An Overview of GSE Reform*

Andrew Davidson

*This article appeared in a different form in the Spring 2016 issue of the *Journal of Structured Finance*

"It ain't over till it's over," Yogi Berra told us. But with GSE reform, it seems like we are stuck between it never started and it's already finished.

In 2008, Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs) that securitize about half of the nation's mortgages were put into conservatorship. Hank Paulson, Secretary of Treasury at the time, declared, "The conservatorship is a temporary condition, a 'time out' period where the new President and Congress must decide what role government in general, and the GSEs in particular, should play in the housing finance market…. This is a situation where the next Administration and Congress will need to take decisive action."

Exhibit 1. GSE Bingo Board

	GSE	Private Firms	Bonds		Privatize	Mutual	Utility	Gov't
Origination								
Aggregator (including cash window)								
Underwriting and servicing rules								
Loan credit risk (<80)								
Loan credit risk (>80)								
Housing Goals								
Bond admin/ trustee								
Bond guarantee								
MBS portfolio								

GSE BINGO

The conservatorship, to date, does not seem temporary and two presidential terms and eight Congresses later, there has yet to be "decisive" action. To understand where we and the housing finance system are today and the possibilities for completing reform, I have developed a "bingo" board of GSE functions and potential governance structures, shown in Exhibit 1.

Down the left side, the bingo board lists various functions that make up the securitization process. Across the top row is a listing of various types of entities that can perform these functions. The first of these is the current GSEs (Fannie Mae and Freddie Mac). The next column is competitive private firms, including banks, mortgage banks, and mortgage insurance companies. These firms operate under a variety of different regulatory structures. The Bonds column refers to securitized products that are held by bond investors. To the far right is the Gov't column, which reflects activities carried out by the government. The other columns will be discussed in the context of the reform proposals in the following discussion.

SECURITIZATION PATHWAYS

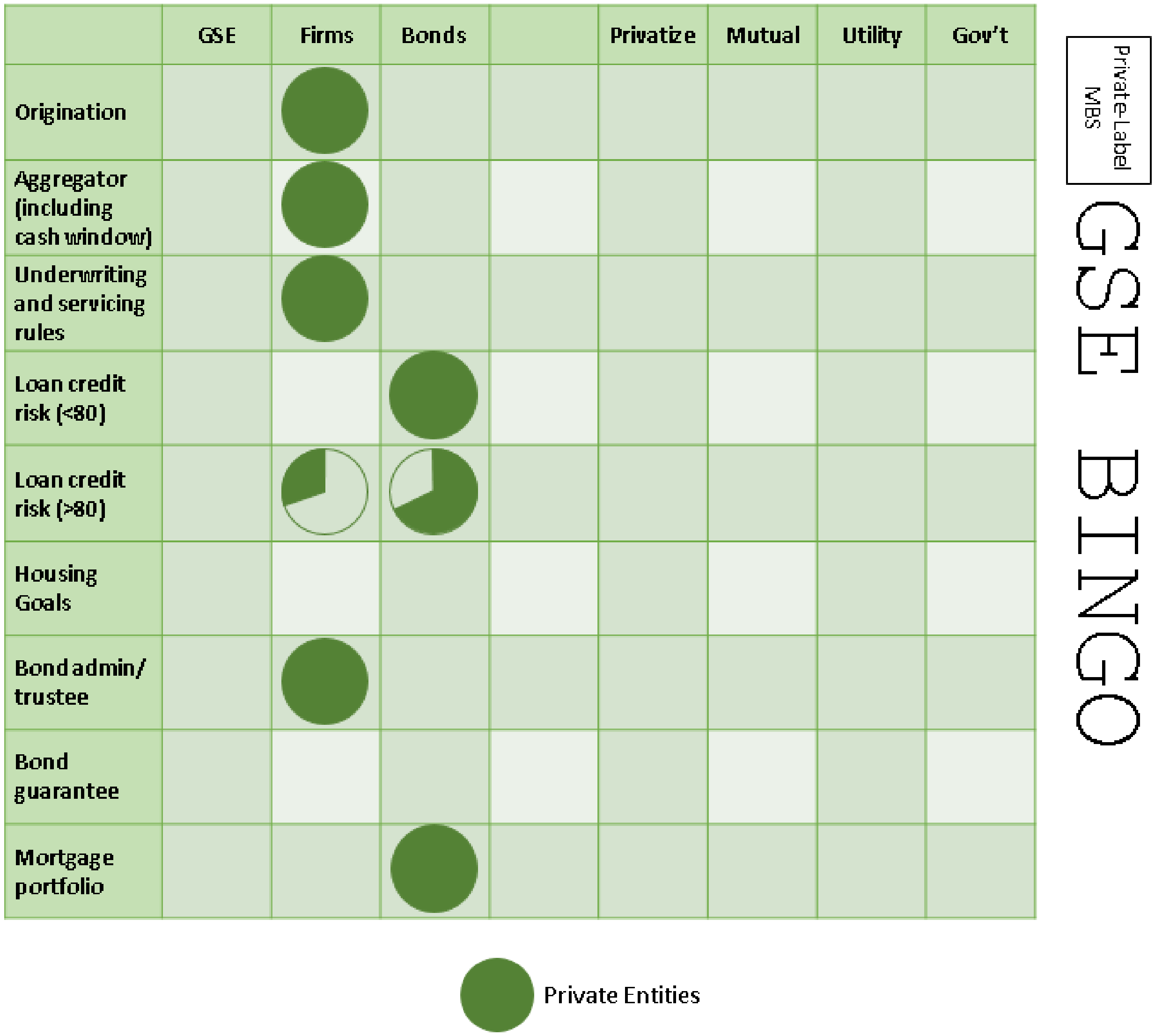
There are essentially three pathways for transforming mortgage loans into mort- gage-backed securities (MBS): the government pathway, the agency pathway, and the private-label pathway.

