. But the one caution I am giving you is, while they are doing that, the pace at which they come you cannot command. You cannot predict and you cannot write a timetable to be certain of, and therefore, you need to take what you have got that is working and transition it to having a role in the new system so that you have continuous mortgage credit formation along the way.

Chairman JOHNSON. Thank you all, our witnesses, for being here with us for an unusual hearing. Given the number of Members urging the Committee to move quickly, we anticipated greater attendance. I also want to thank——

Senator WARNER. Mr. Chairman, I am proud to be here.

Chairman JOHNSON. I also want to thank Senator Crapo for his thoughtful questions, good partnership and commitment to housing finance reform. This hearing is adjourned.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF JAMES MILLSTEIN

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, MILLSTEIN AND COMPANY

NOVEMBER 22, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to testify on the development of an effective transition plan for the U.S. housing finance system.

I have spent the entirety of my 30-year professional career—as a lawyer, banker, and public servant—in the corporate restructuring business. I have restructured companies as diverse as American Airlines, WorldCom, and Charter Communications in the United States, Cadillac Fairview in Canada, United Pan European Communications, EuroDisney, and Marconi in Europe, and Daewoo Corporation in Korea. During the recent financial crisis, I served as the Chief Restructuring Officer of the U.S. Department of the Treasury. In that role, my primary responsibilities were managing, restructuring and designing the exit from the Department's substantial investments in AIG and Ally Financial.

I am here today because embedded in the task of reforming our Nation's housing finance system is a restructuring of the two largest players in that system: Freddie Mac and Fannie Mae. These companies now operate in conservatorship under the control and direction of the Federal Housing Finance Agency. Because they are central to mortgage credit formation in the United States today, "winding them down" as some members of Congress and the Administration suggest is certain to have significant and adverse consequences for mortgage credit availability and for the nascent housing and economic recovery. Rather than wind down, I urge you to consider a restructuring alternative that addresses the fundamental causes of the companies' insolvency, eliminates the private gain/public loss nature of their current Government sponsorship, generates a significant profit to Treasury for supporting their solvency, and, most importantly, ensures a smooth transition to a new housing finance system that better protects taxpayers against future losses while providing for the continuing availability of credit to the creditworthy.

There appears to be a growing consensus in the policy community around the basic architecture of that new housing finance system. A Federal guarantee on qualified mortgage products is required to ensure the widespread availability of a 30-year fixed-rate product, and to sustain the deep and liquid mortgage securities funding markets that have developed over the past 30 years to complement balance sheet lending from the U.S. banking system. The guarantee should be explicit and structured as reinsurance, available to reimburse investor losses only after a layer of private "first-loss" insurance provided by well-capitalized mortgage insurers or subordinated capital provided through structured product markets has been exhausted. The reinsurance should be priced at arm's length by an independent agency required to use its reinsurance fees to build a reserve fund to protect taxpayers against future loss should that reinsurance ever be called. Finally, in contrast to the system prevailing before 2008, the Government reinsurer also needs to be a strong regulator with authority over all issuers, guarantors and servicers with whom it interacts in the new system. In this regard, I commend Senators Corker and Warner and the coalition of other members of this panel behind S.1217 for putting out a bill with all of these elements in it.

However, the transition to this new system contemplated by S.1217 is fraught with difficulty and needs serious rethinking to mitigate three significant risks that any credible transition plan must address. First, our fragile economic recovery cannot afford the risk of a significant disruption in mortgage credit. Borrowing rates will need to rise in the new system to reflect the cost of the first-loss capital and new reserves required to protect taxpayers on their guarantee. At the same time we need to protect against a significant contraction in the availability of housing credit that would push us back into recession. Second, the Government must end its ongoing backstop of Fannie Mae and Freddie Mac in conservatorship in a way that minimizes the likelihood that Treasury will need to cover future losses on their $5.5 trillion of liabilities. While the substantial guarantee fees and net interest margin which the companies are currently earning and paying over to Treasury may look like an asset to be seized by taxpayers as the quid pro quo for their bailout, it could easily turn out to be a substantial liability if there were another significant housing downturn. Managing that liability in a responsible way to avoid future taxpayer losses is a critical challenge of the transition. Third, there must be a credible path toward the development of the substantial layer of private "first loss" capital on which the functioning of the new system will depend. If you build the new Government reinsurer but the required layer of first-loss capital doesn't come in the size or at the pace of your contemplated wind down of Fannie and Freddie, the whole system will shut down before it has a chance to start. The idea that "if you build it, they will come," may work in the movies, but you are playing with the Nation's housing finance system. Hope is not a credible strategy.

You have to make a fundamental choice in meeting these challenges in the transition: Restructure Fannie and Freddie and use their assets and operations to create a well-capitalized set of private market players who can ensure that the new system functions as contemplated, or wind them down on the bet that if you build the new reinsurance system, new private players with the sizeable capital required to make the new system function will come. My concern with both S.1217 and the Protecting American Taxpayers and Homeowners Act introduced in the House of Representatives is that each is based on the bet that to-be-named new players with capital yet to be raised will show up right on queue as the two institutions at the center of the current system are mechanically wound down. As I hope to demonstrate in the following testimony, we don't have to gamble with the future of the housing market. There is a better alternative.

Evolution of the Government's Role in the Conforming Mortgage Market

A responsible transition begins with a clear understanding of the status quo and how it arose.

In the late 19th and early 20th centuries, there were various attempts to use bond markets to fund housing and commercial real estate. But the lack of adequate securities law and insurance company regulation, the absence of uniform contractual investor protections, poor underwriting, and outright fraud led to repeated funding market collapses, subjecting the U.S. economy to painful downturns. The 1870s and 1880s featured a permutation of covered bonds, where mortgage originators issued debt to the public collateralized by pools of the mortgages they had originated. While this market functioned for a time and funneled investor dollars into housing finance, it eventually collapsed because the originators violated their purported underwriting standards and packed the pools with nonconforming collateral. In the 1900s, New York title guarantee companies originated mortgages, insured them, and sold participation certificates backed by them (an early form of mortgage-backed securities). These title insurance companies eventually failed, and the mortgage securities markets they supported collapsed, because of poor underwriting, thin capitalization, and weak State insurance regulation. The 1920s featured the issuance of single-property real estate bonds, each governed by a separate set of indenture provisions, the proceeds of which were used to finance large construction projects. Poor underwriting and weak investor protections led to its eventual collapse. The same decade (the roaring 20s) also saw bank and thrift failures at an average rate of 600 per year (in a banking system with approximately 10,000 banks and thrifts), a crisis by today's standards and significantly disruptive to home lending and local economic activity. The pace of bank and thrift failures peaked 5 years after the Crash of 1929 when, in 1933, roughly 4,000 banks and thrifts failed, resulting in widespread foreclosure and a severe contraction of housing finance credit.

In response to the housing and banking crisis of the 1930s, the Federal Government restructured the banking system and significantly expanded its role in housing finance. Among other things, the Banking Act of 1933 created and Banking Act of 1935 expanded the authority of the Federal Deposit Insurance Corporation (FDIC), an independent agency of the Government chartered to provide Federal deposit insurance to banks to prevent the bank runs that forced the Roosevelt Administration to impose a national 2-month long bank holiday in early 1933. The acts also provided the FDIC with regulatory authority over its member banks, initially funding its reserve fund with loans from the Treasury and Federal Reserve. Those loans were repaid with interest after member bank insurance fees began to accumulate. When faced with widespread bank failures during the recent financial crisis, the FDIC's Deposit Insurance Fund also fell into deficit. However, instead of drawing on its line of credit with Treasury to replenish its coffers, the FDIC pulled forward insurance assessments and imposed additional fees on its member banks. The Dodd-Frank Act of 2010 requires the FDIC's Deposit Insurance Fund to reach 1.35 percent of insured deposits by 2020.

In the 1930s, Congress also addressed mortgage finance directly. In 1932 it created and capitalized the Reconstruction Finance Corporation (RFC), which made loans to, among others, banks and mortgage associations.[1] In 1932, Congress estab-

[1] The RFC funded various relief projects during the Depression and authorized loans and investments to support the Government's efforts during World War II. It also established multiple companies to carry out its mission. The RFC was ultimately disbanded in 1957.

lished the Federal Home Loan Bank System in order to create additional funding for home loans originated by savings and loan institutions. Federal Home Loan Banks (FHLBanks) make loans to member institutions secured against eligible collateral—typically mortgages—and issue debt to the public to fund such lending activity. The cost of that funding is generally lower than an individual member can obtain because the debt is the joint and several obligation of all FHLBanks, which operate under Government-sponsored charters. The FHLBanks are capitalized by their members, whose borrowing limits are proportionate to their respective capital contributions. The FHLBanks are regulated by the Federal Housing Finance Agency and have a minimum capital requirement of 4 percent of assets. In exchange for their Federal charters and exemption from State taxation, FHLBanks pay an assessment of 10 percent of annual earnings for affordable housing programs.

These efforts helped stabilize banks and other mortgage providers in the 1930s. But many would-be homebuyers in the 1930s remained shut out of the mortgage market, and home construction remained muted. The average mortgage required a large downpayment, had a maturity of 3 to 5 years, and featured large balloon payments at maturity. Although most loans were renewable at maturity the interest rate would reset, subjecting borrowers to the risk of significant interest rate movement over the short life of the mortgage loan, with no ability to hedge that risk.

The National Housing Act of 1934 established the Federal Housing Administration (FHA) to address this problem and facilitate credit for home construction and repairs to a broader swath of borrowers. By offering insurance in exchange for a fee and assuming a first layer of risk, the FHA made possible the issuance of fixed-rate, long-term mortgage with regular monthly payments.[2] The act authorized the creation of a reserve fund to support claims made on the Government's insurance: the Mutual Mortgage Insurance Fund (MMI Fund). The act also provided initial capital for the fund, and it has since been funded through premiums on insured mortgage loans. Today the MMI Fund is required to maintain a reserve of 2 percent of insured loans based on projected losses over a 30-year horizon. During most of its history, a portion of premiums collected in excess of that reserve minimum have been transferred to Treasury. Between 2001 and 2007, for example, the program transferred approximately $14 billion to Treasury. Earlier this year, for the first time in FHA's history, it borrowed $1.7 billion from Treasury to bring the MMI Fund reserve up to its congressionally mandated minimum level. The FHA single-family mortgage insurance program generally targets first-time and lower-income homebuyers, although during the recent crisis, when other private mortgage insurers failed or became undercapitalized, the FHA significantly expanded its footprint to ensure credit availability.

The same act that created the FHA also authorized the agency to create "national mortgage associations" to purchase and sell FHA-insured mortgages. The objective was to create additional liquidity for housing credit beyond the then FDIC-guaranteed deposit-based funding available in the banking system or though the discounting of mortgages at the FHLBanks. Similar to the FHLBanks, the national mortgage associations would tap capital markets to fund FHA-insured mortgage originations. Unlike the FHLBanks, they would not be cooperatives. Instead, it was contemplated that they would have a broad base of private equity investors. However, 4 years after passage of the National Housing Act in 1934, no national mortgage association charters were ever taken out by the private sector. As a result, at the urging of the Roosevelt Administration, the Government-owned RFC began buying FHA-insured loans and in 1938 formed a subsidiary that became the only chartered national mortgage association: the Federal National Mortgage Association (Fannie Mae).

Fannie provided a secondary mortgage market into which originators could sell loans, which freed capital and provided funding so that those originators could recycle the funds and extend additional mortgage credit. In 1954, after 16 years as a purely Government entity, the Federal National Mortgage Association Charter Act converted Fannie into a mixed-ownership corporation, where the Government held preferred stock and private investors held its common stock. In 1968, in order to remove its growing balance sheet liabilities from the Federal budget, Congress split the company in two, leaving behind the Government National Mortgage Association (Ginnie Mae), a Government entity that began guaranteeing passthrough securities backed by mortgages insured by FHA, the Department of Veterans Affairs, and Farmers Home Administration and fully privatized the ownership of Fannie Mae. However, the Government charter remained with the privatized Fannie, and with that charter came the obligations to serve the public policy ends of increasing home ownership and supporting low- and moderate-income housing. This original policy

[2] As opposed to short-term balloon payment mortgages that were more traditionally available.

error in the 1968 privatization created a private shareholder-owned company with a public mission, allowing Republican and Democrat Administrations alike to pressure Fannie to increase credit availability to serve political ends. It also allowed Fannie to use its public mission as political ammunition to fend off challenges from banks to its market power and to its relatively lax regulatory oversight.

In 1970 Congress created the Federal Home Loan Mortgage Corporation (Freddie Mac) to compete with Fannie, expand the secondary market for mortgages, and help thrifts manage interest rate risk. Freddie had the same charter and implied Government guarantee as Fannie, but it was initially capitalized and owned by the FHLBanks. In 1971 Freddie issued its first mortgage backed security (MBS). Securitizing mortgages purchased from thrifts defined the company's business model over the next few decades, while Fannie continued primarily to purchase and hold mortgage loans in its portfolio funded with balance sheet borrowing from the capital markets. Both Government-sponsored enterprises (GSEs) were permitted to purchase non-FHA-insured loans.

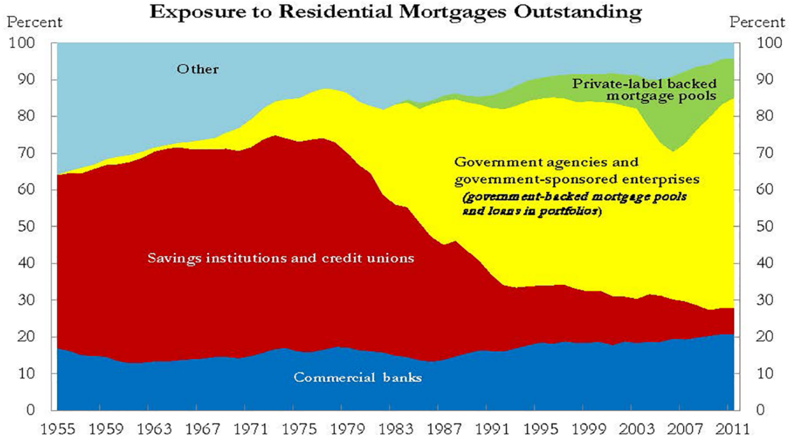
Inflation, interest rate volatility, economic downturns, and the beginning of a 30-year wave of bank deregulation in the late 1970s and early 1980s wreaked havoc on savings and loan associations, also known as "thrifts", as well as on Fannie. Thrifts funded most of the long-term mortgages they held with short-term obligations, largely deposits. Until the 1980s regulators imposed ceilings on the rates of interest on savings and time deposits that thrifts could pay. The Depository Institutions Deregulation and Monetary Control Act of 1980 phased out those limits.[3] Meanwhile the then relatively new money market funds began to grow rapidly with little regulatory impediment, competing with thrifts for deposits. As a result, the rates paid on deposits increased, and the thrifts faced a mismatch between their funding costs (deposits) and the earnings on their primary assets. Fannie, as a balance sheet lender, was exposed to similar risks, although it funded itself in the capital markets, largely through long-term debt, rather than with deposits. To try to help thrifts mitigate losses from the mismatch between their deposit funding costs and the interest rates on their long-term mortgage assets, the Garn-St. Germain Depository Institutions Act of 1982 permitted them to expand into corporate lending, an area for which they had little underwriting experience. In relatively short order, thrifts experienced significant losses during the recession that occurred during the mid-1980s, and the sector virtually collapsed by the late 1980s, simultaneously putting the FHLBanks under pressure. The same act also authorized banks to provide adjustable-rate mortgages.

Regulatory forbearance and a rapid change in its funding profile away from long-term debt toward short-term debt permitted Fannie to weather that particular storm, and by the early 1990s it began to shift away from a long-term buy and hold strategy to the Freddie securitization model. Meanwhile, in 1989 Congress reorganized and privatized Freddie, and it opened membership in the FHLBanks to commercial banks. The latter action more than offset the losses suffered by the FHLBanks during the savings and loan crisis of the late 1980s. As a result of the expansion of FHLBank membership to include commercial banks, FHLBank assets increased by a factor of six to roughly $1 trillion.

During the 1980s, as the savings and loan crisis intensified and many thrifts failed and withdrew from the mortgage funding markets, the GSEs, FHA, VA, Ginnie, and the FHLBanks—filled the void and increased their respective share of credit exposure to the residential mortgage market. The figure to the right [*below*] illustrates that between 1982 and the mid-1990s, as the dominant savings and loan share of the market shrank, the GSEs and Government agencies went from less than 10 percent of the market to roughly 50 percent of it.

[3] This was the first in a series of legislative deregulatory initiatives for the financial sector over a 30-year period, which culminated in the repeal of the separation of commercial and investment banking that had been provided by the Banking Act of 1933.

Exposure to Residential Mortgages Outstanding



Source: Federal Reserve Board.
Notes: Other includes life insurance companies, finance companies, real estate investment companies, private pension funds, state and local government retirement funds, households and nonprofit institutions, and non-financial corporate and non-corporate businesses.

After the collapse of the savings and loan associations in the 1980s, and the concomitant rise of the GSEs and Government agencies in the market, the only other significant change in mortgage funding was the creation and growth of the private-label mortgage backed security (PLS) market. Like MBS issued by the GSEs, PLS facilitated the pass through of funds from security investors to mortgage originators. However, instead of leaving the credit risk with the Government or one of its Government-sponsored proxies, the PLS market passed credit risk onto private investors. Regulators and rating agencies facilitated the growth of this market by lowering capital charges imposed on banks to hold PLS, especially certain highly rated allegedly riskless tranches of them, and by permitting their use as collateral in short-term funding markets. While the single-family residential mortgage market roughly doubled in size between 2000 and 2007 to over $10 trillion, PLS outstanding in that market more than quadrupled, increasing from approximately $400 billion to $2.3 trillion. A significant portion of that increase represented PLS composed of subprime and Alt-A mortgages, PLS which proved, we now know, to be rife with poor underwriting, misrepresentations, and outright fraud.

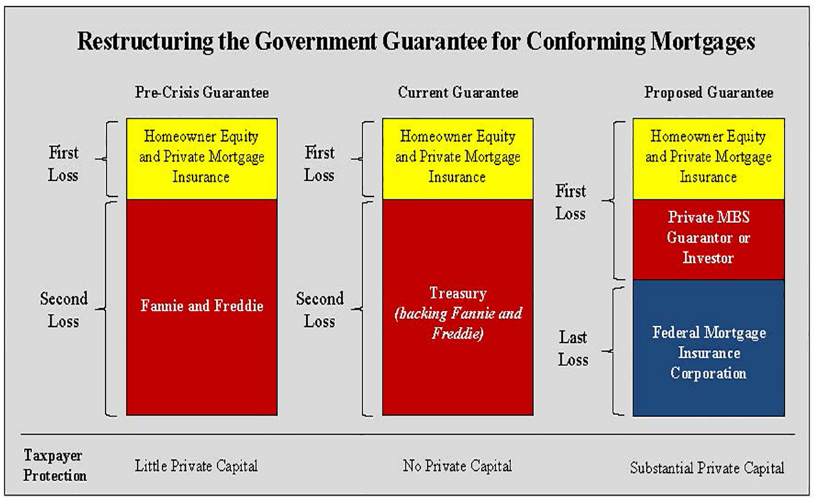
Encouraged by legislated charter amendments in 1992 imposing new affordability goals, growing competition from issuance in the PLS markets, and private shareholder return expectations, Fannie and Freddie used their Government-subsidized balance sheets to purchase riskier assets, including PLS backed by subprime and Alt-A mortgages. By contrast, the conforming loans bundled in MBS which the enterprises guaranteed were quite conservatively underwritten and exhibited default rates and loss severities modest by comparison to the default rates and loss severities exhibited by the PLS which they bought. But weak regulation of the enterprises failed to deter them from what would prove to be a path toward self-destruction. And regulatory arbitrage encouraged banks to purchase large volumes of PLS as well, effectively setting them on the same path as Fannie and Freddie.

House prices began to collapse in 2006. PLS investors fled the market and MBS issuance other than what the GSEs supported came to a complete halt by the middle of 2008. In addition, banks cut back sharply on balance sheet lending. The entire sector of private mortgage insurers, who had conceptually provided credit enhancement for banks and the enterprises, became insolvent. The thin layers of capital at Fannie and Freddie proved woefully inadequate to absorb losses from the risky assets they had acquired in their portfolios.

And so it was, in the summer of 2008, that the Federal Government found the economy spiraling deep into recession with the continuing collapse in home prices and mortgage credit formation adding weight to that fall. No one was left to take credit risk in mortgages except for Government agencies and the GSEs. And by early September, it seemed that the GSEs might be on the brink of failing.

Treasury intervened. It sought and obtained legislation that created a new regulator, the Federal Housing Finance Authority (FHFA), over the entities with authority to place Fannie and Freddie into a Government supervised conservatorship or receivership. Treasury had hoped that the mere existence of that resolution authority would assure markets that the Government would ultimately make good on what had been an implicit guarantee of the enterprises' liabilities, and that Fannie and Freddie would be able to fund themselves in private markets without the need for formal Federal Government support.

However, as financial conditions continued to deteriorate, in September 2008 the FHFA placed Fannie and Freddie into Federal conservatorships. To ensure that they would remain solvent and continue to provide funding to the mortgage markets, Treasury entered into Preferred Stock Purchase Agreements through which it committed to inject fresh capital into the companies. Treasury also took a warrant on 79.9 percent of each company's common stock. This investment structure allowed Treasury to achieve its goals without taking the liabilities of the enterprises onto the Federal balance sheet. [4] This Treasury backstop convinced agency MBS and debt investors that they were not at risk of default, and they continued to buy GSE MBS and funded debt throughout the crisis.



Through the mechanism of the Preferred Stock Purchase Agreements, Treasury transformed what had previously been an implicit guarantee of two private companies into an explicit guarantee of their balance sheet solvency. Rather than extending the guarantee directly to their liabilities, however, Treasury guaranteed each entities' ability to pay their obligations when due by committing to an open ended purchase of sufficient preferred stock to cover the entities' losses.

Between the fall of 2008 and the end of 2011, to cover both accounting reserves and allowances and real cash credit losses at the enterprises, as well as a mandatory 10-percent dividend on the amount of its outstanding senior preferred stock, Treasury provided $187 billion to Fannie and Freddie. However, as the housing market stabilized in 2011, the enterprises' losses abated, and they started to become extraordinarily profitable. Prices of securities in their portfolios were rallying, guarantee fees had increased, and large reversals in reserves and allowances seemed likely. In August of 2012, Treasury and FHFA amended the terms of the PSPAs, changing the fixed 10-percent dividend on the outstanding preferred to a variable dividend equal to 100 percent of the enterprises' earnings in any quarter. As a result, by the end of this year—six quarters after the amendment—Fannie and Freddie will have returned to taxpayers almost the entirety of the $187 billion that Treasury invested in them. [5]

[4] Accounting rules could require consolidation if the Government owns 80 percent or more of a private company.

[5] Treasury invested $187 trillion in the two companies. Through the end of the third quarter of 2013, they had returned $146 billion through dividends on Treasury's preferred securities. In their recent earnings releases, the companies announced that they would send another $39 billion in dividends by the end of December 2013. That will bring total dividends to $185 billion.

Nevertheless, more than 5 years after Fannie and Freddie were placed into conservatorship, the PLS market is moribund, balance sheet lending by banks remains weak, and those private mortgage insurers that have survived only as a result of regulatory forbearance and continuing fee streams related to MBS guaranteed by the GSEs. As a result, Fannie and Freddie, together with FHA, VA, and Ginnie, underwrite the credit risk on and facilitate funding for 9 out of every 10 new mortgages written in the United States today. After 5 years of conservatorship, the GSEs remain liable for $4.4 trillion securities backed by single-family mortgages—nearly half of the outstanding mortgage debt on single-family residences in the United States—as well as $1.1 trillion of on-balance-sheet funded debt. But, as a result of the August 2012 amendment, and the sweep of all of their earnings to the Treasury Department, neither company has any material capital standing between the taxpayers and potential future losses on those $5.5 trillion of liabilities.

Lessons From Evolution for the Transition

One of the most important lessons from the evolution of the mortgage markets in the United States is that the willingness of private investors to take on mortgage credit risk is quite volatile, subject to huge swings in appetite between irrational exuberance and fear. After the turn of the century, PLS investors piled into a loosely supervised, poorly underwritten market with securities whose underlying collateral support was both opaque and riddled with fraud and misrepresentation. In this respect, the PLS market of the 2000s was not at all unlike the private mortgage markets that briefly flowered in the 1870s and 1880s and then again in the 1910s and 1920s. They were robust for a time and then floundered on their own excesses.

Today, institutional investors remain wary of doing business with any of the previous participants in the underwriting chain. And it is safe to assume that it will be a long time before investors trust any of the mortgage brokers and bank aggregators that managed to survive the crisis, or the ratings agencies that were complicit in their flawed offerings. The few PLS deals that have been done in the last few years are being done almost entirely by new nonbank finance companies against mortgages of high credit quality with huge layers of "first loss" protection ahead of the investors.

The thrift industry has all but disappeared as a source of mortgage funding and overall bank portfolio lending is down 20 percent from 2008. Although banks have worked through the majority of their troubled residential mortgages, capital requirements have increased, making it more expensive to hold mortgage loans on balance sheet. And while deposits at banks have expanded slowly since the crisis, they would need to allocate their entire deposit base to fund the existing mortgage market. That means that banks would have to stop all commercial and consumer lending, grinding our economy to a halt, and the fate of the sector would be tied to a single asset class.

Private mortgage insurers have begun to add to their aggregate credit risk and capital over the past 2 years. But they still have only half the $17 billion in capital they had at their peak—well short of the capital that would be required to adequately support the likely $750 billion to $1 trillion in annual demand for conforming mortgage loans over the next 5 years.

Another important lesson from history is that change is slow. It took 25 years and a major change in the regulatory landscape governing the thrift industry for the GSEs and Government agencies to obtain a majority of the credit risk in the U.S. mortgage market. Assuming that an objective is to prevent the mortgage credit market from shrinking dramatically, it will likely take an equally long time to shift a material amount of that credit risk back into private hands. That is because Fannie and Freddie are the central pipes of the current mortgage funding system. Everyone participating in the origination, aggregation, securitization, and servicing of mortgage credit risk in America connects to them. They are the only standard setters with any market credibility. They own nearly half the credit risk in the mortgage market. Banks depend on them to move risk off their balance sheets while capturing profits from the spread between the primary and secondary market. Private mortgage insurers depend on credit enhancement requirements that Fannie and Freddie impose on conforming mortgages. Rate investors rely on their guarantees to funnel investment funds into the housing market. And, without their participation, the so-called To-Be-Announced market would shrink considerably (only Ginnie securities would remain), and rate locks for consumers on conforming mortgages would disappear. They have done more mortgage modifications and workouts than any other lender in the system. In short, while it could be done, winding Fannie and Freddie down will entail a massive restructuring of the entire infrastructure of the mortgage funding system. It is not going to be as simple as flipping a light switch or clearing a field and building a baseball diamond.

A final takeaway is that the now express Government guarantee of Fannie and Freddie's solvency has left the Government with a rather complicated liability management problem. The credit investor most at risk from a botched transition, in which mortgage credit availability contracts, house prices decline and delinquencies and defaults spike again, is the Treasury Department. Treasury now effectively stands behind those $5.5 trillion in liabilities, with virtually no capital in front of it.[6] What now looks like a huge asset could quickly turn into a massive liability for taxpayers if a "wind down" throws the mortgage funding markets into disarray.

A Smooth Transition: Transforming the Government Guarantee and Managing Existing Liabilities

Given that history and the current state of the housing market, I see one viable path to the end state envisioned in S.1217 that does not put the economy or taxpayers at risk: restructure, recapitalize, and privatize the single-family and multifamily guarantee businesses of Fannie and Freddie. Doing so would solve the thorniest problem in the transition: ensuring the creation of a durable layer of private capital ahead of the FMIC backstop.

Note that I am not proposing that you reinstate the precrisis GSE model. On the contrary, I suggest that you tear it down. Eliminate the "national mortgage association" charters dating back to 1934 that enabled Fannie and Freddie to operate Government-sponsored hedge funds, using Government-subsidized cost of funds to purchase risky mortgage assets on a highly levered basis. Wind those portfolios down to levels necessary to operate a cash window to facilitate the purchase of mortgage loans from small banks and credit unions and to manage the workout of troubled mortgages that they guarantee. Fully privatize their single-family and multifamily businesses separately, and subject them to strong safety and soundness and capital adequacy regulation. Create conditions for competition among private sector participants, while establishing a credible resolution regime for all participants, including those who may otherwise be deemed too big to fail. Substitute their existing access and affordability requirements with FMIC regulatory authority and dedicated Federal vehicles subject to congressional oversight and funded through fees on all securities issued in the conforming market. In short, I propose fixing the problems with these businesses and using what remains to bridge to your new system.

Below I provide a framework for evaluating any transition plan, followed by a more detailed explanation of what I propose. Finally, I evaluate the transition plan in S.1217.

Framework for Transition

Any responsible transition plan for reforming the Government's role in housing finance should satisfy the following 10 criteria:

1. Avoid a sharp contraction in mortgage credit that would depress house prices and risk another recession;
2. Avoid saddling Treasury with losses from the remaining liabilities at Fannie and Freddie to which it is currently exposed;
3. Establish an adequate and durable layer of private capital ahead of the FMIC and taxpayers;
4. Preserve liquidity between the old and new systems, including through the TBA market;
5. Maintain secondary market access for small and community banks without forcing them to go through large U.S. banks;
6. Prevent concentration of mortgage risk in large U.S. banks;
7. Facilitate competition among private loss providers on FMIC-reinsured MBS;
8. Avoid consolidating GSE obligations onto the Federal balance sheet;
9. Contribute to deficit reduction; and
10. Respect the rule of law.

A Realistic Way Forward

Again, I urge you to use the two companies currently under your control and central to the current mortgage system to transition smoothly to a new, safer system.

Use them to build capital cushions at each issuer adequate to protect the Government on the $4.4 trillion in outstanding MBS that the Government has backstopped through the conservatorships. To build that capital, FHFA should immediately direct the enterprises to increase their guarantee fees to market levels, reflecting a

[6] Under the terms of the PSPAs, each company currently has a capital reserve of $3 billion, which is required to decline to $0 in 2018.

return on capital that other private insurers have to factor into their fees. And Treasury should suspend its profit sweep and allow the companies to retain their earnings. Building capital to restore the companies' solvency is one of the express mandates of the statute authorizing the creation of the conservatorships, a mandate that has been entirely ignored during the past 5 years.

Meanwhile, begin building reserves at the new Mortgage Insurance Fund to protect the Federal Mortgage Insurance Corporation when the new system is turned on. Ten basis points of guarantee fees on the existing GSE MBS books should be reallocated to start building the FMIC reserve fund. In exchange, once the FMIC is up and running, it could reinsure the outstanding $4.4 trillion of legacy Fannie and Freddie MBS. This would relieve Treasury of any further obligation to backstop future losses on those securities through the PSPAs. It would also create continuity between the securities issued under the old regime and securities issued in the new regime, ensuring that securities in the new regime are issued into a deep and liquid market based on the same reinsurance. Without this bridge, legacy GSE MBS will be orphaned from the new market, and FMIC securities will suffer in pricing during the transition.

The personnel, assets, and operations associated with the single-family and multifamily businesses in each enterprise should be separated. Each separated business should be licensed to purchase FMIC reinsurance. And when they attain adequate capitalization levels, those businesses should be rechartered under State insurance and corporate charter statutes. Equity in each of the separately capitalized businesses should be sold to the highest bidder or in an initial public offering. This separation would promote focused management and reduce consolidated market power that could squeeze out competition. The privatized single-family businesses should be permitted to maintain portfolios of sufficient size to operate a cash window for small banks, credit unions, and other originators, to manage troubled mortgages which they have guaranteed, and to conduct basic Treasury operations.

None of these private companies would have special privileges—no implicit or explicit guarantee of their liabilities that Fannie and Freddie enjoy today as a result of their "national mortgage association" charters and the express backstop from Treasury of their solvency in conservatorship. They will not have the ability to issue Government guaranteed debt to fund expansive on-balance-sheet mortgage portfolio investments, which Fannie and Freddie had the ability to do under the Government-sponsorship model. And each of the separated businesses and new entrants should be subject to a resolution regime that could facilitate their failure without wrecking mortgage credit formation or the functioning of the mortgage market generally. In the case of future failure, shareholders can be wiped out and any mortgage guarantee infrastructure transferred to new ownership. That regime should be modeled on the FDIC's orderly liquidation authority for banks and financial institutions deemed systemically important by the FSOC.

Finally, conduct the ritual slaughter that so many are demanding. The highly levered investment portfolios each firm ran before the crisis—in effect, their Government-sponsored hedge funds—should continue to be wound down under Federal supervision. The public charters that allowed private shareholders to benefit on the backs of taxpayers should be terminated. Affordability and access requirements that have been suspended by the FHFA in conservatorship will end with the termination of the charters. Fannie and Freddie should ultimately be placed into receivership and liquidated.

I appreciate the trepidation of recreating two dominant players in the mortgage market by releasing parts of Fannie and Freddie back into the wild, however they may have been restructured. Therefore, an important element of both the transition and the end state is to ensure that there is a competitive marketplace for conforming mortgage credit risk.

There are at least six concrete, mutually reinforcing steps that the FHFA and FMIC can take during the transition to promote a more competitive market structure while ensuring continuity through the recapitalization and privatization of the mortgage guarantee businesses:

1. *Common MBS Security:* The FMIC could work with private market participants to establish a common To-Be-Announced market for securities eligible for FMIC insurance and facilitate options for multilender pools of eligible single-family mortgages. A single FMIC security could remove the largest barrier to entry for new issuers to compete with Fannie and Freddie. The difference in liquidity between Fannie and Freddie securities has given Fannie a more competitive position in the MBS market over Freddie. To combat Fannie's advantage over Freddie and both companies' advantages over any new issuer, a common TBA market through which a single FMIC security could be issued would

defeat the competitive advantages the privatized mortgage guarantee businesses would otherwise have over any new issuer or guarantor. Establishing a single security and extending it to legacy GSE MBS could be accomplished in 2 to 3 years.

2. *Capital Surcharges:* Legislation could require the FMIC to impose heightened capital and other heightened prudential requirements on any issuer or bond guarantor that establishes a dominant market position. This would be similar to the heightened requirements being debated for large banks and other financial institutions designated by the Financial Stability Oversight Council. New entrants with lower capital requirements should then be able to offer the same first loss protection to taxpayers on better terms while achieving comparable return on equity for their investors. S.1217 imposes a hard limit on market share, which risks discontinuities and inefficiencies that will translate into unnecessarily higher mortgage pricing. Adverse capital charges rely on economic incentives to achieve the same desired outcome, while providing flexibility to the regulator to preserve efficiencies in the market. If the consensus is to impose a hard limit on market share, I urge you to base that limit on some empirical analysis of the benefits and costs of the market structure which that hard limit will dictate.
3. *Infrastructure Licensing:* At least during the transition, the FMIC could coordinate with the FHFA to allow new MBS guarantors to use the issuance infrastructure of the enterprises and/or the common securitization platform in exchange for a fee to help establish and grow their market share. This could eliminate or at least mitigate another substantial barrier to entry, and ensure that there are existing, viable competitors when the restructured single-family and multifamily businesses of Fannie and Freddie are privatized.
4. *Common Securitization Platform:* Meanwhile, efforts to establish a common securitization platform (CSP) that could serve as a market utility should continue. However, it is important to recognize that the platform will take several years to reach its first milestone—bond administration functions—and as currently envisioned even in its final phase it will support only a quarter of the aggregation and issuance chain necessary to generate FMIC-reinsured MBS. It is more realistic during the transition to expect that the FMIC will rely on a combination of issuers (similar to Ginnie Mae) and whatever is available at the CSP, which will continue to evolve. The FMIC need not wait on the CSP to reach a particular level of maturity to begin offering reinsurance. The FMIC should supervise the CSP, but its operations could be managed by private market participants.
5. *Pricing:* Raising guarantee fees at the enterprises to take into account a proper return on capital charge will also have the collateral benefit of creating a pricing umbrella under which new private investors and insurers can compete.
6. *Equal Access:* In all events, the FMIC should offer reinsurance to all new entrant first-loss providers who meet its capital and other eligibility requirements.

With respect to minimum capital requirements, it would be a mistake to set capital requirements at arbitrarily high levels. Doing so will increase borrowing costs with little to no incremental improvement in the safety of the system. It will trap capital that could otherwise be used productively in our economy. And it may impair returns on MBS guarantee businesses to such a degree that you will deter the investment necessary to capitalize new entrants. It would also be a mistake to set capital standards for first-loss providers or for a subordinated layer of first-loss capital in reform legislation that are substantially higher or lower than those required of other providers of mortgage credit, such as banks. To do so would create a type of regulatory arbitrage between the capital required for mortgages held in whole loan form on balance sheet versus mortgages held in MBS form with FMIC reinsurance, an arbitrage that was partially responsible for the flight of mortgage credit out of the banking system and into the previously undercapitalized GSE system historically. Forcing mortgage credit back into the banking system by having substantially higher capital requirements for FMIC first-loss providers is not only inconsistent with heightened capital standards coming out of the crisis for banks going forward. It would also exacerbate the Too Big To Fail problem with our largest banks if in fact better returns on balance sheet mortgage lending leads to accelerated asset growth at the largest banks.

Based on recent experience with the largest mortgage credit shock in any of our lifetimes, and consistent with what banking regulators are targeting, a total capital requirement between 4 and 5 percent would be adequate to protect the FMIC against loss. Such a level would be consistent with the 10-percent capital standard that S.1217 calls for, assuming a relatively conservative risk-weighting for conforming mortgages. I warn against expanding the set of eligible capital beyond the definition accepted by banking regulators. Regarding the capitalization level for the MIF, we believe that a reserve balance of 1.5 percent is appropriate and achievable within an acceptable timeframe without imposing undue costs on the conforming market. This is greater than the 1.35-percent minimum level that the FDIC is targeting for the Deposit Insurance Fund, and behind 4 to 5 percent of first-loss capital, it would have been more than adequate to protect taxpayers against loss during the recent crisis.

Allowing the single-family and multifamily businesses at the heart of today's conforming market to be recapitalized and privatized rather than liquidated would provide continuity in the transition. Meanwhile, the six tools identified above could be used to ensure that a more diversified set of first-loss providers could enter the market and provide a check on the perpetuation of the dangerous duopoly that now exist under the conservatorships. In addition, when the new system is switched on and the FMIC begins to offer reinsurance on new conforming MBS, there would be at least two issuers/guarantors with sufficient capital and capacity to provide small banks and credit unions an effective conduit to the secondary market without having to sell their customer relationships to the countries' largest banks. And those two issuer/guarantors would be able to provide a counterweight to the large banks in the mortgage market generally. In turn, mortgage risk would not become concentrated in the banking sector. Legacy MBS obligations would follow the privatized companies, not be absorbed onto the Federal Government's balance sheet. Privatization proceeds would flow to the Government and generate over $100 billion in deficit reduction. [7]

AIG Precedent

During my recent tenure as the Chief Restructuring Officer at Treasury, I had primary responsibility for the oversight of the Government's capital commitments to AIG, which rivaled in size the amount of capital invested to date in Fannie and Freddie. After a series of restructurings of that $182 billion commitment, we designed and implemented a recapitalization plan for AIG that involved (i) selling off almost half of its insurance businesses to generate sufficient proceeds to repay its debt to the Federal Reserve and (ii) exchanging Treasury's $50 billion of preferred stock into 92 percent of the common equity of the company. Treasury then sold the common stock into the public markets in a series of secondary offerings in 2011 and 2012, which fully eliminated Government ownership of AIG. In the end, taxpayers made almost $23 billion on an investment that the OMB initially projected would result in $50 billion of losses for the Government.

As with Fannie and Freddie, at the height of the financial crisis regulators determined that the potential failure of AIG could threaten the stability of the financial system. Failures in management and regulation were blamed for allowing the company to reach that point. However, once taxpayer capital was committed, Treasury and the Federal Reserve Bank of New York went to work figuring out how to fix the company and recover the taxpayer support, all while protecting broader financial stability. Approximately $2 trillion of notional derivatives at AIG Financial Products were wound down and substantially derisked before the recapitalization was consummated in early 2011. Operating businesses were sold as going concerns in value-maximizing transactions in order to reduce the company's complexity, shrink its balance sheet and repay its Government support. Financial leverage was reduced to responsible levels. Management refocused on AIG's core property and casualty and life insurance businesses, which remain today important cornerstones of the global insurance landscape and integral parts of the daily risk management realities for countless policyholders.

The key lesson from this process is that tried and true methods of corporate reorganization within our existing rule of law can be used to move forward with reform. Privatizing recapitalized and newly State-chartered mortgage-guarantee businesses would enable Treasury to recover its substantial investment in the companies and begin moving toward a safer housing finance system driven by market incentives,

[7] Since Fannie and Freddie were put into Federal conservatorships, the Congressional Budget Office (CBO) has treated them as consolidated entities of the Government that confer a subsidy (budget cost) to the market because CBO estimates that the price the companies charge to guarantee mortgages against default is lower than a private entity would charge. Severing the single-family and multifamily businesses' special relationship with the Government and divesting the Government's financial interests in those businesses subsequently in the market would eliminate the guarantee-fee subsidy and generate cash proceeds from sales that CBO could score as a substantial negative subsidy (budget benefit) over the budget window.

with private capital first in line for losses. Taxpayers deserve both outcomes. Once the companies have enough capital to cover their "first loss" insurance exposure, Treasury should outline a detailed privatization plan in consultation with various stakeholders. The firms could then be released from Government control and Treasury's ownership stakes in the restructured entities sold to private investors over time.

Maximizing the asset value of what the Government controls today and selling it off over time to ensure the new system has at least two well-capitalized first-loss providers is a far safer bet in transition than hoping that new capital sources and avenues for funding mortgages will arrive in appropriate size to support the market according to an arbitrary wind down time line. Moreover, it would provide a clear roadmap to the desired end state that all private market participants can plan for and invest around.

The Transition Proposed by S.1217

The transition suggested in S.1217 has elements of the above proposal but ultimately rests on a leap of faith, faith that if we build a new system, new private capital will come in sufficient size and speed to allow the new system to meet the future demand for mortgage funding currently being channeled through Fannie and Freddie. If it does not, the new system will shut down before it ever has a chance to get off the ground. As a result, the implementation of the new system contemplated in S.1217 carries significant execution risk, depending on capital yet to be raised by players yet to be named. It also puts taxpayers at risk, not only from potential shocks resulting from the contemplated break-up of the two largest players in today's mortgage market, but also from the $4.4 trillion of MBS liabilities which the bill puts on the Federal Government's balance sheet. Further, by imposing capital requirements on first-loss providers in the new system higher than those are imposed on regulated depositary institutions, S.1217 ignores the lessons of the recent crisis which suggest that capital will flow to that part of the financial system where permitted leverage is the greatest and leveraged returns are the highest.

S.1217 requires that Fannie and Freddie cease doing any new MBS business and wind their portfolios down to $0 by the FMIC certification date; that is within 5 years after the bill's enactment. This arbitrary deadline risks significant dislocation in mortgage credit formation if private capital is not raised in sufficient amounts to substitute for Fannie and Freddie on that timetable.

The bill would consolidate $4.4 trillion of GSE MBS liabilities onto the balance sheet of the Federal Government. This poses two problems. It will create discontinuities in the trading markets for those legacy MBS and the new FMIC-reinsured MBS, orphaning the existing securities and creating significant liquidity constraints on the new FMIC MBS which will negatively affect mortgage pricing during the transition. Separately, putting the full faith and credit behind those contingent liabilities could balloon the Federal debt. This would complicate an already difficult debate over the sustainability of U.S. debt and austerity measures.

S.1217 provides that Fannie and Freddie be repurposed in three ways. First, parts of their businesses are to be sold to a mutual with small bank members. I am sympathetic to the desire to provide small banks with access to the secondary mortgage market away from large banks. Fannie and Freddie do that today. Why create execution risk of trying to recreate Freddie out of spare parts from both companies? The bill is also unclear how the mutual would be capitalized, governed, or established to compete on pricing with large banks. Second, the bill takes the multifamily businesses "at no cost" and puts them inside the FMIC. Although it may be a placeholder for a better plan, in its current form, it is neither legal nor workable. Third, the bill would allow certain businesses to be sold as going concerns. But here too, it would strip them of assets and purport to sell them without any capital. A financial institution without capital is like a widget factory with no assembly line: you can sell the building but you are not going to get going-concern value for the business that it houses. As a drafting matter, if this is the path you want to pursue, S.1217 needs to be redrafted to expressly override HERA's provisions that obligate the conservator or receiver to maximize the sale proceeds of the assets it seeks to liquidate.

More generally, S.1217 requires 10-percent capital at first-loss providers. Assuming the conforming market is $5 trillion in 7 to 10 years after a significant portion of the legacy books have rolled over, and assuming that the bill means for that capital to be defined as a percentage of total assets, a 10-percent capital requirement means that $500 billion of first-loss capital needs to be raised to backstop the conforming MBS market. That is a gargantuan sum relative to the existing equity capital in the banking and insurance sectors. On top of this, the bill requires another 2.5 percent, or $125 billion, in the MIF to be raised within 15 years. Again, the bill provides no direction of how either such capital level will be reached. But each is critical to the functioning of the new system. In short, the bill is based on a leap of faith that such a substantial amount of capital will be raised by players yet to be named.

Conclusion

By highlighting the important role that the mortgage guarantee businesses of Fannie and Freddie play in today's mortgage funding markets, and by taking on the politically charged idea that the safest and surest path to raising the significant amount of new capital on which the new system depends and ensuring continuity in mortgage credit formation during the transition is to recapitalize and privatize those businesses, I hope that my testimony today will stimulate a frank conversation about how to handle the transition. I do not envy you the task ahead: To say that housing finance reform is the most complicated policy, economic and corporate finance challenge I've seen in my 30 years in the restructuring business would be a gross understatement.