Although the players differ between these three pathways, each has a set of similar functions and services that compose the pathway. Each function serves a different role in the process and entails different costs and risks. Entities that are involved in securitization may engage in one or more of the functions. The functions broadly are as follows:

- origination
- servicing
- aggregation
- establishing underwriting and servicing rules
- bearing loan-credit risk
- achieving housing goals
- bond administration
- bond trustee
- bond guarantee,
- investing in securitized products

For the private-label pathway, shown in Exhibit 2, the origination, aggregation, and underwriting rules are set by private firms. The credit risk is mostly distributed via subordinated bonds. (It was these subordinates bonds that were re-securitized into CDOs and played a significant role in the financial crisis.) Sometimes the risk of loans with a high loan-to-value ratio (LTV) is backed by mortgage insurance. The private pathway does not have explicit housing goals, nor is there an overall bond guarantor. Prior to the crisis, the bond market was the funding mechanism for the system with bond investors purchasing the most senior, highest-rated bonds. The role of the bond market as an investor in the senior bonds was to a large extent mediated by the rating agencies. Bond investors prior to the crisis expected the rating agencies to review the underwriting standards, servicing practices, and loan quality to ensure that bond performance would meet expectations. In the wake of the crisis that relationship has broken down.

Exhibit 2. Private-Label Pathway



For the government pathway, shown in Exhibit 3, the key players are the FHA (Federal Housing Administration), the VA (U.S. Department of Veterans Affairs), and GNMA (Government National Mortgage Association, better known as Ginnie Mae). The government performs most of the securitization functions. Private firms are responsible for originating mortgages and aggregating pools, as the government does not provide a cash window to purchase loans. The government via the FHA sets the rules for underwriting and servicing and provides a guarantee on the loans including those with high LTVs. Ginnie Mae provides a government wrap on the MBS and provides bond administration services. The government generally doesn't hold MBS, however, since the crisis, the Fed now has a significant portfolio of MBS.

For the agency (or conventional) pathway, shown in Exhibit 4, the key players are Fannie Mae (Federal National Mortgage Association), Freddie Mac (Federal Home Loan Mortgage Corporation), and their regulator, the Federal Housing Finance Agency (FHFA). Pre-crisis, Fannie Mae and Freddie Mac's operations expanded to include all of the securitization functions, except those that were explicitly prohibited. The origination of loans and the bearing of credit risk for loans with LTVs greater than 80 % were performed by private firms. The GSEs performed the other functions of aggregation, setting underwriting and servicing rules, bearing credit risk for loans with LTVs under 80 % (and the residual credit risk on high-LTV loans beyond the mortgage insurance coverage), meeting housing goals, bond trustee and administration, as well as maintaining large portfolios of mortgages and mortgage-backed securities. The GSEs were able to operate with a high degree of leverage due to an “implied” guarantee from the government. During the crisis, that implied guarantee effectively was made explicit as the GSEs had insufficient capital and access to credit markets without clarification of the degree of government support.