As I noted previously, you have a fundamental choice in meeting the challenges in transition: Fix what you have and use it to move to a better-capitalized system of mortgage funding, or destroy what is working today and make a leap of faith that new capital will be raised by players to be named. For the sake of the Federal budget, the stability of the mortgage funding markets and the value of the single-most important asset for most Americans, I hope that I have persuaded you that the choice is clear.

PREPARED STATEMENT OF JOHN BOVENZI

PARTNER, OLIVER WYMAN

NOVEMBER 22, 2013

Introduction

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee. My name is John Bovenzi, and I am a Partner at Oliver Wyman, a business unit of Marsh and McLennan Companies (MMC). I would like to thank you for affording me an opportunity to share my perspective on housing finance reform.

Much of my perspective on housing finance reform draws on my 28 years of experience at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). I served as Deputy to the Chairman of the FDIC from 1989 through 1992, the period of time when the FDIC was responsible for establishing and managing the RTC. From 1992 to 1999, I was Director of the FDIC's Division of Resolutions and Receiverships and played a key role in merging the RTC into the FDIC. From 1999 to 2009, I served as Deputy to the Chairman and Chief Operating Officer at the FDIC.

I believe there is much of value in the FDIC's and the RTC's experience that can be helpful to the Committee as it determines the best path forward for housing finance reform.

Overview of the FDIC and the RTC

First, let me briefly provide an overview of the two agencies' missions and responsibilities.

As you know, the FDIC is an independent agency created by Congress in the aftermath of the Great Depression. Its mission is to maintain stability and public confidence in our Nation's financial system, and it has three primary roles through which it carries out this mission: (1) by insuring deposits, (2) by examining and supervising financial institutions for safety and soundness and consumer protection, and (3) by managing receiverships of failed institutions.

The RTC was a temporary Federal agency established under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in August of 1989. Its mission was to manage the assets and liabilities of Savings & Loan Institutions (S&Ls) that had been placed into conservatorship. The agency's goal was to dispose of these assets as quickly as practicable at maximum value in order to reduce taxpayer expense.

The RTC resolved 747 S&Ls with assets totaling nearly $400B during its 6-year existence. While heavily criticized at the time, today, the RTC is widely viewed as a success story. The total cost to taxpayers from the failed S&Ls wound down by the RTC was about $80B, a far lower number than originally projected. After its work was done, the RTC demonstrated that a Government agency can put itself out of business effectively and efficiently once its mission has been accomplished.

How the FDIC's and the RTC's Experience Can Be Applied to a New Federal Mortgage Insurance Corporation

Title 1 of the "Housing Finance Reform and Taxpayer Protection Act" would create a new Federal Mortgage Insurance Corporation (FMIC) to provide insurance protection for mortgage-backed securities. In the proposed legislation, the new FMIC is modeled to a large extent after the FDIC, so observations on the FDIC's structure and experience may be useful. Also, as a start-up Federal agency, the RTC experience in establishing itself also should be of value.

Lessons From the RTC's Experience

I'll start with the RTC's experience in creating a new Federal agency, since I believe that is where we can learn the most. There are three important points I would like to make at the outset.

First, the creation and subsequent experience of the RTC show that a new Federal agency can start up and be successful in a relatively short period of time. However, the RTC experience also shows that the complexity of the political and operational issues that must be addressed requires that stakeholders show some degree of patience. There will be bumps, missteps, and delays along the way.

Second, the leadership of such an organization is critically important. The Director will need to possess both the skills to work effectively with a large number of stakeholder groups, as well as the managerial skills to effectively address the many operational issues that will be faced by a new agency.

Third, ultimately the employees of the two Government-sponsored enterprises and the Federal Housing Finance Agency (FHFA) will determine whether the start-up is a success or a failure. They are the people who have the ability to effectively transfer critical functions to a new agency. Their experience and expertise should not be undervalued or lost if Congress decides to move in the direction of the proposed legislation.

Let me elaborate on these three points.

Regarding the first point, that time and patience will be necessary, when the RTC was created, it needed a new governance structure, new information systems, new staff, and new policies and procedures. The FDIC was able to provide a great deal of support, but not nearly enough. Initially, seven hundred employees were transferred from the FDIC to the RTC. Still, the RTC needed to hire many more employees and contractors. Both the internal hiring and contractor procurement processes had to be fair and transparent, with all of the necessary controls, including background checks. This took time, when people outside the agency were more focused on seeing immediate results.

To get off to a faster start, the RTC initially adopted many of the FDIC's policies and procedures, but these proved to be insufficient. The RTC's mission and duties were not the same as the FDIC's so most of those policies and procedures needed to be revised or created from scratch, generally with sufficient time for public comment and revisions based on those comments. Information systems were an even greater challenge. The FDIC's systems were not suited for the RTC's needs. New systems had to be created, only to be populated with poor data from insolvent S&Ls. Finally, as a political compromise, the RTC's governance structure started out with two Boards of Directors, one for policy and one for operations. The blurred line between these two sets of responsibilities led to finger pointing and a lack of accountability.

As a result, the RTC's start-up went slower than what most observers had hoped for and there was a great deal of frustration with the RTC. But some perspective is necessary. The RTC successfully managed its way through those problems and today is widely viewed as a success story. The agency saved taxpayers money and finished its work early.

Regarding the second point, that the new agency's leadership will need to possess both leadership and management skills, I'll simply say that while this may be obvious to most people, there is an occasional tendency for the leadership of a Government agency to focus almost exclusively on high level policy issues and not give sufficient attention to operational details. A director need not personally focus on all of the operational details involved in the start-up of a Government agency, in fact that would be counterproductive. However, that person must have a clear appreciation of the significance of internal operations and ensure there are clear delegations of authority and accountability.

As to the third point, that a new agency's success or failure will be determined by the employees of the GSEs and the FHFA, there are a few issues that Congress should consider based on the RTC's experience.

Title 3 of the proposed legislation abolishes the Federal Housing Finance Agency and transfers its staff, infrastructure, technology and other resources to the FMIC, but the bill is silent as to the fate of the employees of Fannie Mae and Freddie Mac. If those two enterprises are to be shut down some of their operations will have to be transferred to the FMIC or elsewhere, which means some jobs would become available in other organizations. But the uncertainty surrounding how many jobs will be available, on what terms, and who will get them will create significant complications in ensuring a smooth transition. The experience and the expertise of Fannie Mae's and Freddie Mac's employees will be needed to have an effective transition, so some thought needs to be given as to how that skill and talent can be preserved.

As a limited life agency, the RTC's employees knew that by doing their jobs correctly they might be putting themselves out of a job. The same applied to the FDIC's employees who were responsible for handling the spike in bank closings. Eventually the economy would recover and their workload would vanish.

Certain steps were taken to mitigate the harmful effects on the RTC's and the FDIC's employees. By law, RTC employees also were FDIC employees, thus they had the same rights as FDIC's employees. This meant that when the two agencies were merged together the career civil servants in each agency had equal rights to the remaining jobs. Other FDIC and RTC employees who had been hired on a temporary basis were in a more tenuous position. In most cases, they were not likely to have their contracts renewed once the workload diminished to the point where staff reductions were necessary.

To the credit of the employees at both agencies, they continued to do their jobs effectively even though they did not know if, or for how long, those jobs might last. Indeed after the two agencies were merged together, the FDIC had to undergo a large and painful downsizing given the substantial reduction in its workload in going from the crisis to the postcrisis period.

Throughout that difficult period, constant and clear communication was critical. Employees needed as much information as possible so they could better plan for their future. The same would be true here. It will not be possible to provide jobs for everyone and some attrition will certainly occur, but should Congress go down this path, the employees at the GSEs should know that they will be treated fairly and respectfully.

Lessons From the FDIC's Experience

Regarding lessons that may be learned from the FDIC's experience, I would like to make some comments on three broad areas: (1) corporate governance, (2) financial strength, and (3) the supervision of financial-sector participants.

Corporate Governance

Independence and a system of checks and balances are two important features of the FDIC's governance structure that have served the agency well over time. These features also are part of the proposed structure for the Federal Mortgage Insurance Corporation.

Once certain parameters have been established around an agency's power and authority, an independent structure allows an agency to carry out its duties in a responsive manner. Because the market is constantly changing, an agency needs the ability to continually assess new information and adapt to those changes.

The FDIC has a five person Board of Directors, each appointed by the President and confirmed by the Senate. No more than three Board members may be from the same political party. In my view, this structure has served the FDIC well over time by providing appropriate checks and balances on important policy decisions.

The FDIC also has a strong Office of the Inspector General that provides independent reviews of the agency's operations to prevent waste, fraud and abuse. The Inspector General is appointed by the President and reports directly to Congress as well as to the FDIC Chairman. This too has served the FDIC well as part of an overall system of checks and balances. The creation of an Office of the Inspector General is an important safeguard that has been included in the proposed bill.

Based on my experience it appears that the proposed bill covers the most important aspects of creating a strong governance structure.

Financial Strength

Much has been learned over the past 30 years about what is required to maintain a deposit insurance fund strong enough to not have to rely on taxpayer support during a financial crisis. During the 1980s and early 1990s nearly 3,000 insured depository institutions became insolvent and were closed. As a result, the Bank Insurance Fund became insolvent. While the FDIC did not have to rely on taxpayer support, it did have to substantially raise bank deposit insurance premiums during the crisis period, when banks could least afford to pay more. This had several adverse effects, not the least of which was exacerbating the credit crunch that existed at that time.

Because of that experience, Congress relaxed some of the controls on the FDIC's ability to manage the size of its deposit insurance fund, but it was not enough. During the 2008 financial crisis the FDIC's deposit insurance fund again had insufficient funds. The agency did not have to rely on taxpayer support, but once more it did have to charge banks substantially higher premiums when banks could least afford to pay them. As a result Congress further relaxed the controls on the FDIC's ability to assess high enough premiums over the course of the business cycle. Now the agency has the authority it needs to build the deposit insurance fund to high enough levels that it can withstand a crisis period. This new authority allows the FDIC to charge higher premiums during the healthy part of the economic cycle, so it will not be forced to further dampen credit availability during an economic downturn.

The proposed bill includes targets for the size of the FMIC's Mortgage Insurance Fund. After the first 5 years of its existence the FMIC is expected to have charged participating institutions fees sufficient to create a fund that is 1.25 percent of all outstanding covered securities. After 10 years the ratio is targeted to be 2.5 percent of all outstanding covered securities. It is difficult to know what size fund is needed to protect taxpayers against losses. For many years the FDIC's statutory target ratio of the deposit insurance fund to insured deposits was 1.25 percent. Prior to the 1980's the rationale was that while arbitrary, history had shown that the 1.25 percent target ratio worked. In the aftermath of two financial crises it was clear the 1.25 percent ratio did not work. Since then the FDIC analyzed what fund size would have been necessary to keep the deposit insurance fund from becoming insolvent. That review led the agency to raise its target ratio to 2 percent.

The important point is that the FMIC will need sufficient flexibility and authority to manage the size of the Mortgage Insurance Fund based on continuous analysis so it can protect taxpayers against losses during economic downturns.

Supervision of Financial-Sector Participants

The FDIC sets standards for bank behavior. The agency has the authority to set entry standards for groups that seek to obtain bank charters and the authority to remove deposit insurance protection for banks that aren't meeting those standards. In between, the FDIC has a wide range of formal and informal enforcement actions it can employ to force banks to meet its supervisory standards without removing a bank's deposit insurance coverage. These authorities include issuing formal cease-and-desist orders, civil money penalties, and agreeing to informal memoranda of understanding. The FDIC also has examination authority to ensure banks are in compliance with FDIC supervisory standards and to determine whether enforcement actions are necessary. Also, to help ensure that supervisory actions are taken in a timely manner, the FDIC is subject to Prompt Corrective Action requirements, which mandate that certain supervisory actions be taken as bank capital levels drop below prescribed levels. In their entirety these powers are an important part of safeguarding the financial system and protecting the deposit insurance fund.

The proposed bill would grant some, but not all, of these authorities to the FMIC. The new agency would have authority to determine entry standards for mortgage servicers, issuers, and guarantors. Those standards track the FDIC standards in many respects, since they include a review of the financial history of the applicant, its capital adequacy, the character of management, and the risk posed to the insurance fund. The bill also empowers the FMIC to issue civil money penalties and revoke its approval if a participating institution does not continue to meet its standards. However, the bill does not grant the FMIC examination authority, nor does it allow for a full range of enforcement actions.

Based on my experience, it would be worth considering whether the FMIC should be granted broader supervisory and enforcement authorities beyond controlling entry and exit into and out of the program and the ability to issue civil money penalties. The FDIC has rarely used its power to revoke deposit insurance coverage, finding it to be a cumbersome process compared to its other enforcement alternatives such informal memoranda of understanding and formal cease-and-desist orders. The FMIC likely would have the same experience. Other more practical enforcement tools may be more effective in helping the FMIC accomplish its objectives. Also, consideration should be given to giving the FMIC examination authority. While off-site monitoring can be used to help monitor bank behavior, over time the FDIC has found there is no substitute for the direct interaction with bank management that occurs during the examination process.

How the RTC's Experience Can Be Applied to the Proposed Wind Down of Fannie and Freddie

Title 5 of the "Housing Finance Reform and Taxpayer Protection Act" requires that Fannie Mae and Freddie Mac be wound down and phased out of business over a 5-year period. The RTC had a similar requirement in its original charter. By statute the agency, which was created in 1989, had to be wound down and merged into the FDIC by year-end 1996. It accomplished that objective a year earlier than originally planned. Given those similarities there may be some valuable lessons based on the RTC's experience should Congress determine that it wants to wind down Fannie and Freddie's operations. We already covered issues related to the treatment of the GSE's employees so I won't repeat those concerns here, rather I'll talk briefly about governance issues and sales processes.

Corporate Governance

Many of the same governance principles that apply to the creation of a new agency also apply to the wind down of an existing agency or agencies. Strong oversight is critical because taxpayer dollars and important public policy objectives are at stake.

The RTC was governed by a Board of Directors with additional oversight provided by Congress, an Office of the Inspector General, and the General Accounting Office (GAO), among others. Such checks and balances, while introducing some degree of inefficiency, are well worth the costs in order to ensure there are strong oversight, effective internal controls, and fair processes.

Sales Processes

According to the proposed legislation, Fannie Mae and Freddie Mac should have no more than $552.5B in real estate related assets (mortgage loans and mortgage-backed securities) by year-end 2013. The bill requires that these assets be reduced by at least 15 percent a year over a 5-year period. Any remaining assets are to be put into receivership after that point. This is not significantly different than what the RTC was charged with accomplishing. Most of the $400B in assets from the insolvent S&Ls that the RTC was responsible for also were real estate related assets.

The RTC experimented with a large variety of sales processes for the different types of assets it managed. It learned much through trial and error, but a few key principles emerged to help guide the agency.

First, virtually all sales were subject to an inclusive, open and transparent competitive bidding process. The RTC did not engage in negotiated sales with individual buyers for pools of assets, despite the desire for such by many potential buyers. The agency recognized that open competition would maximize value and that it also reduced the possibilities for fraud or abuse. Given that a number of the insolvent S&Ls that were costing taxpayer money had committed fraud and abuse, it was that much more important that the Government cleanup be beyond reproach.

Second, the RTC partnered with the private sector in the disposition of many its assets. For pools of assets that required particular expertise, the RTC found it best to sell a portion of the pool to private-sector investors with the required expertise and retain partial ownership of the assets. Such partnerships allowed the RTC, and hence taxpayers, to benefit from the added value the right management could bring to those assets as well as from any appreciation in assets value over time due to an improving economy.

Such public/private-sector partnerships in managing and disposing of assets aren't without their challenges. Often both sides have a healthy degree of mistrust for one another. The private sector often views the Government as an unreliable and slow business partner, while the Government often sees the private sector as overly focused on its financial returns and under appreciative of the types of processes and controls that must be put into place whenever taxpayer money is at stake.

These differences can be overcome by clarifying up front what the expectations are for each business partner. The Government needs to understand that financial incentives for the private sector maximize value for taxpayers. Private sector asset managers need to understand that they have to comply with certain processes and oversight that they may view as inefficient and time consuming, but that are necessary to show the public that the overall process is being managed in a way that treats people fairly and shows them that their money is not being wasted.

During the most recent financial crisis the FDIC effectively used public/private equity partnerships (and the closely related loss-sharing agreements it entered into with the acquirers of insolvent banks) to manage many of the assets it was responsible for as receiver for failed banks. It found that these partnerships greatly enhanced asset values and returns to failed-bank creditors, including the FDIC's deposit insurance fund.

Such agreements between the public and private sector, while valuable in certain situations, are not necessarily the preferable sales technique in all situations. Some assets can be sold outright and still maximize value, in part by eliminating ongoing commitments and administrative burdens on the part of the Government. Each asset category and situation should be evaluated on its own merits to determine the best strategy.

As the Committee and the Congress deliberate further on this important issue, I and my colleagues at Oliver Wyman are ready to collaborate with you to offer our experience and expertise on this key public policy matter.

PREPARED STATEMENT OF MARK ZANDI

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NOVEMBER 22, 2013

Much of the debate over the future of the Nation's housing finance system has focused on the system's end state—whether housing finance should be privatized, retain some form of Government backstop, or even remain effectively nationalized as it is today. No matter which goal is chosen, however, reform will not succeed without an effective transition. A clearly articulated plan for getting from here to there is vital; otherwise policy makers will be appropriately reluctant to move down the reform path.

For the purposes of this testimony, it is assumed that the future housing finance system will be a hybrid system, much like that proposed in recent legislation introduced by Senators Corker and Warner, S.1217. That is, private capital will be responsible for losses related to mortgage defaults, but in times of financial crisis, when private capital is insufficient to absorb those losses, the Government will step in. Mortgage borrowers who benefit from the Government backstop will pay a fee to compensate the Government for potential losses.

While there are advantages and disadvantages to any housing finance system, a hybrid system is the most likely to be implemented. Such a system will preserve the long-term fixed-rate mortgage as a mainstay of U.S. housing, and it will ensure that affordable mortgage loans are available to most middle-income Americans through good and bad times. Taxpayers will backstop the system, but it will be designed so that lenders and borrowers bear the ultimate cost.

A hybrid system will require substantial new private capital. Currently, little private capital is involved in making mortgage loans; the Federal Government acts as the Nation's principal mortgage originator via Fannie Mae, Freddie Mac, and the Federal Housing Administration. How much private capital will be needed depends on many factors, but assuming the new system's requirements are consistent with those applied to the Nation's largest banks, as much as $175 billion in today's dollars might have to be raised.

For context, this amounts to more than the equity raised in the 10 largest initial public offerings in U.S. history combined, including those for the insurer AIG and the credit-card giant Visa. Such a large amount will not be easy to raise quickly. Any viable transition plan must therefore clearly determine where the private capital will come from and at what cost.

The transition plan must also spell out the fate of Fannie Mae and Freddie Mac. While few wish to return to the old system, which was dominated by these thinly capitalized, too-big-to-fail behemoths, the consensus stops there. Some insist that Fannie and Freddie be completely dismantled, while others propose using their current profits to recapitalize and ultimately reprivatize them.

Dismantling the two institutions would risk disrupting the flow of mortgage credit, which, for all their faults, Fannie and Freddie have continued to provide efficiently through the Great Recession and subsequent recovery. On the other hand, recapitalizing and privatizing the institutions could leave them in control of U.S. housing finance. It is unclear who could compete with them; without such competition, the future system will eventually resemble the old one. A dominant duopoly will allow the entities to overcharge for their services and will become the taxpayers' problem if they blunder again.

A host of smaller but still critical technical and legal issues must also be resolved in the transition to a new system. Moving Fannie and Freddie from their current conservatorship status to receivership to new ownership will be complicated. Their mortgage securities must be managed by whoever succeeds them at least as efficiently as they are doing. Shifting oversight authority from the Federal Housing Finance Agency, Fannie's and Freddie's current regulator, to the overseer of the future system will also involve many steps. And ensuring that small lenders have access to the Government backstop for the mortgages they originate will not be easy.

Some initiatives necessary to reshape the housing finance system are already under way and should be nurtured. The FHFA is developing a common securitization platform, which will be important no matter the system's final form. The platform should support greater transparency, which in turn will promote better credit risk management and lower future mortgage defaults, more liquidity, better access for small lenders and increased competition.

The FHFA is also requiring Fannie and Freddie to share more risk with private investors, including private mortgage insurers and investors. This should provide information and experience necessary for the risk-sharing envisaged under most housing finance reform proposals.

The transition to the future housing finance system will require legislation and take years to implement, but cannot begin unless there is a clearly laid-out road to reform. With such a road map, it is plausible that housing finance reform could become law soon. It is exciting to think that the new housing finance system could conceivably be in place at the start of the next decade.

A more detailed description of the road to housing reform is provided in the paper as an appendix to this testimony, "The Road to Reform", Mark Zandi and Cristian deRitis, Moody's Analytics white paper, September 2013.

Transition Objectives

The transition from the current, largely nationalized housing finance system to the future hybrid system must protect the economic recovery. Government support to the housing finance system cannot be withdrawn too quickly without undermining the housing recovery, which is vital to the broader economic recovery. Mortgage credit conditions are still very tight: Lenders remember the massive losses suffered during the housing crash and are uncertain about a number of regulatory issues. Prematurely withdrawing Government support would exacerbate this problem.

Taxpayers should be made financially whole during the transition. The Government's support to Fannie and Freddie should be repaid, along with the cost of backstopping the rest of the financial system when Fannie and Freddie failed, and the costs associated with setting up a new financial system. Taxpayers should also receive a return on their financial support commensurate with the risks they have taken.

Private capital standing in front of the Government's guarantee must be adequate to absorb mortgage losses resulting from all but the most severe financial crises and economic downturns. This is necessary to protect the Government against losses and avoid future bailouts. A substantial amount of private capital, from varied sources, will be needed by the future housing finance system.

The transition to the new housing finance system must reduce the system's reliance on large and complex financial institutions such as Fannie Mae and Freddie Mac. The housing finance system's design must ensure that institutions in the system can fail without catastrophic economic consequences.

Access to affordable owner-occupied and rental housing must be maintained through the transition. This has become even more important in the wake of the Great Depression and the significant destruction of homeowners' equity in the Great Recession, ongoing financial pressure on low-income households, and changing demographics.

Legacy Fannie and Freddie Securities

Investors in legacy Fannie and Freddie MBS and debt securities must be protected. The Federal Government now guarantees existing MBS and bond obligations of Fannie and Freddie through agreements between the Treasury Department and the two firms. This must continue through the transition period. Not doing so would undermine investors' faith in the U.S., raising borrowing costs and exacerbating the Nation's fiscal problems. This is a legacy of the old system, and while the new system should avoid re-creating this obligation, we cannot retroactively change expectations without damaging the Nation's credibility in global credit markets.

S.1217 addresses this issue by providing an explicit guarantee on the "payments of all amounts which may be required to be paid under any obligation" of the Government-sponsored enterprises. Legacy GSE MBS would thus be backed by the Government's full faith and credit, much like a GNMA MBS. This support applies to mortgage-backed securities that have been issued by Fannie and Freddie in the years leading up to the "certification date," when the GSEs stop issuing MBS.

Legacy GSE MBS must be made fungible with Government-backed MBS in the new housing finance system. In S.1217 this would be MBS backed by a Government regulator—call it the Federal Mortgage Insurance Corp. One possibility is to establish a resecuritization process whereby investors in legacy MBS are able to, but not required to, convert them into FMIC MBS. These new MBS would be deliverable into the new to-be-announced market, and would simply require a new CUSIP number and a matching-up of payment delays.

Investors should be able to exchange legacy GSE MBS for the new FMIC MBS indefinitely and without cost. When the existing stock of legacy securities outstanding becomes small enough so that the costs of maintaining the exchange program exceed its benefits, some type of "clean up" call may be appropriate.

Common Security

Smoothing the transition to these new securities would be the development of a common Government-guaranteed security prior to the full implementation of the new housing finance system. This would improve liquidity in the TBA market and result in lower mortgage rates. A common security would also lower entry barriers to the guarantor market, as no guarantor would have an advantage because of the liquidity of the securities they back.

This is a problem in the current housing finance system, as Freddie Mac securities are much less liquid than Fannie Mae securities. Fannie and Freddie split the MBS market 60–40, but on a typical day the trading volume of Fannie MBS is 10 times greater than that of Freddie MBS. To compensate, Freddie is forced to charge a lower guarantee fee than Fannie. In the second quarter of 2013, Fannie's average G-fee was 57 basis points, compared with Freddie's 51 basis points.

There are some modest differences between the securities—Freddie pays investors more quickly than Fannie and its securities prepay a bit more quickly—but the key difference is their liquidity. This liquidity difference makes the mortgage market less efficient and less competitive, and leads to higher costs for mortgage borrowers and taxpayers.

A potential near-term fix to this problem would be to make Fannie and Freddie securities fungible, creating a common TBA security. That would require a change to the good-delivery guidelines for TBA, to allow the delivery of either Fannie or Freddie securities into the same contract. The securities themselves would not change; their separate TBA markets would simply be merged. Both securities would still be separately identifiable and tradable, only the TBA trades would be merged. Not only would this interim step improve liquidity, it would demonstrate investor interest in a truly common security that would be an important feature of the future hybrid housing finance system.

The Future of Fannie and Freddie

A critical question in the transition to a future housing finance system is what to do with Fannie Mae and Freddie Mac. For all that is wrong with the current system, Fannie and Freddie are doing an effective job buying conforming mortgages, bundling them into MBS with a Government guarantee, and selling them to global investors. The mortgage market is not working as well as it should, but it is working. Whatever is done with Fannie and Freddie must not disrupt this flow of mortgage credit, for the sake of the housing and economic recoveries.

Arguably the most straightforward approach, with the least amount of near-term risk, would be to recapitalize and reprivatize Fannie and Freddie. Both are currently profitable, as a result of improving mortgage credit conditions and their higher guarantee fees. The two agencies' profits are flowing to the U.S. Treasury, rapidly repaying the $188 billion Fannie and Freddie received from taxpayers in order to stay in business. The GSEs are on track to repay the Treasury's investment by the end of this year.

After that, their profits could be used to build the capital necessary for them to become private guarantors in the future finance system. Once appropriately capitalized, they would be reprivatized, with the Government selling them to private investors to maximize the return to taxpayers.

There is a considerable downside to this approach, however: The future housing finance system could again be dominated by Fannie and Freddie or their successors. The system could encourage competition, for example, by establishing a new common securitization platform run as a Government utility that produces a single Government-backed security. The reincarnated Fannie and Freddie would also likely be classified as systemically important financial institutions, or SIFIs, and thus face stiffer capital and liquidity requirements. This would raise their cost of capital vis-a-vis newer entrants, further supporting competition.

But the two giant firms would still have considerable advantages of size and scale, important legacy relationships, and entrenched software and systems. Most likely this approach would create a hybrid system dominated by a duopoly, firms with significant power over the mortgage and housing markets that would be much too big to fail. The arrangement would be uncomfortably similar to the dysfunctional system that prevailed prior to the Great Recession.

An alternative approach would be to simply put Fannie and Freddie into receivership and liquidate their assets. Guarantors in the hybrid system would be largely new entities, begun by those purchasing Fannie's and Freddie's assets. There is significant risk in this approach, as there would be no assurance that the new guarantors would be able to continue the institutions' activities, at least not in a timely way. The chance of a disruption in the flow of mortgage credit would be uncomfortably high.

A better approach would be for the Government to put Fannie and Freddie into receivership, and to strip them of their key assets. They would then be rechartered as new private guarantors, able to license back these assets from the Government receiver. Their operations would not be disrupted, ensuring that the mortgage market functioned smoothly through the transition. But to level the competitive playing field, any other new guarantors could also license the same key assets from the receiver. This would facilitate easy entry into the guarantor market and thus encourage competition.

The current Senior Preferred Stock Purchase Agreement between the U.S. Treasury and Fannie and Freddie would need to be restructured to permit the redemption of the Treasury's senior preferred shares and the cancelation of its warrant in the firms. The restructured SPSPA would determine the appropriate compensation taxpayers require from Fannie and Freddie for their financial support.

Fannie and Freddie would be put into receivership, and their operating assets and liabilities moved into limited life regulated entities, or LLREs, allowing them to maintain their operations independent of the resolution process. This is similar to the procedure envisaged in Dodd-Frank for failing SIFIs. The assets of the LLREs would then be sold or licensed back to Fannie's and Freddie's successor firms, which would be chartered as independent guarantors, and to the new competitor guarantors.

Fannie's and Freddie's $4.5 trillion legacy guaranty book would not be included in the assets transferred from the Government receiver to the LLREs. More private capital would be needed to support the legacy books than could be raised in a reasonable period, ensuring that the new housing finance system would never get going. The receiver would engage the new guarantors to manage the loans in the legacy books, providing a steady source of revenue.

Sources of Private Capital

A substantial amount of private capital will thus be necessary to support the future housing finance system. Over time, some will come through the guarantors' retained earnings. This will not help in the early years, but under conservative assumptions, retained earnings could eventually provide as much as one-third of the guarantors' capital requirements.

The equity market is another potential source for early capital. Some financial institutions have held big initial public offerings in the recent past: AIG, Visa, and Bank of America each raised close to $20 billion in equity. The guarantors in the future housing finance system should see returns on equity similar to those of the money-center banks and life insurers, or about 10 percent. This would be consistent with a valuation of 100 percent of tangible book value and a price-earnings multiple of 10. The guarantors' return on equity would be less than the 15-percent ROE that private mortgage insurers have historically received, although this appears to have declined to near 13 percent in the current low interest-rate environment. It is encouraging that many private mortgage insurers have been able to raise significant equity capital in recent months.

But it is hard to see the equity market producing all the remaining capital needed by the guarantors. Equity investors will be rightly nervous about the new system, and will question the guarantors' earnings prospects in a highly regulated and mature market. The guarantors' earnings may also be relatively volatile, fluctuating with the housing and business cycles, and their market share will shift against the nonguaranteed part of the mortgage finance system. And of course there is the reputational risk associated with playing a pivotal role in the provision of mortgage credit.

Equity investors in the new guarantors would likely include those currently taking equity stakes in private mortgage insurers. Shareholders in the Nation's largest PMI companies include mutual funds such as Fidelity and the Vanguard Group, pension funds such as TIAA–CREF, asset management firms such as Goldman Sachs Asset Management and State Street Global Advisors, hedge funds such as Paulson & Co. and Citadel, and diversified financial institutions such as BlackRock.

A wide range of global reinsurers are also providing capital relief to the PMI companies and would likely be interested in taking stakes in the new guarantors.

Yet, even if the guarantors can raise the amount of equity envisaged from public markets, a capital shortfall will remain. This would be temporarily filled by the Nation's large mortgage originators through a seller-financing arrangement. In the hybrid system assumed here, originators would not be permitted to own guarantors, but there would be an exception while the system is being established. In that period, originators would be required to temporarily take equity in the guarantors in partial payment for the Government-guaranteed mortgages they sell. The equity received by the originators as payment would be valued at 100 percent of tangible book value.

The success of requiring large originators to temporarily hold equity in the guarantors hinges on several factors. Most importantly, the originators, which include the Nation's largest banks, would need to have excess capital. Capital ratios in the banking system are at a record high and rising: According to the Federal Deposit Insurance Corp., the Tier 1 capital ratio for all banks is above 9 percent and climbing. Banks are also making record profits, and although their recent profitability is temporarily supported by improving credit quality and the resulting release of loan loss reserves, they should have plenty of excess capital given their long-term earnings power and more limited growth opportunities postregulatory reform.

While bank originators may object to this arrangement, they also have a strong incentive to ensure that guarantors in the new hybrid system are well-capitalized. Originators will prefer a well-functioning housing finance system, with a Government backstop and a TBA market, to alternatives that require them to hold many more mortgages on their balance sheets. However, since the banks' investments in the guarantors would have pedestrian returns, and since a 100-percent risk-weighting would be capital-intensive, bank originators would be expected to sell their stakes in the guarantors as soon as their capital is no longer needed. There would also be a reasonable divesture period, in case they are unexpectedly slow to sell their shares.

Critical to this arrangement's success is that even with their equity stakes, the large bank originators should have no control over the guarantors. Otherwise, small lenders would be appropriately nervous about their ability to compete. Large originators would receive nonvoting or B-shares as payment from the guarantors. This is similar to the arrangement Visa set up with its bank members when it designed its IPO. Once the B-shares were sold to nonoriginator investors, they would become voting A-shares.

Common Securitization Platform

A well-functioning common securitization platform is an important requirement for a successful transition to a new housing finance system. All non-Ginnie Mae, Government-guaranteed securities should use a common securitization platform. Although not required, nonguaranteed securities could use the same platform.

The common securitization platform would produce a more liquid market, facilitate loan modifications in future downturns, and give issuers operating flexibility at a low cost. It would also allow for a robust TBA market. Such a platform is also important for lowering barriers of entry into the future mortgage guarantor market, allowing for more competition and reducing too-big-to fail risks.

The securitization facility would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities. For a fee, the securitization facility would provide a range of services, including mortgage loan note tracking, master servicing, data collection and validation to improve transparency and integrity, and bond administration.

Mortgage loans included in securities that use the common securitization facility would be covered by a uniform pooling and servicing agreement and uniform servicing standards that encourage prudent underwriting and align investor and borrower interests. This would encourage the adoption of similar standards for other mortgages.

The common securitization platform would permit multiple originators to sell mortgages into single securities with access to the Government guarantee. In return, the originators would receive pro rata shares of the security. Pooling requirements would be largely the same as for typical single-originator securities, and they would be good for delivery into the TBA market. Originators could thus easily convert securities to cash before the securities were created, an especially important feature for smaller originators.

Transition Contingencies

It is important to recognize the possibility that the transition process may not go as smoothly as planned. The transition involves complex changes to the legal and operational framework at the center of housing finance. It also involves the development of new guarantors and securities and new oversight responsibilities over a wide range of institutions and activities. Given all these moving parts, it is plausible to think that things will not come together as quickly as hoped.

As such, any legislation to reform the housing finance reform system should allow for some flexibility in the timing of the transition process. In S.1217 the transition process must be completed within 5 years. There should be some flexibility in this deadline, as the FMIC needs the ability to speed or slow the process if it jeopardizes the housing market and capital markets more broadly. Suppose, for example, that there is a major financial crisis in year five of the transition. The FMIC should thus have the authority to reduce or even eliminate the private capital first-loss requirement in cases of significant financial market disruption. It is thus also critical that the GSEs be able to continue their business operations until the new system is fully operational.

Conclusions

Since the Government took over Fannie Mae and Freddie Mac during the financial collapse 5 years ago, effectively nationalizing the Nation's housing finance system, nothing meaningful has changed. The Government still makes nearly nine of every 10 U.S. mortgage loans. This is bad for both taxpayers and homebuyers.

Taxpayers are on the hook for potential losses on the hundreds of billions of dollars in mortgages that Fannie and Freddie insure each year. This is not necessary: Private investors are willing to take on much of this risk and, with some safeguards, are capable of doing it.

The longer Fannie and Freddie stay in Government hands, the more lawmakers will be tempted to use them for purposes unrelated to housing. This has already happened. Last year's payroll tax holiday was partially paid for by raising the premiums Fannie and Freddie charge homebuyers for providing insurance. Mortgage borrowers will be paying extra as a result over the next decade.

The housing market's revival has allowed Fannie and Freddie to again turn large profits, amounting to tens of billions of dollars each year. Policy makers may begin to rely on these profits to fund Government spending, making it especially hard to let Fannie and Freddie go.

Policy makers may also eventually be tempted to make Fannie and Freddie lend to people who really cannot afford mortgages. This is partly how the two institutions got into financial trouble during the housing bubble—they took on more risk than they should have to meet their housing-affordability goals. Helping disadvantaged households become homeowners is laudable, but experience shows that politically driven help can be abused.

The bigger problem now is the limbo status of Fannie and Freddie, which fosters indecision at the two institutions and by their regulator, the FHFA. Lenders who do business with Fannie and Freddie are unsure of the rules, and are thus extra cautious, keeping credit overly tight for potential homebuyers. This is evident in the average credit scores of borrowers through Fannie and Freddie, which today are in the top third of all of credit scores.

Lawmakers recognize the current situation's dangers and have introduced legislation to reform the Nation's housing finance system. Yet these legislative efforts lack a clear plan for getting from the current housing finance system to the future one. The transition cannot be bungled: The Nation's economic recovery depends on housing, which in turn depends on the flow of mortgage credit. The $10 trillion U.S. mortgage market is also critically important to the entire global financial system.

Yet while the transition will be complicated and rife with risk, it is eminently doable.

The Federal Government has unwound much of its extraordinary intervention in the economy prompted by the Great Recession. Fiscal stimulus has been replaced by fiscal austerity. The Trouble Asset Relief Program bailout fund will soon be history. The Federal Reserve is planning to begin normalizing monetary policy. That leaves Fannie and Freddie and the Nation's housing finance system as the largest piece of unfinished business. It is time to finish it.

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The Road to Reform

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Debate is heating up over the future of the nation's housing finance system. Much of the back and forth has focused on the system's end state—whether housing finance should be privatized, retain some form of government backstop, or even remain effectively nationalized as it is today. No matter which goal is chosen, however, reform will not succeed without an effective transition. A clearly articulated plan for getting from here to there is vital; otherwise policymakers will be appropriately reluctant to move down the reform path. This paper presents a clear road map to the new housing finance system.[1]

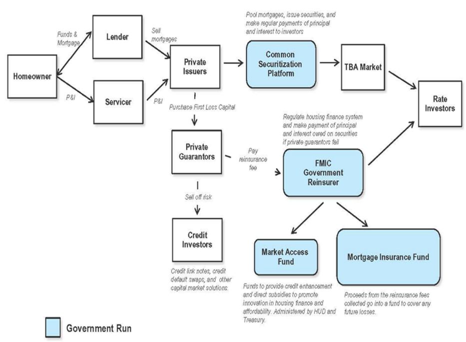
For this paper, it is assumed that the future housing finance system will be a hybrid system. That is, private capital will be responsible for losses related to mortgage defaults, but in times of financial crisis, when private capital is insufficient to absorb those losses, the government will step in. Mortgage borrowers who benefit from the government backstop will pay a fee to compensate the government for potential losses. Under most proposals, between a third and half of all mortgage loans will be covered by this catastrophic government backstop.

While there are advantages and disadvantages to any housing finance system, a hybrid system is the most likely to be implemented. Such a system will preserve the long-term fixed-rate mortgage as a mainstay of U.S. housing, and it will ensure that affordable mortgage loans are available to most middle-income Americans through good and bad times. Taxpayers will backstop the system, but it will be designed so that lenders and borrowers bear the ultimate cost. A hybrid housing finance system has the broadest political backing: Senators Bob Corker (R-TN) and Mark Warner (D-VA) recently introduced legislation to establish a hybrid system, and President Obama has expressed support.[2]

A hybrid system will require substantial new private capital. Currently, little private capital is involved in making mortgage loans; the federal government via Fannie Mae, Freddie Mac, and the Federal Housing Administration acts as the nation's principal mortgage originator.[3] How much private capital will be needed depends on many factors, but assuming the new system's requirements are consistent with those applied to the nation's largest banks, as much as $175 billion in today's dollars might have to be raised. For context, this amounts to more than the equity raised in the 10 largest initial public offerings in U.S. history combined, including those for the insurer AIG and the credit-card giant Visa. Such a large amount will not be easy to raise quickly. Any viable transition plan must therefore clearly determine where the private capital will come from and at what cost.

The transition plan must also spell out the fate of Fannie Mae and Freddie Mac. While few wish to return to the old system, which was dominated by these thinly capitalized, too-big-to-fail behemoths, the consensus stops there. Some insist that Fannie and Freddie be completely dismantled, while others propose using their current profits to recapitalize and ultimately reprivatize them. Dismantling the two institutions would risk disrupting the flow of mortgage credit, which, for all their faults, Fannie and Freddie continued to provide efficiently through the Great Recession and subsequent recovery. On the other hand, recapitalizing and privatizing the institutions could leave them in control of U.S. housing finance. It is un-

Chart 1: Future Housing Finance System



clear who could compete with them; without such competition, the future system will eventually resemble the old one. A dominant duopoly will be able to overcharge for their services and will become the taxpayers' problem if they blunder again.

A host of smaller but still critical technical and legal issues must also be resolved in the transition to a new system. Moving Fannie and Freddie from their current conservatorship status to receivership to new ownership will be complicated. Their mortgage securities must be managed by whoever succeeds them at least as efficiently as they are doing. Shifting oversight authority from the Federal Housing Finance Agency, Fannie's and Freddie's current regulator, to the overseer of the future system will also involve many steps. And ensuring that small lenders have access to the government backstop for the mortgages they originate will not be easy.

Some initiatives necessary to reshape the housing finance system are already under way and should be nurtured. The FHFA is developing a common securitization platform, which will be important no matter the system's final form. The platform should support greater transparency, which in turn will promote better credit risk management and lower future mortgage defaults, more liquidity, better access for small lenders and increased competition. The FHFA is also requiring Fannie and Freddie to share more risk with private investors, including private mortgage insurers and investors. This should provide information and experience necessary for the risk-sharing envisaged under most housing finance reform proposals.

The transition will require legislation and take years to implement, but given the current political environment, the most likely scenario is gridlock. Despite compelling economic arguments for action, there are lower than even odds that Congress will come together any time soon around a reform plan. A clearly laid-out road to reform could help raise these odds, however. With such a road map, it is plausible that housing finance reform could become law soon after the 2014 midterm elections. The transition would likely begin in 2016 and the bulk of it completed five years later. It is exciting to think that the new housing finance system could conceivably be in place at the start of the next decade.

The end state

While the debate over the future housing finance system is far from settled, it is assumed here that policymakers will ultimately adopt a hybrid system. Knowing where the system is headed is necessary for laying out a clear transition process.

In the future hybrid system, private investors provide the capital supporting the system, but there is a government backstop in case of a catastrophic financial crisis (see Chart 1).[3] That is, under most circumstances, private investors shoulder losses when mortgages default. But during rare, catastrophic situations such as the Great Recession, when mortgage losses wipe out private capital, the government ensures that mortgage lending is uninterrupted.

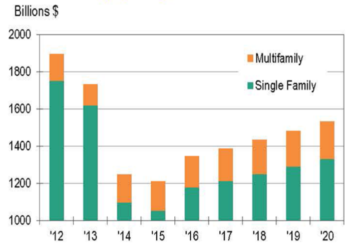
To be eligible for the government's catastrophic guarantee, mortgage-backed securities must include only high-quality mortgage loans, and substantial private capital must be able to take losses before the guarantee kicks in.[4] To ensure that the private institutions and investors follow the rules, a government regulator—call it the Federal Mortgage Insurance Corporation—oversees the housing finance system. The FMIC also maintains an insurance fund—the Mortgage Insurance Fund—to cover any losses the government may incur in a catastrophic situation. The FMIC charges a guarantee fee, or g-fee, to fund the MIF and oversee the housing finance system.[5]

To obtain the government guarantee, mortgage-backed securities must also use a common, government-run securitization platform. This would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities.[6] A common platform would standardize securitization, create significant economies of scale, and provide a more liquid market for MBS, benefiting both private investors and homeowners.

As in the current system, mortgage originators, servicers and MBS issuers could be affiliated with each other. A new addition would be private MBS guarantors: monoline companies, backed neither explicitly nor implicitly by the government and prohibited from being owned by originators or issuers. These guarantors would be required to maintain capital and liquidity similar to major banks. They would purchase catastrophic insurance from the government, so that the government would repay MBS investors if the guarantors became insolvent. The guarantors themselves could fail, however.

The envisaged hybrid system would be resilient to financial and economic crises and

Chart 2: Mortgage Origination Outlook



Sources: MBA, Moody's Analytics

would mitigate the impact if crises did occur. The system would also provide access to desirable mortgage products such as long-term, fixed-rate loans for creditworthy borrowers. And it would be designed to allow small mortgage lenders easy access to the government guarantee and promote affordable single-family and rental housing, since qualifying multifamily mortgages would also be eligible for the government guarantee.[7]

Transition objectives

The transition from the current, largely nationalized, housing finance system to the future hybrid system must meet five principal objectives:

- *Protect the economic recovery.* Government support to the housing finance system cannot be withdrawn too quickly without undermining the housing recovery, which is vital to the broader economic recovery. Mortgage credit conditions are still very tight: Lenders remember the massive losses suffered during the housing crash and are uncertain about a number of regulatory issues. Prematurely withdrawing government support would exacerbate this problem.
- *Repay taxpayers.* Taxpayers should be made financially whole. The government's support to Fannie and Freddie should be repaid, along with some of the costs of backstopping the rest of the housing market after Fannie and Freddie failed, and the costs associated with setting up a new financial system. Taxpayers should also receive a return on their financial support commensurate with the risks they took.
- *Protect holders of legacy Fannie and Freddie MBS and debt securities.* The federal government now guarantees existing MBS and bond obligations of Fannie and Freddie through agreements between the Treasury Department and the two firms. This must continue through the transition period. Not doing so would undermine investors' faith in the U.S., raising borrowing costs and exacerbating the nation's fiscal problems. This is a legacy of the old system, and while the new system should avoid re-creating this obligation, we cannot retroactively change expectations without damaging the nation's credibility in global credit markets.
- *Ensure more and varied sources of private capital.* Private capital standing in front of the government's guarantee must be adequate to absorb mortgage losses resulting from all but the most severe financial crises and economic downturns. This is necessary to protect the government against losses and avoid future bailouts. A substantial amount of private capital, from varied sources, will be needed by the future housing finance system.
- *Eliminate too-big-to-fail.* The transition to the new housing finance system must reduce the system's reliance on large and complex financial institutions such as Fannie Mae and Freddie Mac. The housing finance system's design must ensure that institutions in the system can fail without catastrophic economic consequences.
- *Promote affordability.* Access to affordable owner-occupied and rental housing must be maintained through the transition. This has become even more important in the wake of the Great Depression and the significant destruction of homeowners' equity in the Great Recession, ongoing financial pressure on low-income households, and changing demographics.