Exhibit 3. Government Pathway

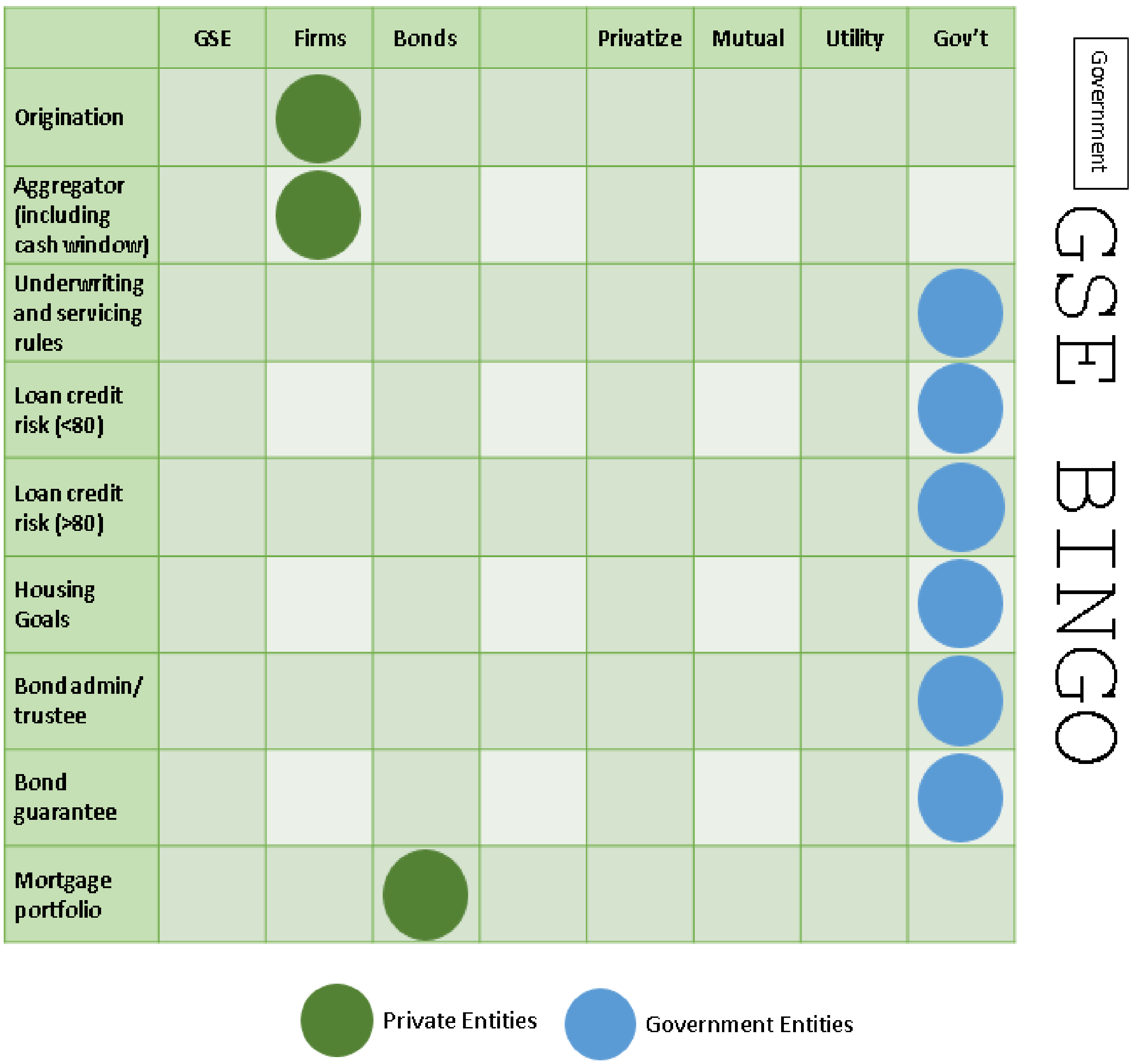


Exhibit 4. Agency Pathway

GSE REFORM BINGO

Since Fannie Mae and Freddie Mac were put into conservatorship in 2008, there has been much discussion of GSE reform. Several bills have advanced in Congress promoting various forms of GSE reform. Although GSE reform has many complex components, the GSE reform debate, at least abstractly, can be viewed a discussion of which entities should perform the various functions of the securitization pathway and what the rules they operate under should be.

One dimension of the GSE reform debate is a fundamental disagreement between various constituencies over whether the government should have a larger or smaller role in the housing market. Proponents of a smaller government role claim that the government role distorts the markets and contributed to the housing crisis. Proponents of a greater role for the government stress the need for government intervention to level the playing field and allow the expansion of home ownership. Others in the middle stress the importance of the government guarantee for maintaining liquidity in the secondary market and providing a stable housing finance system for all Americans. (In this debate, facts and opinions are often confused, but that is a discussion for another different day.)

Regardless of the views on the extent of the role of the government in housing, there is a more broadly based desire to end a system that allowed for "private gain and public loss." Fannie and Freddie prior to conservatorship were owned privately but had access to an "implied guarantee" from the U.S. government. This allowed them to operate with less capital than private entities and capture the value of government sponsorship.