How much capital?

The future hybrid finance system's capital requirements depend on a range of factors, including mortgage origination volume, the share of originations receiving the government guarantee, and the amount of private capital needed to stand in front of the guarantee. Based on the assumptions described below, the system will require $123 billion in new capital by 2020, and $175 billion over the long run (in today's dollars).

Origination volume

In 2016, the year the transition to the new hybrid housing finance system begins, single-family mortgage originations are expected to total nearly $1.2 trillion, a significant drop from recent years because of lower anticipated refinancing activity.[8] The average coupon on outstanding mortgages is currently close to 5%. With mortgage rates expected to average 6.5% by 2016, most homeowners with mortgages will have little reason to refinance.[9]

Partially offsetting the drop in refis will be stronger originations for home purchases. This will be fueled by rising home sales and prices and a greater demand for mortgages as investor demand wanes and first-time and trade-up buyers become more active.[10] Purchase volumes will be dampened somewhat by lower loan-to-value ratios; these are currently high because of the loss of equity during the housing crash and the high share of low down payment FHA lending. LTVs are expected to decline modestly through the end of the decade as homeowners' equity is rebuilt and FHA lending recedes.

Single-family mortgage originations are expected to rise approximately 3% per year between 2016 and 2020, reaching $1.4 trillion (see Chart 2). This is consistent with expected long-run house price growth, as the other factors affecting origination volumes will largely offset each other.

Multifamily mortgage originations are expected to total $170 billion in 2016. This would be a record, produced as the multifamily market benefits from a further modest decline in the homeownership rate. Foreclosures will remain elevated through 2016 as the last of the problem single-family loans made during the housing boom are resolved. Between 2016 and 2020, multifamily originations are expected to grow 4% per year to $200 billion. Strong demand during this period for apartments from an expanding cohort of people between ages 25 and 34—the principal source of apartment demand—is expected to support stronger growth in rents and multifamily property prices.

Guarantee share

The share of single-family mortgage originations that qualify for a government guarantee will largely be determined by policymakers. A key policy lever affecting the share is the limit on conforming loans. Currently, Fannie and Freddie loans are capped at $625,000 in high-cost areas and $417,000 everywhere else. Assuming policymakers set the loan limit at $417,000 across the country, based on the distribution of loans currently backed by Fannie and Freddie, just under 40% of originations would be eligible for the guarantee. It is thus assumed that the share of single-family mortgage loans receiving the catastrophic government guarantee in the hybrid system will decline steadily, from approximately 65% now to 40% by 2020.

The conforming loan limit will determine the guarantee share, because government-guaranteed loans will be favored by mortgage originators. Other alternatives, such as holding loans on originators' balance sheet or securitizing them in the private-label market will be more costly. Based on current pricing for Fannie Mae MBS, the marginal cost of funding for government-guaranteed securities in the hybrid system will be approximately 50 basis points.[11] This compares with well over 100 basis points for bank funding via senior unsecured debt and closer to 150 basis points for private-label MBS.

The difference in marginal funding cost will be much greater in stressed economic periods. During the worst of the Great Recession, the marginal cost of bank funding soared, and the private-label market shut down.

The share of multifamily mortgages with the government guarantee will also be determined by regulatory eligibility limits. These are assumed to remain close to Fannie's and Freddie's current 40% share of originations. The government guarantee is important to ensuring the flow of multifamily mortgage credit during difficult economic periods and to rental developments catering to lower-income households, as well as those in rural and smaller urban areas.

Private first-loss capital

The amount of private capital required to stand in front of the government's guarantee is also a matter of substantial debate, although there is general agreement that it should be greater than it was before the Great Recession. Prior to the downturn, Fannie and Freddie had enough capital to withstand a loss rate of only about 1%. This was clearly insufficient, as the institutions ended up in conservatorship, effectively nationalizing the housing finance system.

In the Corker-Warner hybrid system, private financial institutions are required to have enough capital to withstand a 10% loss before the government steps in.[12] This is an extraordinarily high loss rate, which would occur only in an almost inconceivable financial calamity.

There are benefits to such a high level of capitalization. It would provide a fortress financial foundation for the housing finance system, eliminating taxpayers' exposure to risk and allaying concerns about the government charging too little for its guarantee.[13] It should also dispel moral hazard concerns that private financial institutions could lower their underwriting standards and take on too much risk thinking they would be bailed out by the government. Private capital would have lots of skin in the game.

But the cost of such a high capitalization rate is substantial, as mortgage rates would be significantly higher, especially for borrowers with less than pristine credit and particularly in times of economic stress. It would also misallocate hundreds of billions of dollars in capital that could be used more productively elsewhere.

A good benchmark for the amount of private capital backing housing finance is the amount of losses suffered in the Great Recession. This was the proverbial hundred-year flood. Fannie, Freddie, and the private mortgage insurers will ultimately have a combined loss rate of less than 5% resulting from the recession (see Table 1).[14] This would be a conservative capitalization rate, since in the future system, regulation would demand that guaranteed mortgages be of higher quality than those purchased by Fannie and Freddie before the recession.

Private capitalization of 5% would also be consistent with the amount of capital the nation's largest banks are required to hold under Basel III and the Dodd-Frank Act. To be well-capitalized, systemically important banks will likely need to maintain a 10% Tier 1 common equity ratio. With mortgages receiving a 50% average risk weighting, the guarantors in the hybrid system would need to hold 5% capital.

The level of private capitalization has a significant impact on mortgage rates: The higher the level required, the more guarantors in the future hybrid system will need to charge in guarantee fees. At a 1% capitalization rate, guarantors would need to charge 20 basis points, about what Fannie and Freddie charged before the recession.[15] At a 5% capitalization rate, the fee would be close to 70 basis points, and at 10%, the fee would be almost 140 basis points. For context, Fannie's current average guarantee fee is 57 basis points, consistent with an approximately 4% capitalization rate. Every 10-basis point increase in g-fees adds about $15 to the monthly cost of a typical mortgage.

Required capital

Based on the origination outlook and the expected guarantor share, the amount of mortgage debt receiving a government guar-

Table 1: Residential Mortgage Loan Realized Losses

$ bil

	2006	2007	2008	2009	2010	2011	2012	Total 2006-2012	Debt Outstanding Yr-end 2007	Losses as a % of Debt
Total	17.1	38.5	136.5	216.1	190.0	161.8	159.9	919.9	11,207	8.2
Government-Backed	7.1	7.7	17.9	31.8	51.4	46.3	44.2	206.4		
Fannie Mae & Freddie Mac	0.8	1.8	10.3	21.3	37.3	31.4	26.0	128.9	4,820	2.7
Fannie Mae	0.6	1.3	6.5	13.4	23.1	18.3	14.4	77.6		
Freddie Mac	0.2	0.5	3.8	7.9	14.2	13.1	11.6	51.3		
Federal Housing Administration	6.3	5.9	7.6	10.5	14.1	14.9	18.2	77.5	449	17.3
Privately Backed	10.0	30.8	118.6	184.3	138.6	115.5	115.7	713.5		
Mortgage insurers	1.5	6.9	10.8	9.6	6.6	6.0	6.0	47.4		
Depository Institutions	2.7	7.3	35.0	54.9	48.2	35.3	33.3	216.7	3,729	5.8
Private-Label Mortgage Securities	5.8	16.6	72.8	119.8	83.8	74.2	76.4	449.4	2,209	20.3
Subprime	5.6	15.5	55.9	71.6	39.0	34.7	35.5	257.8		
Alt-A	0.2	0.9	11.3	28.0	24.0	20.5	20.1	105.0		
Option ARMs	0.0	0.2	5.2	17.9	17.4	14.8	16.5	71.9		
Jumbo	0.0	0.0	0.4	2.3	3.4	4.1	4.3	14.6		
Note: Securitized HELOC	0.2	1.5	5.1	5.1	3.4	2.1	1.6	18.9		

Sources: Fannie Mae, Freddie Mac, HUD, FDIC, Federal Reserve Board, Moody's Analytics

antee will increase from approximately $800 billion in 2016 to $3.1 trillion in 2020.[16] With a 5% capital requirement, the amount of private capital needed in the future housing finance system would rise from approximately $37 billion in 2016 to $123 billion in 2020 (in today's dollars). Over the long run, after the guarantors' single-family and multifamily books of business have settled into their 40% shares, close to $175 billion in private first-loss capital (in today's dollars) will be needed to support the housing finance system (see Chart 3).

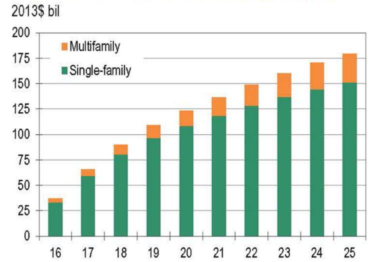
Sources of capital

A substantial amount of private capital will thus be necessary to support the future housing finance system. Over time, some will come through the guarantors' retained earnings. This will not help in the early years, but under conservative assumptions, retained earnings could provide as much as one-third of the guarantors' capital requirements by 2020. By then the guarantors' earning power should be strong enough to make them roughly self-capitalizing. Yet this will not help produce the capital needed when the new system begins operating in 2016, or the roughly $85 billion in capital still needed in 2020 ($123 billion in total capital needs less $38 billion in estimated retained earnings).

The equity market is a potential source for early capital. Some financial institutions have held big initial public offerings in the recent past: AIG, Visa, and Bank of America each raised close to $20 billion in equity. The guarantors in the future housing finance system should have a similar return on equity as the money-center banks and life insurers of about 10%. This would be consistent with a valuation of 100% of tangible book value and a price-earnings multiple of 10. The guarantors' return on equity would be less than the 15% ROE that private mortgage insurers have historically received, although this appears to have declined closer to 12% in the current low-interest rate environment. It is encouraging that many private mortgage insurers have

Chart 3: Private Capital Needs in Hybrid System

2013$ bil



Source: Moody's Analytics

Table 2: Private Mortgage Insurers' Top 10 Shareholders

Mar 31, 2013

MGIC		Radian		Genworth	
Shareholder	%	Shareholder	%	Shareholder	%
Maverick Capital	6.98	Fidelity Management	9.33	Dodge & Cox	7.19
Paulson & Co.	5.03	Paulson & Co.	6.65	The Vanguard Group	6.02
The Vanguard Group	5.02	BlackRock Trust	5.25	Fidelity Management	5.62
BlackRock Trust	4.41	The Vanguard Group	5.16	BlackRock Trust	4.03
Blue Ridge Capital	4.41	Dimensional Fund	5.12	State Street Global	3.94
Old Republic	4.01	Rima Senvest	5.05	Legg Mason Capital	2.78
Dimensional Fund	3.68	T. Rowe Price	4.12	Highfields Capital	2.67
SAB Capital	3.63	Morgan Stanley	2.05	Paulson & Co.	1.83
Fidelity Management	3.48	State Street Global	1.76	ESL Investment	1.70
Perry Capital	2.65	Columbia Management	1.71	Gosha Trading	1.40

Sources: Companies, Moody's Analytics

been able to raise significant equity capital in recent months.

But it is hard to see the equity market producing the entire $85 billion in additional capital needed by the guarantors by 2020. Equity investors will be rightly nervous about the new system, and will question the guarantors' earnings prospects in a highly regulated and mature market. The guarantors' earnings may also be relatively volatile, fluctuating with the housing and business cycles, and their market share will shift against the nonguaranteed part of the mortgage finance system. And of course there is the reputational risk associated with playing a pivotal role in the provision of mortgage credit.

Nonetheless, it is reasonable to expect the equity market to comfortably provide $50 billion in capital over a five-year period. In one plausible scenario, three guarantors would go public in 2016, the first year of the hybrid system, raising a total of $24 billion. Two additional IPOs in 2017 and 2018 would raise an additional $16 billion. The remaining $10 billion would be raised in subsequent equity offerings as the guarantors' capital needs increase. Five guarantors would thus be up and running by 2020.

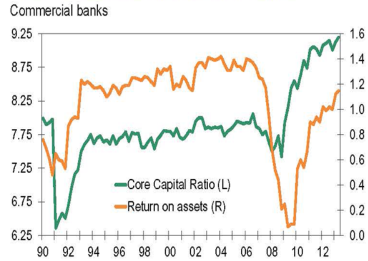
Equity investors in the new guarantors would likely include those currently taking equity stakes in private mortgage insurers. Shareholders in the nation's largest PMI companies include mutual funds such as Fidelity and the Vanguard Group, pension funds such as TIAA-CREF, asset management firms such as Goldman Sachs Asset Management and State Street Global Advisors, hedge funds such as Paulson & Co. and Citadel, and diversified financial institutions such as BlackRock (see Table 2). A wide range of global reinsurers are also providing capital relief to the PMI companies and would likely be interested in taking stakes in the new guarantors.

Yet even if the guarantors can raise the amount of equity envisaged from public markets, a capital shortfall remains that grows from $13 billion in 2016 to $35 billion in 2020. This shortfall would be temporarily filled by the nation's large mortgage originators through a seller-financing arrangement. In the hybrid system assumed here, originators would not be permitted to own guarantors, but there would be an exception while the system is being established. In that period, originators would be required to temporarily take equity in the guarantors in partial payment for the government-guaranteed mortgages they sell. The equity received by the originators as payment would be valued at 100% of tangible book value.

The success of requiring large originators to temporarily hold equity in the guarantors hinges on several factors. Most importantly, the originators, which include the nation's largest banks, would need to have excess capital. Capital ratios in the banking system are at a record high and rising: According to the Federal Deposit Insurance Corp., the Tier 1 capital ratio for all banks is above 9% and climbing (see Chart 4). Banks are also making record profits, and although their recent profitability is temporarily supported by

Chart 4: Banks Will Have Excess Capital

Commercial banks



Sources: FDIC, Moody's Analytics

improving credit quality and the resulting release of loan loss reserves, they should have plenty of excess capital given their long-term earnings power and more limited growth opportunities post-regulatory reform.

While bank originators may object to this arrangement, they also have a strong incentive to ensure that the guarantors in the new hybrid system are well-capitalized. Originators will prefer a well-functioning housing finance system, with a government backstop and a to-be-announced market, to alternatives that require them to hold many more mortgages on their balance sheets. However, since the banks' investments in the guarantors would have pedestrian returns, and since a 100% risk-weighting would be capital-intensive, bank originators would be expected to sell their stakes in the guarantors as soon as their capital is no longer needed. There would also be a reasonable divesture period, in case they are unexpectedly slow to sell their shares.

Critical to this arrangement's success is that even with their equity stakes, the large bank originators should have no control over the guarantors. Otherwise, small lenders would be appropriately nervous about their ability to compete. Large originators would receive nonvoting or B-shares as payment from the guarantors. This is similar to the arrangement Visa set up with its bank members when it designed its IPO. Once the B-shares were sold to non-originator investors, they would become voting A-shares.

The future of Fannie and Freddie

A critical question in the transition to a future housing finance system is what to do with Fannie Mae and Freddie Mac. For all that is wrong with the current system, Fannie and Freddie are doing an effective job buying conforming mortgages, bundling them into MBS with a government guarantee, and selling them to global investors. The mortgage market is not working as well as it should, but it is working. Whatever is done with Fannie and Freddie must not disrupt this flow of mortgage credit, for the sake of the housing and economic recoveries.

Arguably the most straightforward approach, with the least amount of near-term risk, would be to recapitalize and reprivatize Fannie and Freddie. Both are currently profitable, as a result of improving mortgage credit conditions and their higher guarantee fees. The two agencies' profits are flowing to the U.S. Treasury, rapidly offsetting the $188 billion Fannie and Freddie received from taxpayers in order to stay in business. At last count they still owed $42 billion but were on track to repay the Treasury's investment by early 2014.

After that, their profits could be used to build the capital necessary for them to become private guarantors in the future finance system. Once appropriately capitalized, they would be reprivatized, with the government selling them to private investors to maximize the return to taxpayers.

There is a considerable downside to this approach, however: The future housing finance system could again be dominated by Fannie and Freddie or their successors.[17] The system could encourage competition, for example, by establishing a new common securitization platform run as a government utility that produces a single government-backed security. The reincarnated Fannie and Freddie would also likely be classified systemically important financial institutions, or SIFIs, and thus face stiffer capital and liquidity requirements. This would raise their cost of capital vis-à-vis newer entrants, further supporting competition.

But the two giant firms would still have considerable advantages of size and scale, important legacy relationships, and entrenched software and systems. Most likely this approach would create a hybrid system dominated by a duopoly, firms with significant power over the mortgage and housing markets that would be much too big to fail. The arrangement would be uncomfortably similar to the dysfunctional system that prevailed prior to the Great Recession.

An alternative approach would be to simply put Fannie and Freddie into receivership and liquidate their assets. Guarantors in the hybrid system would be largely new entities, begun by those purchasing Fannie's and Freddie's assets. There is significant risk in this approach, as there would be no assurance that the new guarantors would be able to continue the institutions' activities, at least not in a timely way. The chance of a disruption in the flow of mortgage credit would be uncomfortably high.

A better approach would be for the government to put Fannie and Freddie into receivership, and to strip them of their key assets. They would then be rechartered as new private guarantors, able to license back these assets from the government receiver. Their operations would not be disrupted, ensuring that the mortgage market functioned smoothly through the transition. But to level the competitive playing field, any other new guarantors could also license the same key assets from the receiver. This would facilitate easy entry into the guarantor market and thus competition.

The current Senior Preferred Stock Purchase Agreement between the U.S. Treasury and Fannie and Freddie would need to be restructured to permit the redemption of the Treasury's senior preferred shares and the cancelation of its warrant in the firms. The restructured SPSPA would determine the appropriate compensation taxpayers require from Fannie and Freddie for their financial support. Taxpayers should be made financially whole, receiving repayment for the support they provided to Fannie and Freddie, part of the cost of backstopping the rest of the housing market when they failed, and the cost of setting up a new financial system. Taxpayers should also require a return on their financial support commensurate with the risks they took.

Fannie and Freddie would be put into receivership, and their operating assets and liabilities moved into limited life regulated entities, or LLREs, allowing them to maintain their operations independent of the resolution process.[18] This is similar to the procedure envisaged in Dodd-Frank for failing SIFIs. The assets of the LLREs would then be sold or licensed back to Fannie's and Freddie's successor firms, which would be chartered as independent guarantors, and to the new competitor guarantors.

Fannie's and Freddie's $4.5 trillion legacy guaranty book would not be included in the assets transferred from the government receiver to the LLREs. More private capital would be needed to support the legacy books than could be raised in a reasonable period, ensuring that the new housing finance system would never get going. The receiver would engage the new guarantors to manage the loans in the legacy books, providing a steady source of revenue.

The impact on the federal budget of resolving Fannie and Freddie should be modest, although that depends somewhat on whether budget accounting from the Office of Management and Budget or the Congressional Budget Office is used. OMB treats Fannie and Freddie as private companies independent of the government, thus the impact on the federal budget is simply the net cash payments they make to the Treasury. OMB projects that Fannie and Freddie will remit just over $50 billion to the Treasury over the next decade. CBO treats Fannie and Freddie as part of the federal government and uses fair-value accounting to calculate the cost of the net subsidy the government provides mortgage borrowers via the institutions. CBO projects that there will be a negative subsidy of about $10 billion over the next decade.

MBS guarantor market

The future housing finance system is expected to have five to 10 MBS guarantors. Five guarantors would ensure that the system is competitive and free from too-big-to-fail risk. Competition among guarantors would reduce interest rates on MBS and thus mortgage interest rates paid by homeowners. More than 10 guarantors could result in prohibitively high transaction costs. This is important for smaller MBS issuers grappling with the complexity of dealing with many guarantors and their different contracts, data exchange processes, and accounting and underwriting systems.

The MBS guarantor industry would exhibit significant economies of scale. Creating these scale economies is that a guarantor's risk declines as its portfolio increases in size and resembles the risk across all mortgage borrowers. Since the risks in mortgage lending are not independently distributed—the strong form of the law of large numbers does not hold— and significant losses can occur—the mortgage loss distribution is fat-tailed—capital and regulatory costs are high. This favors larger guarantors. Larger guarantors can charge less for more marginal risks since they will have less of an impact on the risk of their entire larger portfolio. And informational asymmetries also advantage larger guarantors that are able to collect more and better data and information.

The scale economies could be reduced somewhat if the government guarantee is confined to QM loans, which seems likely. These loans are more homogenous and the risk premia on a guarantor's portfolio may converge more quickly to the population loss rate. Informational asymmetries could also be less significant if there is greater data transparency in the new housing finance system.

The scale economies in the MBS guarantor industry are expected to peak with guarantors that have close to a 20% share of the market. There may be one or two guarantors that cater to the most homogenous part of the mortgage market with a larger share, and several smaller guarantors that are more niche insurance providers. A guarantor established to cater to small mortgage originators as envisaged in a number of hybrid systems might be an example of a niche guarantor. For context, the five largest life insurance companies account for one-third of that market, while the top five property and casualty insurers account for almost half. The private mortgage insurance is more concentrated, particularly in the wake of the housing bust and the industry's consolidation, with the five largest PMI companies accounting for 85% of that market.

Transition steps

A number of steps important to the transition process are already being taken, and should be encouraged. Most notable is the FHFA's effort to merge the securitization platforms of Fannie and Freddie. A common securitization platform will ultimately lead to a single, government-backed mortgage security to replace the current Fannie and Freddie securities. Fannie's and Freddie's recent efforts at risk-sharing with private investors will also support the transition by encouraging innovative ways to attract private capital to housing finance.

Common securitization platform

In the hybrid system envisaged here, all government-guaranteed securities would use a common securitization platform. Although not required, nonguaranteed securities could use the same platform. The common securitization platform would produce a more liquid market, facilitate loan modifications in future downturns, and give issuers operating flexibility at a low cost. It would also allow for a robust TBA market.

The securitization facility would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities. For a fee, the securitization facility would provide a range of services, including mortgage loan note tracking, master servicing, data collection and validation to improve transparency and integrity, and bond administration.

Mortgage loans included in securities that use the common securitization facility (including all mortgages that benefit from the government guarantee plus some nonguaranteed loans) would be covered by a uniform pooling and servicing agreement and uniform servicing standards that encourage prudent underwriting and align investor and borrower interests. This would encourage the adoption of similar standards for other mortgages.

The common securitization platform would permit multiple originators to sell mortgages into single securities with access to the government guarantee. In return, the originators would receive pro rata shares of the security. Pooling requirements would be largely the same as for typical single-originator securities, and they would be good for delivery into the TBA market. Originators could thus easily convert securities to cash before the securities were created, an especially important feature for smaller originators.