To address this dichotomy, GSE reform proposals generally have focused on splitting the functions of the GSEs so that the conflicting private and public purposes are split into different entities with different governance structures. There are several possible governance functions for the entities performing these functions.

There is a wide and perhaps continuous spectrum from one type of governance to another, and each type of entity could be subject to varying levels of regulation and oversight. To simplify the analysis, here we focus on four broad groupings of governance structures.

Private entities issue stock that is owned by individuals, funds, and other entities and are traded in the open market. Most proposals that rely on private entities seek to ensure that there are multiple competitive private entities fulfilling the selected role.

A mutual insurance company (or cooperative) is a private entity, but rather than having ownership traded in the open market, a mutual is owned by its members. For example, a mutual insurance company is owned by the policy holders and a credit union is owned by the depositors. The Depository Trust & Clearing Corp (DTCC) or the Federal Home Loan Banks are examples of entities under this type of governance.

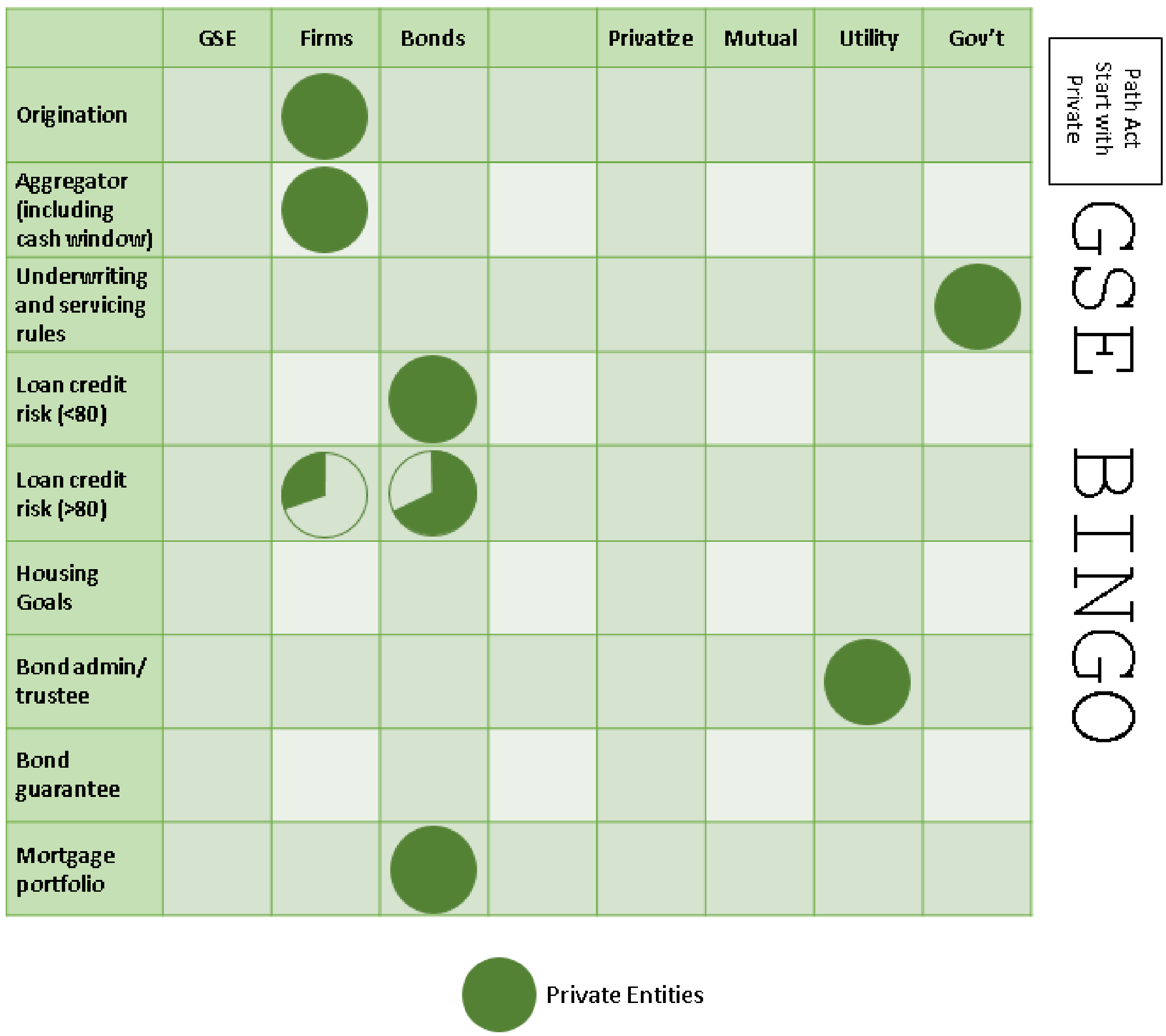
Utilities are generally found in situations where there is a natural monopoly and usually have publically traded ownership coupled with a regulatory structure that controls the entities' activities, pricing, and returns.

Government entities come in many forms, but here we group together those where the function is performed by a government entity with no private ownership. Examples of government entities are the FHA, which is government agency, and Ginnie Mae, which is a government corporation.

Just as there are three pathways to securitization, there are three general approaches to securitization, each taking one of the pathways as a starting point.

H.R. 2767, Protecting American Taxpayers and Homeowners Act of 2013, the Path Act, was introduced by Financial Services Committee Chairman Jeb Hensarling (R-TX) and other committee leaders. The Path Act, shown in Exhibit 5, starts with the structure of the private-label market (Exhibit 2) and then adds government involvement in order to facilitate the continuation of the TBA (to-be-announced) market for mortgage- backed securities. In particular, the Path Act grants extensive regulator y power to the FHFA to establish underwriting and servicing guidelines. It also establishes a National Mortgage Market Utility as a not-for-prof it to fulfill various securitization functions. The shifts in functions between private and government entities are shown by moving the chips on the bingo board.

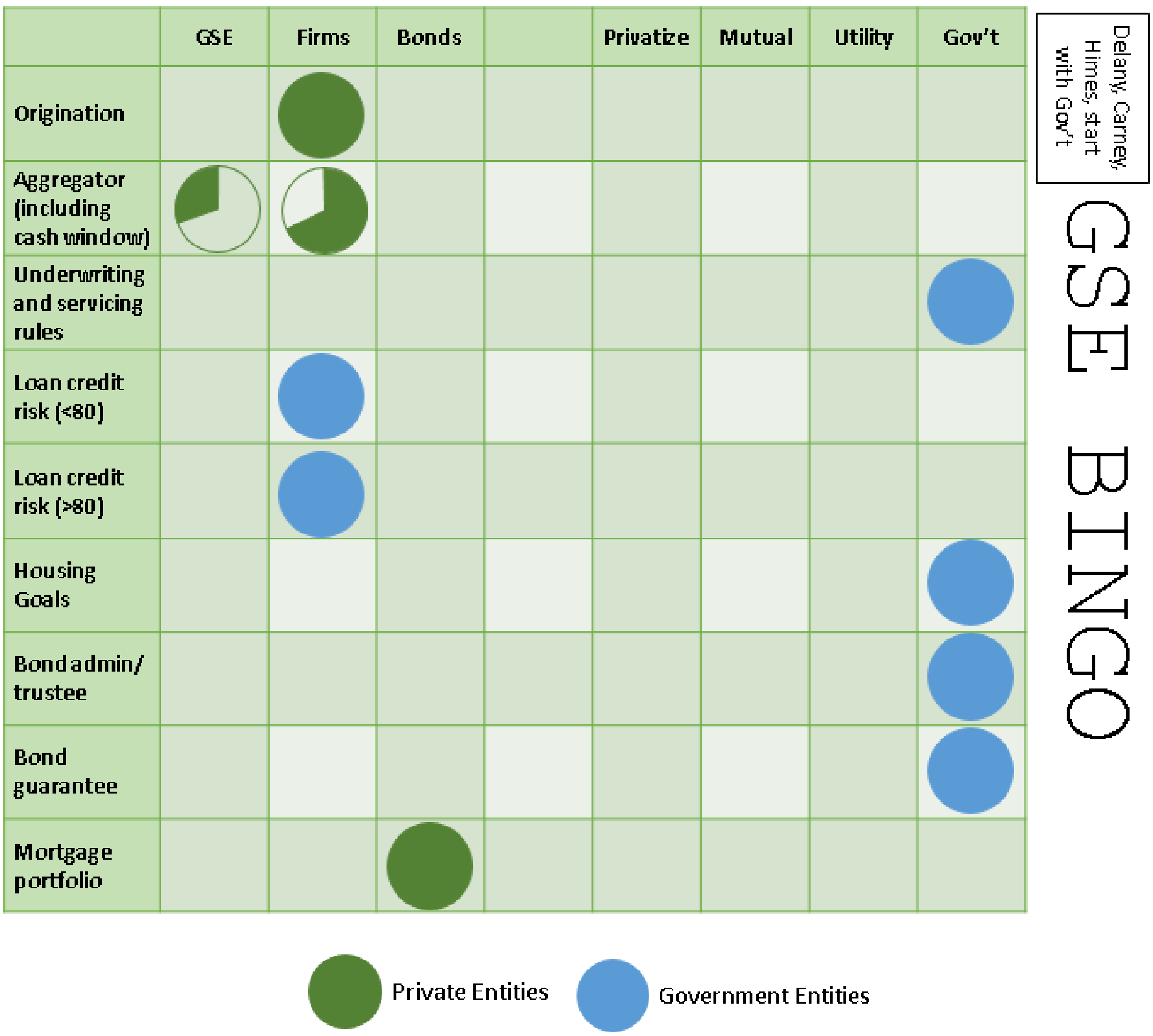
Exhibit 5. The Path Act



Alternatively, H.R. 1491, Partnership to Strengthen Homeownership Act of 2015, illustrated in Exhibit 6, starts with the structure of the government market (Exhibit 3). H.R. 1491 was introduced by Congressmen John Delaney (D-MD), John Carney (at large-DE), and Jim Himes (D-CT). Known as the Delaney–Carney–Himes Act, H.R. 1491 expands the role of Ginnie Mae, but makes two significant changes: 1) It requires that private capital take on the substantial portion of risk on mortgages, and 2) it allows the Federal Home Loan Banks to act as aggregators for mortgage-backed securities backed by the Ginnie Mae guarantee. On our bingo board, this is reflected by moving chips from the Gov't column to the Firms column and by splitting the aggregator chip.

Much of the legislative action has focused on S. 1217, first introduced by Senators Corker and Warner in 2013 and then amended as the Housing Finance Reform and Tax Payer Protection Act of 2014 by Senators Johnson and Crapo. As illustrated in Exhibit 7, S. 1217, known as the Johnson–Crapo Act, starts with the structure of the current conventional market (Exhibit 4) and then seeks to address the governance and economic conflicts in the existing structure. A key feature of S. 1217 was to privatize any of the functions of Fannie Mae and Freddie Mac and create a competitive market for the guarantor function.