Single security

The common securitization platform would also promote development of a common government-guaranteed security, which would improve liquidity in the TBA market and result in lower mortgage rates. A common security would also lower entry barriers into the guarantor market, as no guarantor would have an advantage because of the liquidity of the securities they back.

This is a problem in the current housing finance system, as Freddie Mac securities are much less liquid than Fannie Mae securities. Fannie and Freddie split the MBS market 60-40, but on a typical day the trading volume of Fannie MBS is 10 times greater than that of Freddie MBS. To compensate, Freddie is forced to charge a lower g-fee than Fannie. In the second quarter of 2013, Fannie's average g-fee was 57 basis points, compared with Freddie's 51 basis points. There are some modest differences in the securities—Freddie pays investors more quickly than Fannie and its securities prepay a bit more quickly—but the key difference is their liquidity. This liquidity difference makes the mortgage market less efficient and less competitive, and leads to higher costs for mortgage borrowers and taxpayers.

A potential near-term fix to this problem would be to make Fannie and Freddie securities fungible, creating a common TBA security.[19] That would require a change to the good-delivery guidelines for TBA, to allow the delivery of either Fannie or Freddie securities into the same contract. The securities themselves would not change; their separate TBA markets would simply be merged. Both securities would still be separately identifiable and tradable, only the TBA trades would be merged. Not only would this interim step improve liquidity, it would demonstrate investor interest in a truly common security that would be an important feature of the future hybrid housing finance system.

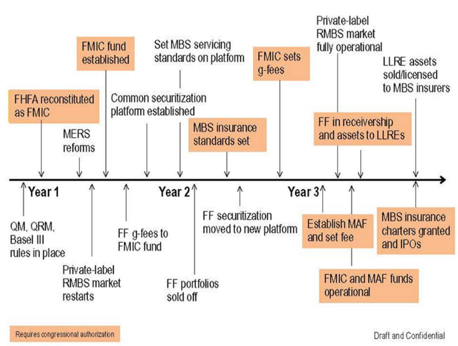
Risk-sharing

Enticing private capital back into the housing finance system is part of the transition to any future housing finance system. It is thus encouraging that the FHFA has mandated Fannie and Freddie to begin that process. The goals are modest but substantive, and they motivate Fannie and Freddie to experiment creatively. Although the pricing on these risk-sharing deals may not be economical, at least for now, what is learned from these efforts will be instrumental to ensuring there is enough private capital to support the future housing finance system.

Freddie recently issued Structured Agency Credit Risk, or STACR, securities, designed to offload the first-loss piece of certain guaranteed MBS into the private capital markets. The STACR's synthetic senior-subordinated floating-rate structure provides investors protection for prepayment and interest-rate risk.[20] Investor demand for the security was limited for a number of reasons—it was not rated and it has no risk-weighting—but it had a reasonably successful debut nonetheless. However, private investors will need more information to assess the relative value of STACR securities and alternative credit risk-sharing arrangements. This is necessary to scale up the effort and to better inform the debate on the future housing finance system.

Fannie also recently engaged in a risk-sharing transaction with NMI, a new private mortgage insurer. Offloading risk to the PMIs is worthy of experimentation, but this effort will also take time to scale up, since as much of the industry is still struggling to resolve its poor quality legacy books and uncertainty regarding future capital requirements.

Chart 5: Housing Finance Reform Timeline



The road to reform[21]

The journey to housing finance reform has begun, but it will be long. Even after reform legislation is enacted, the process could take several years.

The principal steps on the road to reform are as follows (see Chart 5):

- The Consumer Financial Protection Bureau has defined qualified mortgages, or QMs, and bank regulators have recently provided more clarity on the definition of qualified residential mortgages, or QRMs. Basel III capital rules are also being ironed out.
- These rules and others involving servicing and transparency are necessary before private capital will return and the transition to a new system can begin in earnest. The regulations could also significantly affect the extent of the government's backstop in the system. Mortgage loans comprising government-guaranteed MBS are expected to be QM and QRM.
- Fannie Mae's and Freddie Mac's investment portfolios are steadily reduced per the FHFA's strategic plan.
- Fannie and Freddie continue to scale up their risk-sharing efforts with private investors per the FHFA's strategic plan.

- The government-run common securitization platform replaces Fannie's and Freddie's securitization platforms. The TBA market functions without interruption, as the Securities and Exchange Commission continues its exemption of Regulation AB for securities traded on the common securitization facility.
- The Federal Mortgage Insurance Corp., an FDIC-like regulator of the housing finance system, is established, replacing the FHFA. Fannie's and Freddie's MBS are reinsured by the FMIC, fulfilling the government's commitment to existing MBS investors and stabilizing the housing finance system during the transition.
- The FMIC formalizes the government guarantee for mortgage securities; establishes the Mortgage Insurance Fund; determines appropriate g-fees; sets the appropriate amount of private capital needed to protect the government's guarantee; determines standards for the capital adequacy of the new private MBS guarantors, private mortgage insurers, mortgage originators and servicers, MBS issuers, and other players in the housing finance system; and promulgates other necessary regulations.
- The common securitization platform begins issuing a common government-backed security.
- The FMIC implements reforms to the MERS mortgage registry.
- A mechanism for collecting the Market Access Fund assessment on MBS is established. A governance structure is established for the Market Access Fund, and policies are developed to make awards from the fund, creating incentives for high-quality and sustainable affordable housing finance.
- Fannie's and Freddie's charters are revoked, and the institutions are put into receivership. Some of their assets and liabilities are transferred to LLREs, while their legacy guarantee books remain with the government receiver.
- The private-label securitization market steadily revives as the government's role recedes. Conditions necessary for the market to restart are already coming into place, most importantly being the newly established QRM rule. The government's reduced role in housing finance increases the attractiveness of nonguaranteed MBS.
- Seller-servicer agreements between large mortgage originators and the LLREs are restructured so that originators receive cash and equity in compensation for their loan sales. This establishes a mechanism to ensure the new MBS guarantors have sufficient capital as their businesses grow.
- Fannie's and Freddie's successor companies are rechartered and IPOs are held. New MBS guarantors are chartered and IPOs held. All of the guarantors are able to purchase or license assets from the LLREs. The Treasury ensures that this process maximizes taxpayer returns and that the private guarantor market is competitive.
- Pre-conservatorship shareholders of Fannie and Freddie receive no value until the government is repaid in full. Although the government would likely maximize its recovery from selling Fannie and Freddie if those firms were allowed to again dominate the market, this would undermine the purpose of reform. The government can accept a smaller recovery on Fannie and Freddie in order to create a more competitive housing finance system, the paramount objective.
- The government's role in the housing finance system is reduced over time as the required amount of first-loss private capital increases. Taxpayers' exposure is reduced in various ways, including lower conforming loan limits and the attachment point for losses borne by private capital. Unlike the old system in which no private capital stands ahead of taxpayers, the government's guarantee of MBS would be formalized so that government exposure would shrink.

Conclusions

Since the government took over Fannie Mae and Freddie Mac during the financial collapse five years ago, effectively nationalizing the nation's housing finance system, nothing meaningful has changed. The government still backs nearly nine of every 10 U.S. mortgage loans. This is bad for both taxpayers and homebuyers.

Taxpayers are on the hook for potential losses on the hundreds of billions of dollars in mortgages that Fannie and Freddie insure each year. This is not necessary: Private investors are willing to take on much of this risk and, with some safeguards, are capable of doing it.

The longer Fannie and Freddie stay in government hands, the more lawmakers will be tempted to use them for purposes unrelated to housing. This has already happened. Last year's payroll tax holiday was partially paid for by raising the premiums Fannie and Freddie charge homebuyers for providing insurance.22 Mortgage borrowers will be paying extra as a result over the next decade.

The housing market's revival has allowed Fannie and Freddie to again turn large profits, amounting to tens of billions of dollars each year. Policymakers may begin to rely on these profits to fund government spending, making it especially hard to let Fannie and Freddie go.

Policymakers may also eventually be tempted to make Fannie and Freddie lend to people who really cannot afford mortgages. Helping disadvantaged households become homeowners is laudable, but experience shows that politically driven help can be abused.

The bigger problem now is the limbo status of Fannie and Freddie, which fosters indecision at the two institutions and by their regulator, the Federal Housing Finance Agency. Lenders who do business with Fannie and Freddie are unsure of the rules, and are thus extra cautious, keeping credit overly tight for potential homebuyers. This is evident in the average credit scores of borrowers through Fannie and Freddie, which today are in the top third of all of credit scores.

Some in Congress recognize the current situation's dangers and have introduced legislation to reform the nation's housing finance system. Yet these legislative efforts lack a clear plan for getting from the current housing finance system to the future one. The transition cannot be bungled: The nation's economic recovery depends on housing, which in turn depends on the flow of mortgage credit. The $10 trillion U.S. mortgage market is also critically important to the entire global financial system.

Yet while the transition will be complicated and rife with risk, it is eminently doable, as the path presented in this paper illustrates.

The federal government has unwound much of its extraordinary intervention in the economy prompted by the Great Recession. Fiscal stimulus has been replaced by fiscal austerity. The Trouble Asset Relief Program bailout fund will soon be history. The Federal Reserve is planning to begin normalizing monetary policy. That leaves Fannie and Freddie and the nation's housing finance system as the largest piece of unfinished business. It is time to finish it.

Endnotes

1 This paper draws heavily on and builds upon the hybrid system presented in "A Pragmatic Plan for Housing Finance Reform," Ellen Seidman, Phil Swagel, Sarah Wartell, and Mark Zandi, Moody's Analytics, Milken Institute and Urban Institute white paper, July 19, 2013. This system is similar to that envisaged in Corker-Warner, albeit with some notable differences.

2 For a critical assessment of the Corker-Warner legislation, see "Evaluating Corker-Warner," Mark Zandi and Cris DeRitis, Moody's Analytics white paper, July 2013. The president's support for a hybrid system was expressed in a speech.

3 The three agencies are currently responsible for 85% of all purchase mortgage originations. The nation's banks originate the remaining 15%, which they hold on their balance sheets.

4 Loans eligible for a government guarantee would be qualified mortgages as currently defined by the Consumer Financial Protection Bureau.

5 If the MIF was depleted in a future crisis and the Treasury was required to provide financial support to the housing finance system, the FMIC would have the ability to raise guarantee fees on future mortgage borrowers to ensure that taxpayers are made whole.

6 The securitization facility would be used for all non-Ginnie Mae government-guaranteed securities and, although not required, could be used for nonguaranteed securities.

7 Market Access Fund and MBS insurer for small lenders.

8 According to the Mortgage Bankers' Association, during the five years between 2008 and 2012, single-family residential mortgage origination volumes averaged approximately $1.75 trillion per year, of which $1.2 trillion were refinancings. With equilibrium fixed mortgage rates of 6.5% well above the average coupon of approximately 5% on outstanding mortgage debt, future refinancing volume is expected to be closer to $300 billion per year.

9 This is based on the assumption that 10-year Treasury yields will be close to annualized potential nominal GDP growth in the long run. Potential nominal GDP growth is expected to run between 4.5% and 5%, equal to 2% inflation and real GDP growth of 2.5% to 3%. Thirty-year fixed mortgage rates are expected to be approximately 175 basis points over 10-year Treasury yields.

10 The majority of home sales to investors are for cash, while most sales to first-time homebuyers are financed with mortgages.

11 This represents the option-adjusted spread on Fannie Mae 30-year current coupon securities.

12 The protection to taxpayers is 12.5%. This includes 10% in private capital and 2.5% in the mortgage insurance fund. In other words, losses on mortgage securities backed by the government would have to be greater than 12.5% before taxpayers would be called upon to support the system. To produce losses of this amount, a financial crisis would have to be almost three times as severe as the Great Recession.

13 This concern is expressed well by Peter Wallison in a July 1, 2013 Wall Street Journal op-ed, "The Corker-Warner Housing Finance Reform Won't Work." http://online.wsj.com/article/SB10001424127887323873904578569820608849816.html

14 The losses through 2012 are less than 5%, but foreclosures are still high and thus more losses are coming.

15 These mortgage rate impacts are based on a guarantee fee calculator that determines through a net-present-value computation of cash flows the fee necessary to meet conditions for both solvency and return on equity. The calculator is available upon request.

16 This assumes that single-family mortgage debt runs off by 10% per year as a result of prepayments and normal amortization. Multifamily debt is assumed to run off by 2% per year.

17 This would be an even greater risk if, as in some proposed hybrid systems, they would also be permitted to originate mortgage loans.

18 The LLRE is established under the Housing and Economic Recovery Act of 2008. http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/html/PLAW-110publ289.htm HERA gives the FHFA authority to transfer of Fannie's and Freddie's assets to a LLRE to facilitate their orderly liquidation.

19 A thorough discussion of a proposal to create a fungible Fannie-Freddie security is provided in an MBA working paper "Ensuring Liquidity Through a Common, Fungible GSE Security." http://www.mbaa.org/files/Advocacy/2013SingleSecurityConcept-Transition1.pdf

20 It is a synthetic security, in that it references a pool of recently originated mortgages although it is not a credit- linked note. A CLN is a more intuitive structure, but since it is a derivative it would have to satisfy a range of other regulatory requirements. The STACR structure avoids these regulatory issues.

21 To fully understand the steps on the road to reform, it is necessary to understand the hybrid system assumed in this white paper. The system is described in detail in "A Pragmatic Plan for Housing Finance Reform," Seidman, Swagel, Wartell and Zandi.

22 Fannie and Freddie guarantee fees were increased by 10 basis points for 10 years to help pay for the payroll tax holiday. This will raise more than $20 billion for the federal government over the next decade.

PREPARED STATEMENT OF DAVID MIN

ASSISTANT PROFESSOR OF LAW, UNIVERSITY OF CALIFORNIA, IRVINE SCHOOL OF LAW

NOVEMBER 22, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is David Min and I am an Assistant Professor at the University of California, Irvine School of Law, where I teach and research in the area of banking and capital markets regulation. Before coming into academia, I spent over a decade working in financial markets law and policy, both in private practice and in the Federal Government. Most recently, I served as the Associate Director for Financial Markets Policy for the Center for American Progress, where I was responsible for managing the activities of the Mortgage Finance Working Group organized by CAP. I am here, however, in my individual capacity, and not as a representative of either CAP or the Mortgage Finance Working Group.

For the purposes of my testimony, I will assume that the system of housing finance that we transition into will be some variation of S.1217, the bill proposed by Senators Bob Corker (R-TN) and Mark Warner (D-VA).[1] The Corker-Warner bill envisions a so-called "hybrid" system, in which the Federal Government provides explicit and priced reinsurance on mortgage-backed securities insured by approved bond guarantors, in a model based loosely on the deposit insurance model of the Federal Deposit Insurance Corporation. As I have noted elsewhere, the Federal Government has provided, in one way or another, a catastrophic backstop on most residential mortgage funding since the New Deal's banking and housing reforms, and this role has been inextricably linked to a number of key policy objectives, including financial stability, broad and constant liquidity, and the wide availability of the 30-year fixed-rate mortgage that has become the hallmark of U.S. housing finance.[2]

The transition being contemplated would be the largest such undertaking in history, and one that, to the best of my knowledge, has no close precedents. Fannie and Freddie currently hold slightly more than $5 trillion in mortgage-related assets.[3] Since the sudden and steep decline in private mortgage finance that occurred in 2008, the two enterprises have been responsible for more than 60 percent of the new mortgage originations, about $1.7 trillion each year, an amount equivalent to slightly more than 10 percent of our Nation's annual gross domestic product. The Federal Government has some experience in resolving failed institutions—recently, the Government's interactions with AIG and General Motors come to mind, and before that, we had the experience of the Resolution Trust Company in resolving hundreds of failed thrifts. But I can think of no instance in which we have tried to simultaneously resolve large failed institutions and transition their core economic functions into a newly created set of institutions, certainly not on the scale imagined by Corker-Warner.

The experience of the past decade has shown us that the current housing finance model, which relies predominantly on the mortgage-backed securities issued by the Government-sponsored enterprises (GSEs)[4] Fannie Mae and Freddie Mac, well serves a number of critically important policy goals, including offering a broadly available and affordable 30-year fixed-rate mortgage product, meeting the credit needs of underserved populations and product types such as rural areas and multi-family housing, and providing countercyclical liquidity when other sources of housing finance have dried up. Unfortunately, this experience also illustrates a number of serious flaws with the GSE model. Because these enterprises were publicly backed, with private shareholders, they continuously sought to maximize profits by increasing their risk-taking, creating a "heads I win, tails you lose" dynamic between their shareholders and taxpayers. Moreover, protections against taxpayer ex-

[1] Housing Finance Reform and Taxpayer Protection Act of 2013, S.1217, 113th Cong. (2013) (hereinafter "Corker-Warner" or the "Corker-Warner bill").

[2] *See*, e.g., David Min, "How Government Guarantees in Housing Finance Promote Stability", 50 *HARV. J. LEG.* 437 (2013); David Min, et al., "The Future of U.S. Housing Finance: Five Points of View", 17 *J. STRUCTURED FIN.* 36 (2011). Before Agency securitization evolved to dominate U.S. mortgage markets, federally insured depository institutions were the primary source of residential mortgage funding. In both types of financing, the Federal Government holds the catastrophic tail risk. Since the 1940s, this Government backing has existed for the vast majority of U.S. home loans, typically more than 70 percent. Id.

[3] According to their Form 10-K filings, at the end of 2012, Fannie held $3.064 trillion in mortgage related assets, and Freddie held $2.005 trillion.

[4] Following the conservatorship of Fannie and Freddie, many have ceased calling these firms "Government-sponsored," since they are effectively seen as part of the Federal Government. Technically, however the conservatorship was structured in a way that kept the enterprises private and lacking an explicit Government guarantee, so the term "Government-sponsored enterprise" or "GSE" is still accurate.

posure were clearly insufficient in this framework. In my view, the Corker-Warner bill is a good starting point for thinking about how to keep the parts of the current system that worked, while eliminating the parts that proved problematic.

This same balance needs to be reflected in how we think about transitioning to the future housing finance system outlined in Corker-Warner. Thus, while safety and soundness and taxpayer protection are obviously important policy goal, I believe the most important priority in structuring the transition should be to ensure that there continues to be sufficient liquidity across all market segments. Given the complexity and size of the GSEs' current operations, this is a tremendously complex and multilayered task. Moreover, the stakes could not be higher, as major hiccups would have devastating effects on an already-stagnant economy and financial system.

This is particularly true for financing affordable multifamily housing, which is a primary source of rental housing in this country. In the aftermath of the housing crisis, policy makers have generally sought to reduce the emphasis on home ownership and shrink the Federal Government's role in housing finance, which is reflected in Corker-Warner. But achieving these objectives will naturally mean that affordable rental housing will be much more important, both from a social and economic perspective. Thus, one of the most important elements of the transition will be ensuring that we maintain sufficient liquidity for rental housing, such as multifamily housing.

The guiding principle for legislators and regulators who are structuring our housing finance transition must first and foremost be, "Do no harm." Avoiding the disruption of mortgage liquidity, either systemwide or in individual market segments, should be a paramount concern during this period. A failure to adhere to this principle would be catastrophic for the housing markets and the broader economy.

Assessing the Corker-Warner Transition Plan

The Corker-Warner bill contemplates a transition period of no more than 5 years following its enactment, during which time Fannie and Freddie would be phased out and the infrastructure for the new system, including the Federal Mortgage Insurance Corporation (FMIC) at the heart of this framework, is established.[5] Upon enactment, Corker-Warner would eliminate the affordable housing goals currently in place for Fannie and Freddie,[6] and begin to gradually reduce the high cost area loan limits, which currently stand at 150 percent of the conforming loan limit (now set at $417,000) to 115 percent of the conforming loan limit within 5 years.[7] The mortgage assets held in Fannie and Freddie's investment portfolios would be reduced by 15 percent each year until the FMIC is certified as being operational; at the end of that year, their remaining assets would be used to wind down the enterprises and help cover the costs of any remaining legacy guarantees.[8]

Upon FMIC certification, an event which must occur within 5 years of enactment, the charters for Fannie and Freddie are repealed and these firms barred from conducting any new business.[9] At this time, outstanding "legacy" debt obligations (bonds and mortgage-backed securities) issued by the GSEs would be explicitly guaranteed with the full faith and credit of the United States.[10]

At a high level, Corker-Warner provides a thoughtful template for long-term mortgage finance reform. But transitioning to the new system that Corker-Warner creates will be a long and difficult process. The Corker-Warner bill provides some broad guidance and mandates on the question of transition, but many issues remain unresolved and need to be addressed before we move on. I discuss some of these below.

Developing a Common Securitization Architecture

Central to the Corker-Warner framework is the development of a new infrastructure for issuing securities with a common Government guarantee. Currently, Fannie and Freddie each have their own securitization architectures, but creating a common securitization platform (CSP) is a prerequisite to opening the new system up to a multitude of issuers.[11] Creating the CSP is also important for creating a single security, which many see as a precondition for a successful transition towards the

[5] Corker-Warner §§501–506.
[6] Corker-Warner §506.
[7] Corker-Warner §504.
[8] Corker-Warner §505.
[9] Corker-Warner §501.
[10] Corker-Warner §501.
[11] *See,* Edward J. DeMarco, Acting Director, Federal Housing Finance Agency, "The Conservatorships of Fannie Mae and Freddie Mac", remarks before the National Association of Federal Credit Unions Congressional Caucus, Washington, DC (Sept. 13, 2012).

new system, because of the differences in liquidity and pricing that are likely to develop in a system that has more than two issuers.

Even in the current environment, with two virtually identical issuers enjoying the same Government guarantee, investors clearly prefer Fannie obligations over Freddie obligations, and as a result, Fannies trade in deeper and more liquid markets and enjoy better pricing.[12] As of June 2012, the spread between 30-year 4.5-percent Fannie MBS and Freddie MBS was about 48 cents.[13] These spreads are certain to widen with the entry of additional issuers, unless a common security is created. Thus, moving towards a single security seems to be an important part of any transition towards the new system. A single security should also improve liquidity in the important "To Be Announced" (TBA) market, the forward market that is responsible for more than 90 percent of the trading volume in agency MBS (and which allows borrowers to "lock in" their rates).[14]

In theory, establishing a CSP and single security should not be overly difficult. After all, Ginnie Mae securities have a large number of issuers and a shared Government guarantee, and they effectively trade as a single security. Several white papers have been written describing best practices in creating a single security, and they generally share the same recommendations.[15] We need a common platform, such as the CSP, and standardization of terms and contracts, including loan delivery and pooling requirements, remittance requirements, underwriting guidelines, servicing standards, and disclosure policies.