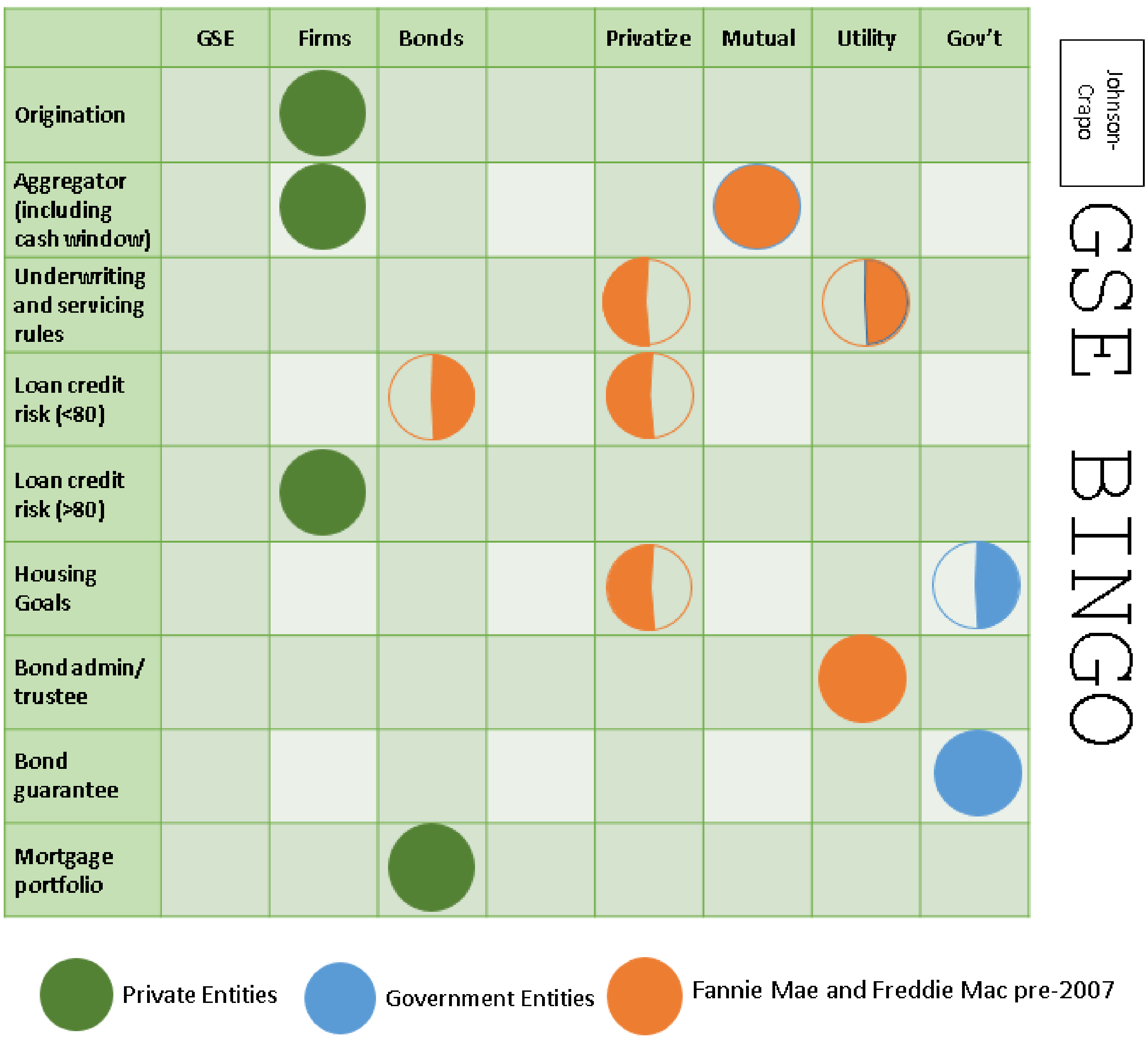
Exhibit 6. Delaney-Carney-Himes Act



Johnson-Crapo also creates a variety of other entities to take on some of the functions of Fannie Mae and Freddie Mac. It creates a securitization utility and allows for the creation of a mutual cooperative to assist smaller originators with aggregation and securitization. As with the other proposals, it relies on a variety of methods to bear the predominant share of the credit risk of mortgages. It also provides a government wrap on eligible mortgage-backed securities issued by the utility. The complex nature of the legislation is reflected in the splitting of many of the GSE functions into different governance structures.

One area of reform that was not resolved in the debate over Johnson-Crapo is how housing goals would be served. Housing advocates felt that there was insufficient requirement for the mortgage guarantors to serve all qualified borrowers, while others felt that the funding of housing trust funds was more than sufficient.

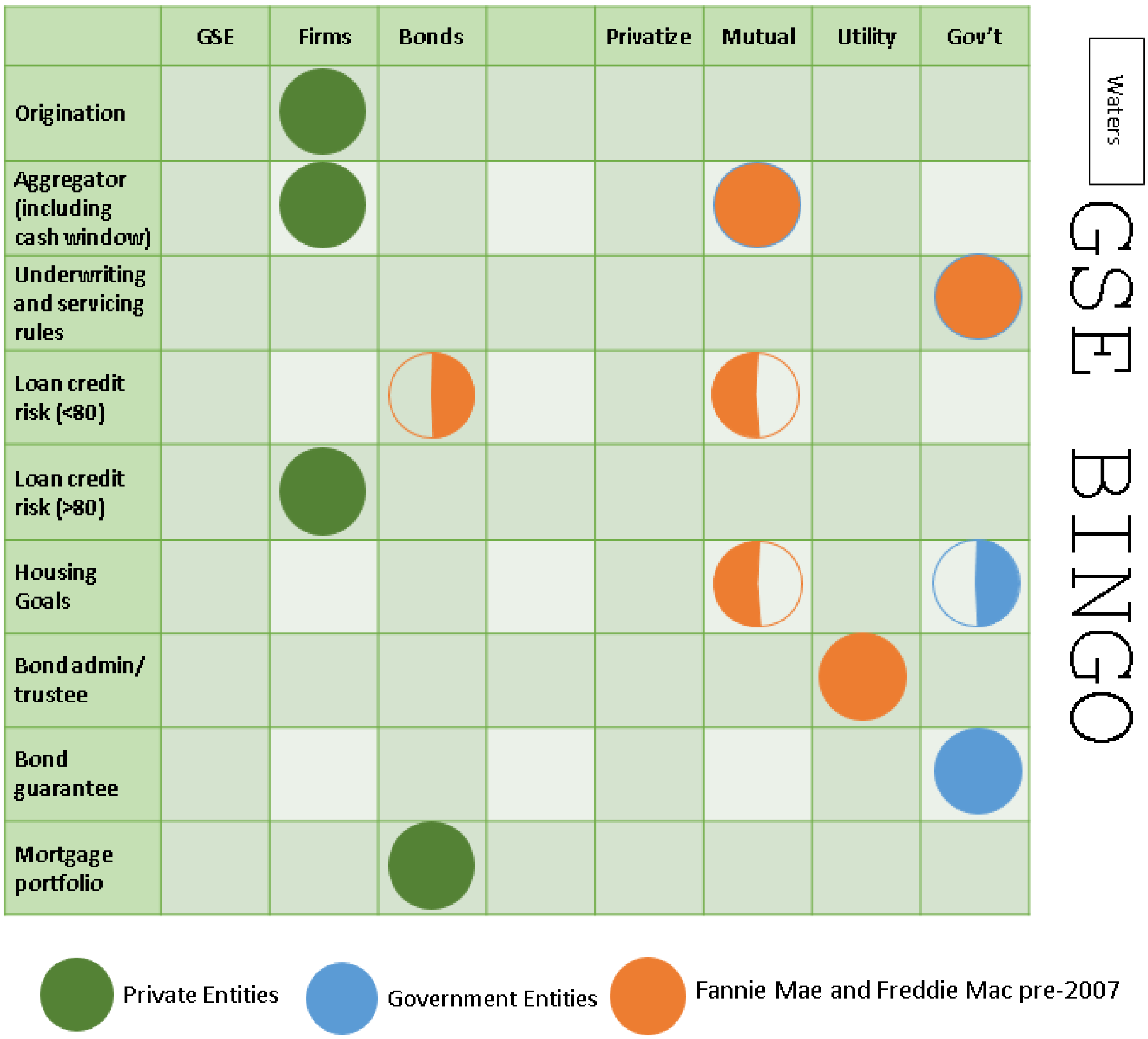
Exhibit 7. Johnson-Crapo



Another variant on a similar theme is the Housing Opportunities Move the Economy (HOME) Forward Act of 2014 introduced by Maxine Waters (D-CA). Like Johnson–Crapo, the HOME Act, illustrated in Exhibit 8, uses a government guarantee for mortgage-backed securities. Instead of relying on competitive guarantors, however, the HOME Act establishes a single mortgage securities cooperative as the issuer. This results in moving chips from the Privatize column on the Johnson–Crapo bingo board into the Mutual column.

Another common theme among all of the proposals is the idea that they would "wind down" or eliminate Fannie Mae and Freddie Mac, perhaps with a few of their functions transferred to new entities. Although there has been much legislation introduced, none of these proposals has yet reached a state where it would be appropriate to say they are likely to be enacted soon.

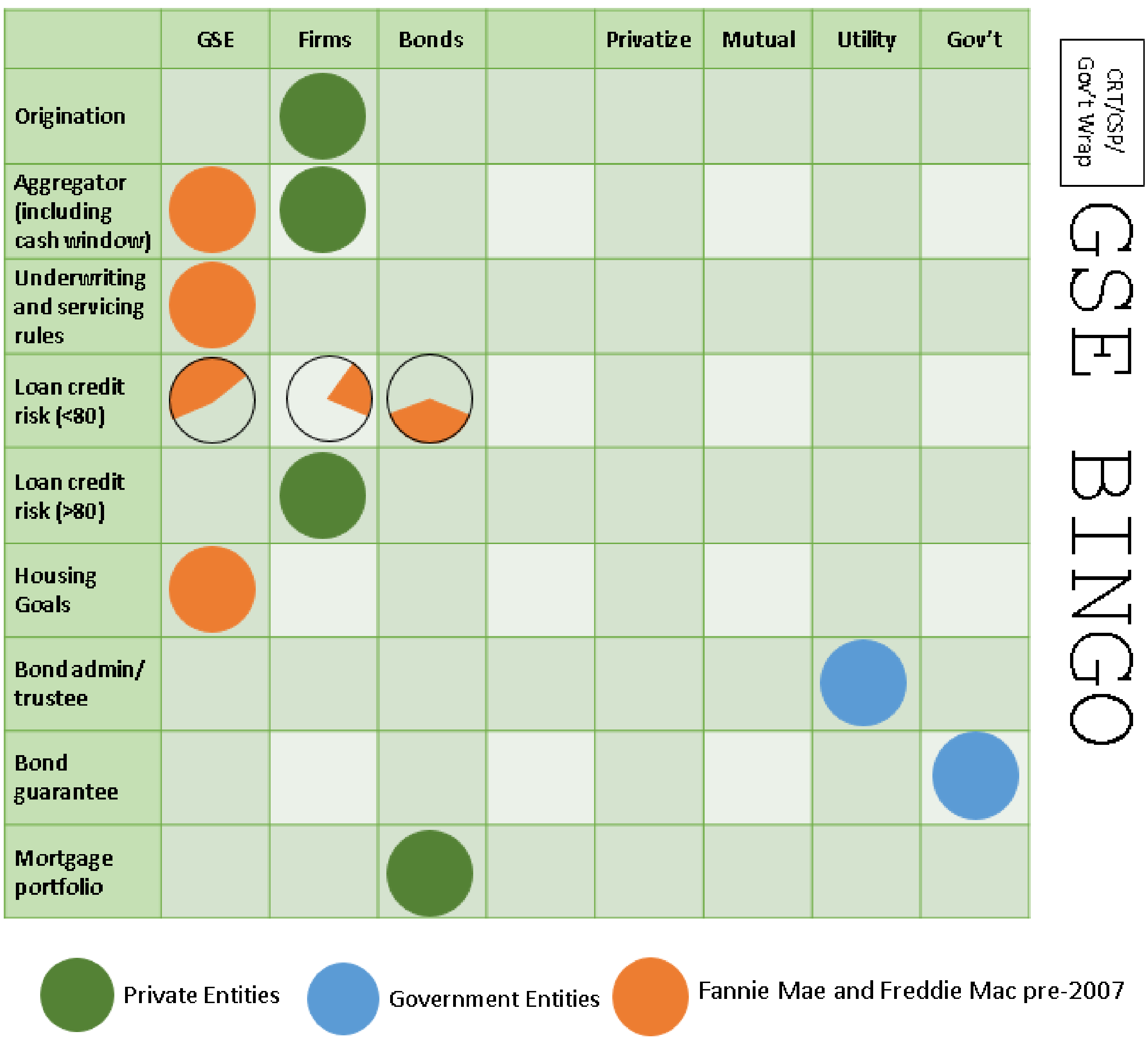
Exhibit 8. HOME Act



WHERE ARE WE NOW?