But in reality, moving towards a common platform and single security may be quite difficult. The technical challenges alone are likely to be very challenging. Fannie and Freddie each created and perfected their securitization infrastructures over many years. Integrating these systems together into an open securitization platform that can be utilized by any approved issuer will be a painstaking task. But as recent history teaches us, developing a complex technology infrastructure can be much more difficult than originally anticipated. It took Wells Fargo 3 years to integrate its data systems with those of Wachovia, following its acquisition of the Charlotte-based bank holding company. Bank of America did not finish integrating its data systems with those of Merrill Lynch until September of this year, nearly 5 years after Merrill was acquired.[16]

Indeed, it is worth noting that the Federal Housing Finance Agency's progress towards creating the CSP is proceeding exceedingly slowly. At this point, more than 18 months after the common securitization platform was first publicly announced by the FHFA,[17] the only public announced progress towards creating this CSP has been the filing of a certificate of formation for a limited liability company and the signing of a lease for office space.[18] The slow pace of CSP development does not bode well for the relatively aggressive time line envisioned by Corker-Warner, which calls for the FMIC to be certified as operational within 5 years.

Achieving Liquidity for the New MBS

Another important transition issue that must be considered is how to best scale up liquidity for the new securities guaranteed by the FMIC in the Corker-Warner framework. Corker-Warner essentially envisions an on/off progression, in which the GSEs are shut down at the same time that the FMIC opens for business. Once the FMIC is certified as operational, the GSEs lose their charters and are barred from conducting any new business. The concern with this approach, of course, is that

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[12] *See,* American Securitization Forum, "Discussion of a Proposed Single Agency Security" 1-2, ASF White Paper Series, July 2, 2012.

[13] Id. at 3.

[14] *See,* generally, James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market", Federal Reserve Bank of NY Economic Policy Review, May 2013.

[15] *See,* e.g., id.; Mortgage Bankers Association, "Ensuring Liquidity Through a Common, Fungible GSE Security", in *Key Steps on the Road to GSE Reform,* Sept. 11, 2013; American Securitization Forum, "Discussion of a Proposed Single Agency Security", supra n. 12; Richard Johns, Executive Director, "Structured Finance Industry Group, Essential Elements of Housing Finance Reform", Testimony Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 12, 2013).

[16] *See,* "Bank of America Merrill Lynch Completes Transaction Data Repository", Press Release, Sept. 16, 2013, available at *http://newsroom.bankofamerica.com/press-releases/commercial-and-middle-market-banking/bank-america-merrill-lynch-completes-transaction.*

[17] *See,* Federal Housing Finance Agency, "A Progress Report on the Common Securitization Infrastructure" (Apr. 30, 2013), available at *http://www.fhfa.gov/webfiles/25144/WhitePaperProgressReport43013.pdf.* The idea for creating a common securitization platform was first announced in February 2012 by FHFA, which followed up with a detailed proposal that was released to the public in October 2012.

[18] *See,* Federal Housing Finance Agency, "FHFA Announces Significant Steps in Organization of Joint Venture To Establish Common Securitization Platform", News Release (Oct. 7, 2013).

when this handoff occurs, there is a lack of demand for the new securities, due to any number of factors (such as a reluctance by investors to be early adopters). If that were to occur, the sudden drop in liquidity could be quite problematic for the housing markets.

Responsibly Reducing High Cost Area Loan Limits

Corker-Warner calls for scaling back the size of the Federal Government's footprint, with so-called "high cost" loan limits being, at least in the transition phase, the primary focus of this reduction. But it is not clear how much private nonguaranteed liquidity is currently available to fill the vacuum that will be created. Some have suggested that depository institutions should play a greater role in financing home loans, reprising the role they once played in originating and holding mortgages to term (as opposed to simply originating mortgages with the intent to sell these to secondary market actors, which has increasingly displaced originate-to-hold lending). But the fact is that bank deposits are simply not a large enough source of funding at this time to replace much of the activity that Fannie and Freddie currently do. As Figure 1 illustrates, the total amount of U.S. bank deposits is barely sufficient to meet U.S. housing finance needs. Moreover, as my fellow witness Jim Millstein has noted, we have been experiencing a net decline in real estate loans held by commercial banks, suggesting that traditional bank balance sheets are an unlikely source of increased housing finance in the near future. [19]

Similarly, it is improbable that private-label securitization, which accounted for so much volume during the housing boom years of 2002–07, will be able to replace much of the vacuum left by a reduced Government footprint in the near future. Since 2008, private-label securitization of mortgages has essentially been nonexistent. Figure 2 lists the underwriting characteristics for all of the private-label mortgage securitization deals that have taken place since the 2008 financial crisis. The credit characteristics are extremely high, and the volume is still very low. As Georgetown Law professor Adam Levitin has described, the PLS market is currently a "market for lemons" and is likely to stay that way for some time, until investors regain confidence in the integrity of the highly informationally asymmetric PLS process. [20] At the same time, the implementation of the "Qualified Mortgage" (QM) standard, which provides safe harbor for mortgage originators, and the "Qualified Residential Mortgage" (QRM) standard, which provides an exemption from the risk retention requirements of Dodd-Frank, are likely to have some impact on the availability of private, nonguaranteed mortgage finance, but it is too early to tell what this impact might be.

In the near term, aggressively lowering loan limits may lead to a gap in the availability of mortgages in high-cost areas, which could adversely affect the housing markets in those regions.

Ensuring the Continued Flow of Mortgage Finance for Underserved Market Segments

Historically, the GSEs have played an important role in providing mortgage credit to underserved market segments, such as rural housing and housing for lower-income households. They have played a particularly important role in providing financing for affordable multifamily rental housing, with roughly two-thirds of the multifamily units they finance being affordable to households earning less than 80 percent of area median income. [21] GSE financing for affordable multifamily rental housing has come from both their guarantee activities and purchases for their investment portfolios, and has been motivated at least in part by their affordable housing goals. The GSEs' footprint in multifamily housing finance has generally been much more variable than their single family market share, shrinking down to about 25 percent of the market when market conditions are good and increasing to

[19] Jim Millstein, Chairman and Chief Executive Officer, Millstein and Co., "A Blueprint for Finance Reform in America", Remarks before the Woodrow Wilson International Center for Scholars, May 22, 2012.

[20] Adam J. Levitin, Professor of Law, Georgetown University Law Center, "Housing Finance Reform: Fundamentals of a Functioning Private-Label Mortgage Backed Securities Market", Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Oct. 1, 2013).

[21] *See,* Ethan Handelman, Vice President for Policy and Advocacy, National Housing Conference, "Housing Finance Reform: Essential Elements To Provide Affordable Options for Housing", Testimony Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Nov. 7, 2013). As Mr. Handelman outlines, one key reason why the GSEs play such a dominant role in affordable multifamily is that, unlike purely private sources of mortgage capital (such as insurance funds or pension funds), they offer long-term products, which are critical for many of the specific needs of developing and maintaining affordable multifamily deals.

fill the vacuum when market conditions deteriorate (70 percent at the height of the crisis).[22]

Corker-Warner calls for an aggressive reduction in the GSE portfolios over a period of 5 years, and for the elimination of the affordable housing goals. Replacing these mechanisms would be a separate set of entities that have been collectively described as the "Market Access Fund," which would be funded by a small levy, between 5 to 10 basis points of outstanding mortgage guarantees.[23] The Market Access Fund would, as my fellow witness Mark Zandi has described, attempt to provide both direct subsidies and explicit credit enhancement to foster greater access to securitization in underserved market segments, particularly in affordable multifamily housing.[24] The existing multifamily guarantee business would be transferred to the FMIC, as Corker-Warner currently stands,[25] although as Dr. Zandi has noted, this is likely a placeholder, as it is difficult to imagine a regulator running a business.[26]

One concern with the proposed transition is that it may wind down key aspects of the current system that have provided financing for these underserved segments—the investment portfolios and the affordable housing goals—without having fully established the Market Access Fund. Given economic and demographic trends, we have already seen a sharp increase in the demand for affordable rental housing. As policy makers seek to deemphasize home ownership and reduce the Federal Government's footprint in single-family housing finance, we should expect to see this demand increase. Thus, it is imperative that we avoid leaving vacuums in the availability of mortgage credit, which would be devastating for renters, rural homeowners, lower income families, and many others who are vulnerable and struggling to make ends meet during a period of economic stagnation.

Attracting Sufficient and Appropriately Priced Capital Into the New System

Another important concern is bringing in sufficient capital to fund the new private MBS issuers that are central to the hybrid system envisioned by Corker-Warner. While some have raised concerns about the availability of private capital willing to serve as equity in this new system,[27] I am optimistic that there is a large pool of capital to draw upon, and I think that last week's proposal from Fairholme Capital Management gives us some evidence of that. The question, of course, is on what terms this capital is available.

The core economics of this business are strong, as Figure 3 indicates. Since their conservatorship, the GSEs have been steadily improving their performance, as the impaired loans guaranteed during the 2003 to 2007 period are written off and the new books of business from 2008 and onward grow to become a larger proportion of their balance sheets. That being said, there are a number of variables that will affect how much capital is available and on what terms. These include capital requirements,[28] expected market size and share (which is affected by, among other things, loan limits and barriers to entry), and the pricing of the Government guarantee.

Corker-Warner requires that private capital representing no less than 10 percent of the guaranteed MBS be placed in a first loss position,[29] although as former Treasury official Phillip Swagel has noted, Corker-Warner contemplates that this

[22] *See,* Shekar Narasimhan, Managing Partner, Beekman Advisors, Inc., "Housing Finance Reform: Essential Elements of the Multifamily Housing Finance System", Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Oct. 9, 2013).

[23] This includes the National Housing Trust Fund and Capital Magnet Fund that were established but not implemented under the Housing and Economic Recovery Act of 2008, as well as other funds meant to provide targeted credit support meant to facilitate securitization of niche products. *See,* Corker-Warner, §§401-403; Ellen Seidman, Phillip Swagel, Sarah Wartell, and Mark Zandi, "A Pragmatic Plan for Housing Finance Reform", June 19, 2013, available at *http://www.urban.org/uploadedpdf/412845-Housing-Finance-Reform.pdf.*

[24] Mark Zandi, Chief Economist and Cofounder, Moody's Analytics, "Essential Elements of Housing Finance Reform", Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Sept. 12, 2013).

[25] Corker-Warner §601.

[26] Mark Zandi and Cristian deRitis, "Evaluating Corker-Warner", Moody's Analytics Report (Sept. 2013).

[27] Mark Zandi and Cristian deRitis, "The Road to Reform" 5-7, Moody's Analytics Report (Sept. 2013).

[28] While it is generally thought that equity investors prefer higher leverage, so as to maximize their potential returns, there is some evidence that lower leverage (such as created by higher capital requirements) leads to higher returns over time. *See,* generally, Malcolm Baker and Jeffrey Wergler, "Do Strict Capital Requirements Raise the Cost of Capital? Bank Regulation and the Low Risk Anomaly", NBER Working Paper No. 19018 (2013).

[29] Corker-Warner §202.

private capital may be tranched, which would lower its costs.[30] Some have argued that this capital level is too high, and will thus lead to both a dearth of private capital and a sharp increase in mortgage rates. For example, Laurie Goodman and Jun Zhu conduct an empirical analysis and conclude that 4–5 percent capital would have covered all of the GSEs' losses coming out of the 2007–08 mortgage crisis.[31] Taking into account the proposed Mortgage Insurance Fund, which is required to reach a reserve level of 2.5 percent of outstanding principal balance within 10 years (1.25 percent within 5 years), Corker-Warner effectively contemplates a 12.5-percent buffer against taxpayer loss,[32] on top of any improvements to mortgage loss rates that may accrue as a result of QM and QRM. This compares to the current system, in which Fannie and Freddie had minimum capital requirements of 2.5 percent of assets plus 0.45 percent of adjusted off-balance sheet obligations (including guaranteed mortgage-backed securities).[33]

Maintaining Sources of Countercyclical Liquidity

A longer-term transition goal should be to preserve sources of countercyclical liquidity. The unfortunate fact about private bank capital is that it is highly procyclical, chasing profits during credit booms and becoming overly risk averse during credit contractions. As a result, the Government is typically the only game in town when it comes to countercyclical liquidity. We need only look to our current mortgage markets to see this phenomenon on display. Since the credit contraction began in 2007, Agency securitization has been responsible for virtually all housing finance, accounting for over 90 percent of residential mortgage originations. Without this countercyclical liquidity, it is certain that the housing bust would have been far worse, with extremely negative effects on the broader economy. Before this most recent housing crisis, the last great housing crisis we had occurred in the 1930s, when we did not have in place any sources of countercyclical liquidity. The result was a 50 percent national delinquency rate and a 10-percent foreclosure rate.[34]

Of course, in winding down Fannie and Freddie, Corker-Warner eliminates the two largest sources of countercyclical mortgage liquidity. Corker-Warner recognizes the need for such a function, however, and thus, in the presence of "unusual and exigent" circumstances, allows for the issuance of securities that do not have 10-percent private capital in a first loss position. In the event that we have another mortgage crisis, this exigency clause may not be sufficient to meet the liquidity needs of the market. Based on observations of the current experience, in which Fannie and Freddie have been responsible for roughly two-thirds of all mortgage originations, it may be the case that greater emergency powers are appropriate.

Recommendations for Transition

Given the issues with the transition contemplated by Corker-Warner, what should we do next? I lay out some recommendations below.

[30] Phillip Swagel, "Housing Finance Reform: Essential Elements of a Government Guarantee for Mortgage-Backed Securities", Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Oct. 31, 2013).

[31] Laurie S. Goodman and Jun Zhu, "The GSE Reform Debate: How Much Capital Is Enough?", Urban Institute, Oct. 24, 2013.

[32] There are two other layers of protection against taxpayer loss that Corker-Warner increases. Private mortgage insurance currently covers a little less than 15 percent of mortgages securitized by the GSEs and takes a first loss position between 6 percent and 35 percent. *See,* Fannie Mae 2013 Third Quarter Credit Supplement; Freddie Mac October 2013 Investor Presentation. Under Corker-Warner, PMI is left in place, covering loans with an LTV over 80, but its coverage amounts are increased. Corker-Warner §2. Homeowner equity is also likely to be increased, by virtue of the 5-percent downpayment requirement created in Corker-Warner. Corker-Warner §2. Fannie Mae's current average loan-to-value ratio on all single-family loans they have guaranteed is 67.1 percent. *See,* Fannie Mae 2013 Third Quarter Credit Supplement. Freddie Mac's average loan-to-value ratio on its single-family conventional guaranty book of business is 73 percent. *See,* Freddie Mac October 2013 Investor Presentation.

[33] *See,* Office of Federal Housing Enterprise Oversight, "Mortgage Market Note: Fannie Mae and Freddie Mac Capital", July 17, 2008. Fannie and Freddie were also subject to risk-based capital requirements, based on a 10-year stress test model. Id. The two enterprises were actually subject to surplus capital requirements due to alleged accounting improprieties and other issues, from 2004 until the time of their conservatorship. *See,* Federal Housing Finance Agency, "Capital Prior to Conservatorship", available at *http://www.fhfa.gov/Default.aspx?Page=146.* Following their conservatorship, FHFA has suspended capital classifications and announcements. *See,* Federal Housing Finance Agency, "Capital Under Conservatorship", available at *http://www.fhfa.gov/Default.aspx?Page=78.*

[34] *See,* David Min, "How Government Guarantees in Housing Finance Promote Stability", supra n. 2.

Delegate More Responsibility to Regulators and Remove Arbitrary Timetables

In a number of different ways, Corker-Warner looks to micromanage the transition process. The GSEs are given specific time lines for lowering their loan limits and winding down their portfolios, and the FMIC is provided with very specific capital requirements as well as a specific schedule for implementing the CSP and ending the activities of the GSEs. But as the above analysis demonstrates, these are highly technical issues that would benefit greatly from dedicated expertise and data. Is 10 percent the right level of capital? Will winding down the GSE portfolios by 15 percent a year have an adverse effect on the housing markets (particularly underserved and vulnerable areas)? Will private sources of mortgage finance come into the market if the GSEs lower their loan limits each year? What if we shut down the GSEs, the CSP opens for business and liquidity is lacking? All of these are questions that are best answered by regulators making decisions based on data analysis, rather than by legislation making choices based on assumptions that may or may not turn out to be correct.

Regulators should be given greater discretion and encouraged to respond to developments on the ground, with broad principles guiding their actions rather than detailed and specific rules. Timetables should not be dictated ex ante, but rather should be developed in response to data-driven analysis. It may be useful to compare the roles of the FHFA and FMIC with those of Federal banking regulators, who enjoy very broad discretion and expansive powers to promulgate and enforce regulations based on their regulatory goals. Given the complexity of the transition we are anticipating, giving regulators more flexibility in their actions and timetable would seem a prudent and more effective course of action.

Thus, I believe that Corker-Warner should not attempt to create specific capital requirements, or create specific timetables, but should instead substitute high level regulatory targets and mandates, while leaving the specifics to the regulators. Greater flexibility and delegation to regulators are preferable for managing a transition of this scale and scope.

Phase in the Transition in Parts, Not All at Once

The current transition plan contemplated by Corker-Warner effectively calls for flipping on a switch (certification of the FMIC), at which point the GSEs will turn off and the FMIC and CSP will turn on. But as recent events may highlight, unanticipated problems may arise, particularly with any transition as complex as moving a trillion dollars in mortgage origination financing over from one platform to another. Flipping the switch may lead us to discover that the lights are not working, or only working in parts of the building.

Rather, I believe a preferable approach would be to adopt a piecemeal approach to transition, turning over small (but increasingly greater) parts of the mortgage markets to the new infrastructure. For example, rather than preparing the CSP architecture to handle the mortgages financed by GSE securitization all at once, we could first start with a dedicated subset of mortgages, such as 15-year fixed-rate mortgages, or "high cost" conforming mortgages. Such an approach would have a myriad of benefits. First, it would allow regulators to test the new system in a meaningful way, and develop data that can help them perfect the new infrastructure. Second, it would help build investor liquidity in the new MBS being produced. Instead of requiring investors to all become early adopters, a piecemeal approach to transition would build volume over time in specific product segments. Third, to the extent that there were problems with liquidity in the transition, such an approach would leave in place the GSEs to pick up any slack that might be needed.

Under this approach, transition could proceed based on meeting specified liquidity benchmarks, and not on a preordained timeframe. Such an approach might actually proceed more quickly than the transition called for by Corker-Warner, since this would allow for earlier partial certifications of FMIC, rather than the all-or-nothing approach currently specified in the legislation. This would also wind down the GSEs in an orderly fashion by removing increasingly larger parts of their business and transferring them to the new system.

Convert Legacy Securities Into New FMIC-Backed MBS

One way to build liquidity in the new system is to offer all holders of legacy securities the option of converting their securities into the new, explicitly guaranteed MBS created under the new housing finance regime.[35] Assuming transition was

[35] Compelling investors to convert their securities could raise contractual and other issues, and thus is likely to raise more problems than it solves. However, if there were cost-effective ways to encourage these investors to convert, those might be worth considering as well.

phased in as described in the previous section, each class of securities could be converted at the time that an equivalent product was offered by the FMIC. This approach would build immediate volume into the new architecture, which would improve liquidity and lower prices.

Preapprove the New MBS for Use in TBA Market and as Collateral

Another relatively simple step that could improve liquidity for the new security is to ensure, ahead of time, that it will be accepted for delivery into the TBA market. As I discussed previously, the TBA market is an enormous futures market that is responsible for over 90 percent of the trading in Agency MBS, and thus is a critical source of liquidity. On their face, these new securities should have no problem fitting into the TBA market, as they are Government-backed (an important de facto requirement for TBA trading) and seem to possess all of the other predicate characteristics.[36] As part of the transition process, regulators should open up discussions with the Securities Industry and Financial Markets Association (SIFMA), which sets standards for the TBA market, and take any steps necessary to ensure that the new MBS are accepted for TBA trading.

Similarly, regulators should seek to preapprove the new MBS as collateral in the various markets and transactions in which Agency MBS is accepted as collateral, such as the Fed's discount window lending, the OTC derivatives market (standards set by the International Swaps and Derivatives Association), and repo markets (standards set by SIFMA). Given that the new MBS carry an explicit Government guarantee (typically the most important requirement), this should not be a difficult task, but simply setting expectations ahead of time may have a large beneficial impact on liquidity.

Give a Running Start to Institutions Focused on Underserved Markets

As I described earlier, the transition process may have particular issues in maintaining liquidity in underserved market segments. As the GSEs are unwound, it may be the case that the new infrastructure is not yet set up well enough to fill the void. To help alleviate this problem, it makes sense to give a head start to the new institutions tasked with serving these markets.

Thus, it may make sense to start funding the Market Access Fund immediately, taking these funds out of the G-fee that is currently being levied by the GSEs. Since 2008, Fannie and Freddie have financed roughly $2.5 trillion in new mortgage originations, and they are charging 50 basis points on these. Taking even a small amount out of this could go a long way in getting the MAF up and running, so that it is able to take on a greater share of the underserved market once transition is underway.

Similarly, it would be useful to immediately fund and activate MBS guarantors with a specific focus on affordable housing finance, with an eye towards immediately becoming part of the new Corker-Warner architecture. Some of you may be familiar with the plan put forth by Raphael Bostic, Shekar Narasimhan, and Mark Willis, which proposes the immediate spin-off of the multifamily securitization assets and business of Fannie and Freddie into a new joint subsidiary.[37] This new multifamily entity would, for a fee, piggyback off of the guarantees of Fannie and Freddie, until such time as the GSEs were eliminated and the FMIC was operational. At that point, the new multifamily entity would convert into an issuer in the new Corker-Warner system.

Whether or not the Bostic/Narasimhan/Willis plan is adopted, it provides an interesting template for thinking about how to serve affordable housing finance needs. As this plan illustrates, it is critical to get things up and running immediately, to give these entities a running start and thus help to ensure that liquidity in these underserved markets will not be lacking when transition occurs.

Providing Expanded Emergency Powers to FMIC To Deal With Housing Crises

Finally, we should think about the importance of tools that can allow our housing finance system to respond to emergency situations. In addition to the current provisions articulated in Corker-Warner, which allow for FMIC to guarantee MBS that don't meet the 10-percent private capital requirement, other powers should be provided, which allow FMIC to effectively provide countercyclical liquidity in the event of another crisis, like the one we are currently emerging from. At a bare minimum,

[36] *See,* generally, Vickery and Wright, "TBA Trading and Liquidity in the Agency MBS Market", supra n. 14.

[37] Raphael Bostic, Shekar Narasimhan, and Mark Willis, "Multifamily Finance Reform", June 24, 2013, available at *http://www.beekmanadvisors.com/presentations/Multifamily%20Finance%20Reform__Moving%20to%20a%20Solution-2013-06-24-DRAFT%20FOR%20DISCUSSION.pdf.*

this should include the ability to raise loan limits and lower its insurance fees. Policy makers may want to consider the feasibility of emergency powers that would allow for expanded eligibility for FMIC guarantees, or the ability to (temporarily) directly invest in mortgage assets.

Conclusion

The topic of transitioning into the new housing finance system of the future is a critically important but highly complex one. The Corker-Warner transition plan provides us with a good starting point to start thinking about some of these difficult issues, and I appreciate the opportunity to discuss this topic with you today. Thank you again for holding this hearing, and for the opportunity to testify. I look forward to your questions.