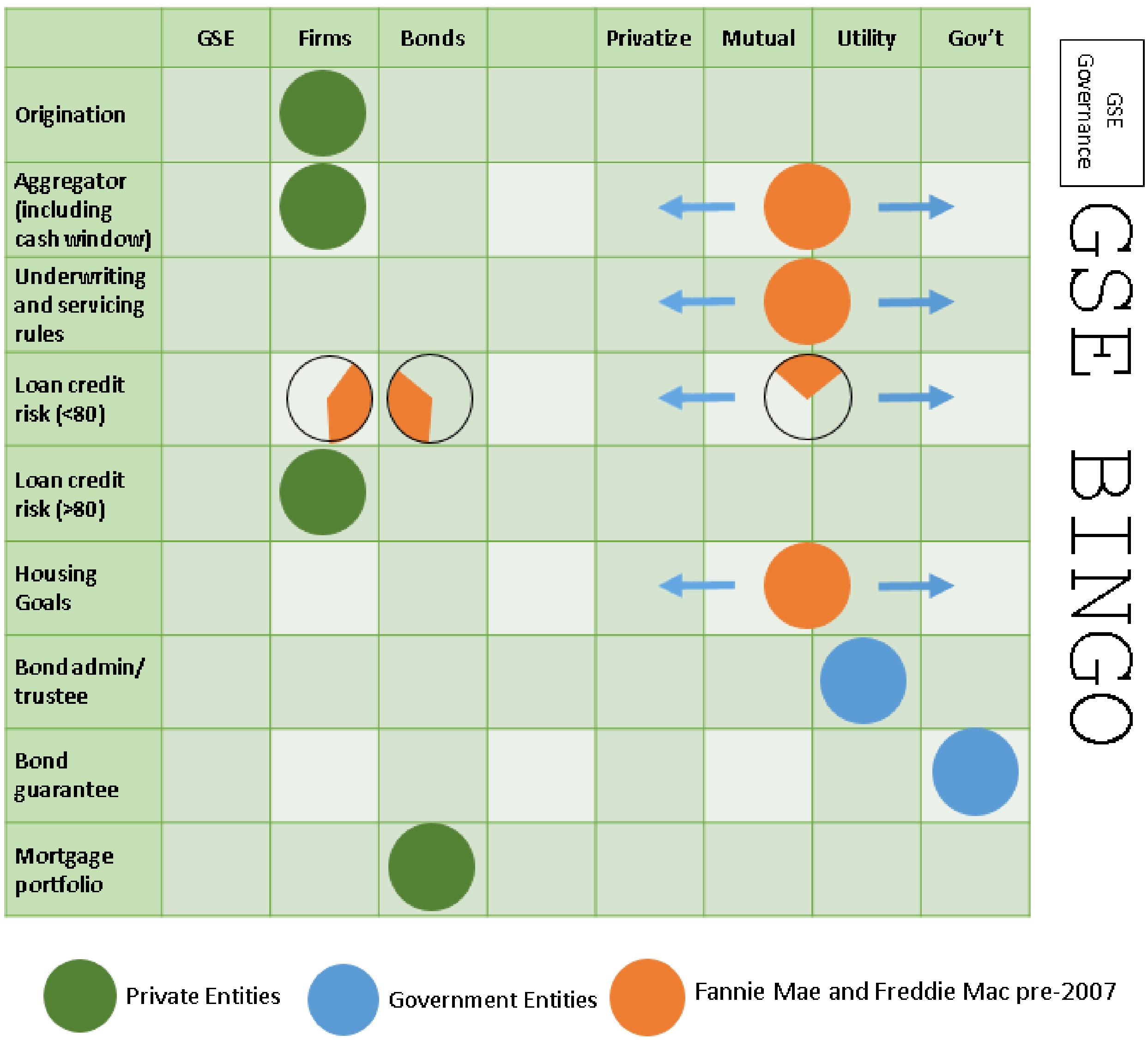
Despite the lack of progress on the legislative front, there has been a substantial transformation of the conventional pathway over the past eight years. While in conservatorship, Fannie Mae and Freddie Mac, under the direction of their regulator, the FHFA, have transformed many of their operations. This includes reduction in retained portfolios, harmonization of underwriting/servicing guidelines, new rules for mortgage insurers, the creation of a securitization platform, and perhaps most dramatically, the creation of the credit risk transfer (CRT) market, shown in Exhibit 9. The CRT market now bears a substantial portion of the risk on newly originated mortgages that previously would have been borne by the GSEs and the government.

Perhaps due to the transformation of the GSEs over the past eight years, or perhaps due to the practicalities of replacing Fannie Mae and Freddie Mac with new untested entities, there is now a greater focus in policy circles on how to continue the transformation of the GSEs rather than winding them down. This transformation could lead to the combination of the two entities (or some of their functions) into a single entity like the common securitization platform or continuation of both entities.



Although there is some talk of "recapitalize and release," most discussions include the idea that some form of Congressional action would be needed to establish the appropriate capital requirements, governance, and regulatory structure even if Fannie Mae and Freddie Mac were to continue play a central role in the conventional mortgage market.

Exhibit 10. Governance Alternatives



CONCLUSION

GSE reform recommendations can be viewed as an attempt to address the fundamental issues of private gain and public loss that were built into the GSE model. Fannie Mae and Freddie Mac had access to a preferential cost of funds due to their implicit guarantee from the U.S. government. During the housing crisis, the GSEs had insufficient capital to maintain their operations and the government felt compelled to put the entities into conservatorship and shore up their finances.

One important aspect of GSE reform is defining what entities, if any, should perform the functions currently performed by Fannie Mae and Freddie Mac. Various legislative proposals are modeled off of replacing Fannie Mae and Freddie Mac with entities reflecting the mechanisms of the private-label market, the government market, and the pre-crisis, conventional market. None of these proposals have yet to produce a plan that meets with general Congressional and Administration approval.

In the meantime, Fannie Mae and Freddie Mac have been slowly transformed, and these transformed entities might themselves form the basis for GSE reform as issues of capital requirements, governance, and regulation are resolved; see Exhibit 10. The remaining functions of the GSEs could land in the Privatize, Mutual, Utility, or Government columns. As the transformation of the GSEs continues and a less polarized discussion of housing finance develops, it may be possible for Congress to address these issues. Or, as Yogi Berra is reported to have said, “When you come to the fork in the road, take it.”

ACKNOWLEDGEMENTS

I would like to acknowledge the input of many who participated in our round table discussion in April 2015 and to the Structured Finance Industry Group (SFIG), which provided me with a summary of the proposed legislation. There are many simplifications that went into the preparation of the GSE bingo boards, I take responsibility for any errors or misimpressions.