Figure 1: Bank Deposits Compared to Residential Mortgage Debt Outstanding[38]

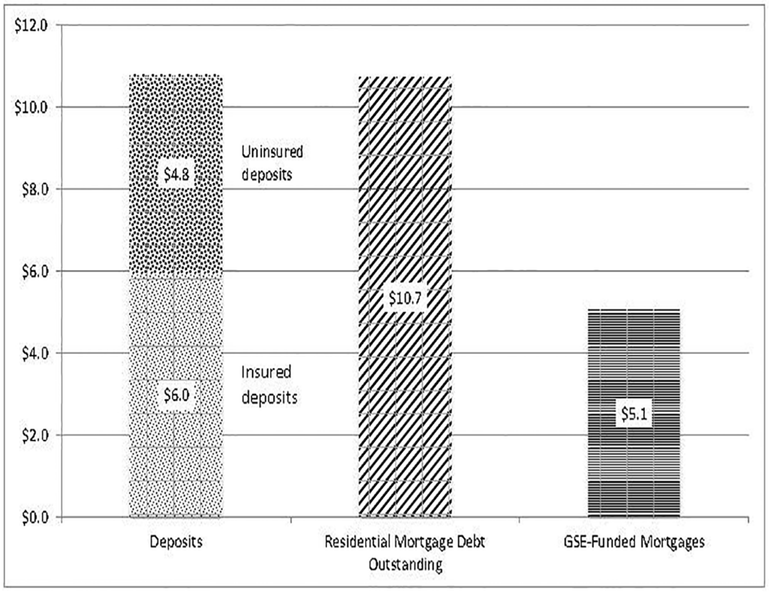


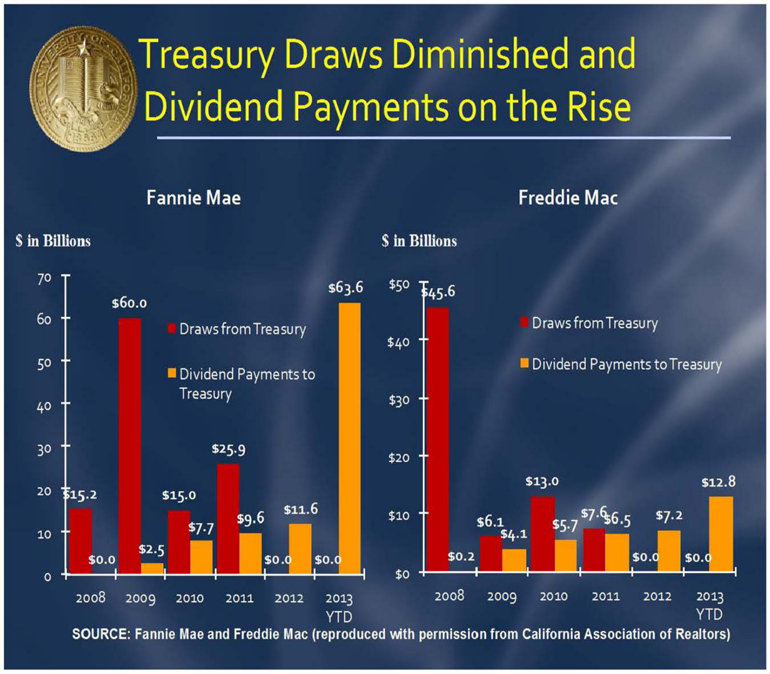
Figure 2: Characteristics of Post-Crisis Private-Label Mortgage-Backed Securities[39]

Total Dollar Volume	$15.3 billion
Total number of deals	33
Total number of securitized mortgages	16,778
Average home price	$1.26 million
Average mortgage balance	$825,000
Average combined loan-to-value ratio	65%
Average debt-to-income ratio	30%
Average FICO score	723

[38] FDIC Quarterly Banking Profile (Second Quarter, 2013), Federal Reserve Statistical Release Z.1 (Second Quarter, 2013), Fannie Mae and Freddie Mac Monthly Summary Reports (September 2013).

[39] Adam J. Levitin, *Housing Finance Reform: Fundamentals of a Functioning Private-Label Mortgage Backed Securities Market, supra* 20 Comparison Report (Sept. 19, 2013)).

Figure 3: The Improving Health of Fannie and Freddie[40]



[40] California Association of Realtors (using data from Fannie Mae and Freddie Mac).

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JAMES MILLSTEIN

Q.1. Should a new system be designed to issue a single security regardless of how many guarantors or issuers there may be? If so, how should the issuance of a single security be structured during transition? How should the issuance of new guaranteed MBS be introduced while ensuring that legacy GSE securities do not become orphaned?

A.1. Yes, the new system should provide for a single conforming To-Be-Announced (TBA) eligible pass-through single-family mortgage-backed security (MBS) reinsured by the Federal Government through the Federal Mortgage Insurance Corporation (FMIC), regardless of the number of guarantors or issuers. Such a "single security" is necessary to avoid liquidity advantages any one issuer or guarantor could obtain, which would likely, over time, pose an insurmountable barrier to entry to competitors for the majority of investor demand for conforming MBS.

The first step toward a single security during transition could be to issue a common GSE MBS. The Federal Housing Finance Agency (FHFA) could work with the Securities Industry and Financial Markets Association to amend the good-delivery guidelines to provide that such a security would be TBA eligible. The Securities and Exchange Commission may need to grant an additional exemption from Regulation AB to ensure that is the case. The enterprises would also need to standardize requirements and processes to be able to issue a common GSE security. We believe that all of this could be accomplished within 2 years if the enterprises are given a clear directive.

Note that depending on the rate at which the FMIC is stood up, the enterprises could, during conservatorship, instead seek to issue a single FMIC MBS. Elements of a Common Securitization Platform (CSP) could be used for such issuance, but it would not be necessary to wait for such a platform to be developed. In the interim, Fannie Mae and Freddie Mac could alter their requirements and processes to do it, similar to issuers participating in the Ginnie Mae II program, which provides for a common security.

To avoid orphaning the market for legacy GSE securities, creating liquidity premia for new issuance, and turning away current investors, the FMIC could reinsure legacy GSE securities in exchange for a fee to appropriately compensate it for the risk of doing so. Alternatives, such as an exchange of old securities for new securities, carry significantly higher execution risk and would be difficult if not impossible to coordinate given the widespread investor base.

Although the single security would account for most of the new conforming market, the FMIC should also work with participants in the new conforming market to facilitate issuance of alternative securities to satisfy different investment demands. For example, the Government-sponsored enterprises (GSEs) accounted for over $200 billion of issuance of collateralized mortgage obligations (CMOs) in 2012. That represented approximately 20 percent of total agency issuance and a significant portion of funding for U.S. residential mortgages. The FMIC should attempt to retain this volume of demand by allowing multiple structured forms of conforming MBS to issue. And the FMIC could prevent the liquidity barriers among issuers of alternative forms of conforming MBS by employing multiple issuer pools, similar to the Ginnie Mae II securities backed by fixed-rate and adjustable-rate mortgages.

Q.2. Please discuss whether or not licensing of Fannie Mae and Freddie Mac's assets can be an important tool in managing their wind down in a manner that maximizes value and minimizes disruption to the housing finance market. Are there other authorities that could be helpful to a regulator in managing their wind down?

A.2. Developing an issuance infrastructure to compete with Fannie Mae and Freddie Mac is another barrier to entry for private competitors. Building such an infrastructure from scratch will require substantial time and expense for any new entrant. While a Common Securitization Platform might eventually provide new entrants with a utility for securitization and bond administration functions, and while the FMIC might also promulgate national standards for origination and servicing, the build-out of a network of mortgage originators and the systems for sourcing and screening their loans to be underwritten or qualified to be included in a guaranteed pool of loans for eventual securitization in a FMIC reinsured mortgage-backed security are critical functions in the MBS issuance chain that are not, to my knowledge, currently contemplated to be included in the CSP.

To allow bond guarantors to compete on equal footing with the GSEs in the interim, Fannie Mae and Freddie Mac could be directed to license or offer necessary elements of their issuance infrastructure for a fee that would reflect run-rate operating expenses for a private competitor. In a sense, these elements of GSE infrastructure would serve as a market utility. And they could do so before the CSP is launched. As more issuance functions are performed by the CSP and private competitors develop their own networks and systems, they would rely less on the legacy GSEs.

During the transition to the new system while the old GSE model is wound down, there are indeed additional authorities that would help a regulator to maximize value and minimize disruption to the housing finance market. Most importantly, the mortgage guarantee businesses of Fannie Mae and Freddie Mac need to be recapitalized and ultimately privatized to ensure that there is adequate private capital to support desired levels of conforming issuance through the transition and in the end state, and to protect taxpayers against loss on the legacy book of GSE MBS before that book is reinsured by the FMIC (as described above in Answer 1). The FHFA, in conjunction with the FMIC and Treasury, need the authority and directive to accomplish this, which would have the added benefit of maximizing the value of the legacy GSE estates for their largest owner: taxpayers. A regulator needs discretion to increase fees charged by the GSEs to guarantee MBS depending on the risk of providing that guarantee, market conditions, the relative costs of private competitors, and the need to recapitalize the mortgage guarantee businesses of Fannie Mae and Freddie Mac. A regulator also needs discretion to change conforming loan limits depending on market conditions. Further, a regulator should have the authority to supervise and establish requirements for participants in the conforming MBS chain, including capital requirements for entities assuming credit risk or providing credit enhancement on individual mortgages or pools, and fees and processes for servicing those mortgages. Finally, a regulator should have the authority to direct the legacy GSEs to experiment with risk-sharing structures, infrastructure leasing and other avenues to facilitate private competition in conforming mortgage credit.

Q.3. Should a common securitization platform be fully operational before the old system is shut down? Are there other goals that should be achieved before the old system is shut down to help make the transition as effective and smooth as possible?

A.3. It is not necessary to wait to launch the new system until a CSP is fully operational. As I explain in my responses to the first and second questions, while a CSP is being established, the legacy GSEs could facilitate the issuance of a single security and could be directed to license issuance infrastructure to private competitors. Both steps could accelerate the entry of new guarantors into the market and thereby allow the FMIC to offer secondary-loss insurance on conforming MBS relatively quickly.

Moreover, it is unclear what it would mean for the CSP to be fully operational. To my knowledge, plans for the CSP are still being developed, and the most likely first phase would provide for a portion of the securitization and bond administration functions currently performed by the GSEs to be performed by the CSP. That first phase will take several years. And beyond that initial phase, I am skeptical that a CSP will ever perform all of the additional elements in the issuance chain, as I explain in my response to the second question. To my knowledge, no one is contemplating that the CSP would purchase loans for cash from originators and warehouse them on its balance sheet until they can be securitized.

There are important goals that should be achieved before the legacy GSE model is shut down. The mortgage guarantee businesses of Fannie Mae and Freddie Mac should be recapitalized and ultimately privatized to ensure that there is adequate private capital to support desired levels of conforming issuance through the transition and in the end state, and to provide an adequate capital cushion in front of the FMIC's reinsurance so as to protect taxpayers against loss on that reinsurance. A single conforming TBA-eligible pass-through single-family mortgage-backed security should be established. The FMIC should be established and its Mortgage Insurance Fund should be capitalized from fees paid by the GSEs for the reinsurance of their legacy MBS. The new regulator should also have the resources necessary to supervise participants in the conforming MBS chain in order to prevent market disruption and to protect taxpayers against potential losses on the FMIC's insurance. Standards for originating and servicing conforming mortgages should be established.

However, the FMIC should not establish standards for securitized conforming mortgages in a vacuum. It should work closely with borrower, lender, servicer, and investor groups to develop standards that are not only theoretically sound but also workable and sensible in practice. To that end, the newly formed CSP is attempting to establish an industry advisory group that would be similar to the Treasury Borrowing Advisory Committee. Such a group would increase the likelihood that the CSP can be useful across the mortgage market. The FMIC should establish similar advisory committees to facilitate meaningful vehicles for private-sector input for the new system before the legacy GSE model is shut down.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM JOHN BOVENZI

Q.1. In an earlier Housing Finance Reform hearing the Committee held on regulatory issues, witnesses called for the new housing finance regulator to have more supervisory and enforcement authorities than simply approval and denial of participation. Do you agree that is something we should consider adding? If so, why is it important to equip a regulator with explicit supervisory and enforcement authorities?

A.1. Based on my experience at the FDIC, I believe it is worth considering whether the FMIC should be granted broader supervisory and enforcement authorities beyond controlling entry and exit into and out of the program and the ability to issue civil money penalties. Those three authorities are important, but in most instances appropriate behavior can be maintained by less extreme enforcement measures than by forcing an institution's exit from the program. The FDIC has found its authority to issue informal memoranda of understanding and formal cease-and-desist orders to be quite effective in that regard. Moreover, the FDIC has rarely used its power to revoke deposit insurance coverage, finding it to be a cumbersome process compared to these other enforcement alternatives.

The FDIC also has examination authority to ensure banks are in compliance with FDIC supervisory standards and to determine whether enforcement actions are necessary. Consideration also should be given to giving the FMIC examination authority. While off-site monitoring can be used to help monitor an institution's behavior, over time the FDIC has found there is no substitute for the direct interaction with bank management that occurs during the examination process.

Finally, to help ensure that supervisory actions are taken in a timely manner, the FDIC is subject to Prompt Corrective Action requirements, which mandate that certain supervisory actions be taken as bank capital levels drop below prescribed levels. In their entirety these powers are an important part of safeguarding the financial system and protecting the FDIC's deposit insurance fund.

Q.2. What should we consider when it comes to employee retention and related issues in the transition?

A.2. Based on my experience at the FDIC and RTC I believe it is critical to provide open and clear communication to employees as to their job status. As a limited life agency, the RTC's employees knew that by doing their jobs correctly they might be putting themselves out of a job. The same applied to the FDIC's employees who were responsible for handling the spike in bank closings. Eventually the economy would recover and their workload would vanish.

But they were the ones who had the experience and the expertise to determine whether their agencies would succeed or fail. The same is true here. Ultimately the employees of the two Government-sponsored enterprises and the Federal Housing Finance Agency (FHFA) will determine whether a new start-up agency succeeds or fails.

Uncertainty surrounding how many jobs will be available, on what terms, and who will get them will create significant complications in ensuring a smooth transition. There may not be answers to all of these questions, but employees can understand that as long as they are kept informed in a timely manner and believe they will be treated fairly, even if there aren't enough jobs for everyone at the end of the transition.

Q.3. Please discuss whether or not licensing of Fannie Mae and Freddie Mac's assets can be an important tool in managing their wind down in a manner that maximizes value and minimizes disruption to the housing finance market. Are there other authorities that could be helpful to a regulator in managing their wind down?

A.3. Licensing certain of Fannie Mae's and Freddie Mac's key assets could be helpful in certain situations in order to preserve value and minimize disruption. This would allow the Government to obtain additional revenue by selling licenses to a number of private-sector firms. For other assets where licensing isn't appropriate, it would be important to ensure that they are sold through open and competitive processes rather than through negotiated sales. It may also be valuable to form partnerships with private-sector participants for the management and sale of certain assets. Such partnerships have served the FDIC well in maximizing value from its failed-bank receiverships.

Q.4. Should a common securitization platform be fully operational before the old system is shut down? Are there other goals that should be achieved before the old system is shut down to help make the transition as effective and smooth as possible?

A.4. As a general matter, to ensure a smooth transition, it is important not to shut down one system before its replacement is operational. This may mean some extra costs in the short run, but stability to the system is too important to risk otherwise. Thus, some patience and flexibility in approach is required as transitions as complicated as a moving to a new housing finance system generally don't move as fast as one hopes or initially anticipates.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM MARK ZANDI

Q.1. Acting Director DeMarco indicated that FHFA is planning further increases to guarantee fees. Do you believe further increases are justified in light of current market conditions?

A.1. No, I don't believe further GSE G-fee increases are appropriate at this time. The housing recovery has been hurt by the close to 100 basis point increase in fixed mortgage rates over the past year. The housing recovery is vital to the broader economic recovery, job growth and lower unemployment. With the Federal Reserve tapering its bond-buying program, long-term interest rates are likely to rise further in coming months. In this context, increasing G-fees and thus mortgage rates would not be productive at this time.

While it is desirable for the GSEs to reduce their footprint in the mortgage market and allow more private lending to occur, private lending remains constrained. The private residential mortgage backed securities market is moribund due to a range of factors, including a lack of regulatory clarity over such things as the QRM rule, and will be unlikely to provide sufficient credit, at least not for much of 2014.

The current G-fees charged by the GSEs is consistent with an approximately 2.5-percent capitalization (this estimate is based on a number of assumptions). While this is an insufficient level of capitalization for the housing finance system in the long-run, it is sufficient for the very immediate future.

Q.2. Should a new system be designed to issue a single security regardless of how many guarantors or issuers there may be? If so, how should the issuance of a single security be structured during transition? How should the issuance of new guaranteed MBS be introduced while ensuring that legacy GSE securities do not become orphaned?

A.2. Yes, the future housing finance system should be designed to issue a common Government-guaranteed security. This would improve liquidity in the TBA market and result in lower mortgage rates. A common security would also lower entry barriers into the guarantor market, as no guarantor would have an advantage because of the liquidity of the securities they back.

This is a problem in the current housing finance system, as Freddie Mac securities are much less liquid than Fannie Mae securities. Fannie and Freddie split the MBS market 60–40, but on a typical day the trading volume of Fannie MBS is 10 times greater than that of Freddie MBS. To compensate, Freddie is forced to charge a lower G-fee than Fannie. There are some modest differences in the securities—Freddie pays investors more quickly than Fannie and its securities prepay a bit more quickly—but the key difference is their liquidity. This liquidity difference makes the mortgage market less efficient and less competitive, and leads to higher costs for mortgage borrowers and taxpayers.

A potential fix to this problem in the transition would be to make Fannie and Freddie securities fungible, creating a common TBA security. That would require a change to the good-delivery guidelines for TBA, to allow the delivery of either Fannie or Freddie securities into the same contract. The securities themselves would not change; their separate TBA markets would simply be merged. Both securities would still be separately identifiable and tradable, only the TBA trades would be merged. Not only would this interim step improve liquidity, it would demonstrate investor interest in a truly common security that would be an important feature of the future hybrid housing finance system.

The future housing finance system should not orphan the currently close to $5 trillion in legacy MBS that are already guaranteed by the GSEs and effectively backed by taxpayers. Any reform process should make clear that the United States will stand behind these legacy obligations. In effect, legacy GSE MBS would become like Ginnie Mae MBS, with a full faith and credit wrap guarantee on the entire security.

Legacy MBS should also be made fungible with the new Government-backed MBS. This would require a restructuring process whereby holders of these legacy MBS can convert them into the new MBS, deliverable into the new TBA market. While there would be some technical issues, including requiring a new CUSIP number and a matching-up of payments delays, they could be easily addressed.

Q.3. Should a common securitization platform be fully operational before the old system is shut down? Are there other goals that should be achieved before the old system is shut down to help make the transition as effective and smooth as possible?

A.3. Yes, a common securitization platform should be fully operational before the old system is shutdown. The CSP would produce a more liquid market, facilitate loan modifications in future downturns, and give issuers operating flexibility at a low cost. It would also allow for a robust TBA market.

The CSP would leverage current efforts by the FHFA to develop a single platform for Fannie Mae and Freddie Mac securities. For a fee, the securitization facility would provide a range of services, including mortgage loan note tracking, master servicing, data collection and validation to improve transparency and integrity, and bond administration.

Mortgage loans included in securities that use the CSP (including all mortgages that benefit from the Government guarantee plus some nonguaranteed loans) could be covered by a uniform pooling and servicing agreement and uniform servicing standards that encourage prudent underwriting and align investor and borrower interests. This would encourage the adoption of similar standards for other mortgages.

The CSP would permit multiple originators to sell mortgages into single securities with access to the Government guarantee. In return, the originators would receive pro rata shares of the security. Pooling requirements would be largely the same as for typical single-originator securities, and they would be good for delivery into the TBA market. Originators could thus easily convert securities to cash before the securities were created, an especially important feature for smaller originators.

Other goals that should be achieved before the old system is shut down include the issuance of a common Government-guaranteed security (see response to Question 2), and well-developed risk-sharing by the GSEs. Enticing private capital back into the housing finance system is part of the transition to any future housing finance system. It is thus encouraging that the FHFA has mandated Fannie and Freddie to begin that process through risk-sharing with capital market investors and private mortgage insurers. The goals so far are modest and should be steadily expanded. What is learned from these efforts will be instrumental to ensuring there is enough private capital to support the future housing finance system.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN JOHNSON FROM DAVID MIN

Q.1. In the written testimony you provided you state, "Regulators should be given greater discretion and encouraged to respond to developments on the ground . . . ." How can a regulator set capital requirements in a manner that protects taxpayers while keeping in mind broader market dynamics, including access to credit?

A.1. As I state in my written testimony, determining the specific level of capital necessary to protect taxpayers from losses is a largely empirical question that ought to be studied in great detail. A number of factors are still unknown, including, importantly, how much investment capital will come into the new system contemplated by Corker-Warner and at what price. With that being said, I would offer the following principles in thinking about how to balance the different policy objectives of reducing taxpayer risk and keeping access to credit broadly and consistently available.

First, capital requirements for the new MBS issuers should generally be harmonized with those for other financial institutions, in order to prevent capital arbitrage.

Second, consistent with many of the proposals put forth in Basel III and by U.S. banking regulators, it is appropriate to think about countercyclical capital measures, such as contingent capital or countercyclical capital buffers. Regulators may also consider following the lead of the Federal Reserve and conducting stress tests to ensure that banks are sufficiently capitalized during credit expansions. On the flip side, during credit downturns, it is necessary to ensure sufficient liquidity, either through relaxing countercyclical capital requirements or other activities.

Finally, in thinking about the "right" level of capital that the new MBS issuers should hold, it may be worth considering the highly disparate performances of different mortgage products. While bank capital requirements currently do not differentiate between different types of home loans, or different types of MBS, the starkly different delinquency rates between say 30-year fixed-rate mortgages originated for Agency securitization and 5-year adjustable-rate mortgages originated for private-label securitization suggest that such a differentiation may be quite appropriate. Such an approach would be somewhat consistent with the treatment of home loans under Basel III's new standardized approach, and with the Qualified Residential Mortgage exemption to risk retention under Dodd-Frank.

Q.2. Should a common securitization platform be fully operational before the old system is shut down? Are there other goals that should be achieved before the old system is shut down to help make the transition as effective and smooth as possible?

A.2. As I stated in my written testimony, I believe the overriding policy goal of any transition should be to do no harm. Thus, it is imperative that the new common securitization platform (CSP) be fully operational before we shut down the old system. But any such endeavor will inevitably have unexpected developments. Therefore, testing out the new system is clearly necessary before the old system is shut down, to avoid jeopardizing the mortgage markets and the broader economy. This reasoning is why I strongly advocate a piecemeal approach to transition. The new system should start with small dedicated pieces of the business currently held by Fannie and Freddie, such as 15-year fixed-rate mortgages or high cost conforming mortgages, before moving on to absorb larger chunks of the conforming market. Such an approach would allow regulators to work out the kinks in the new system before shutting down the old one.