A Blueprint for Housing Finance Reform in America

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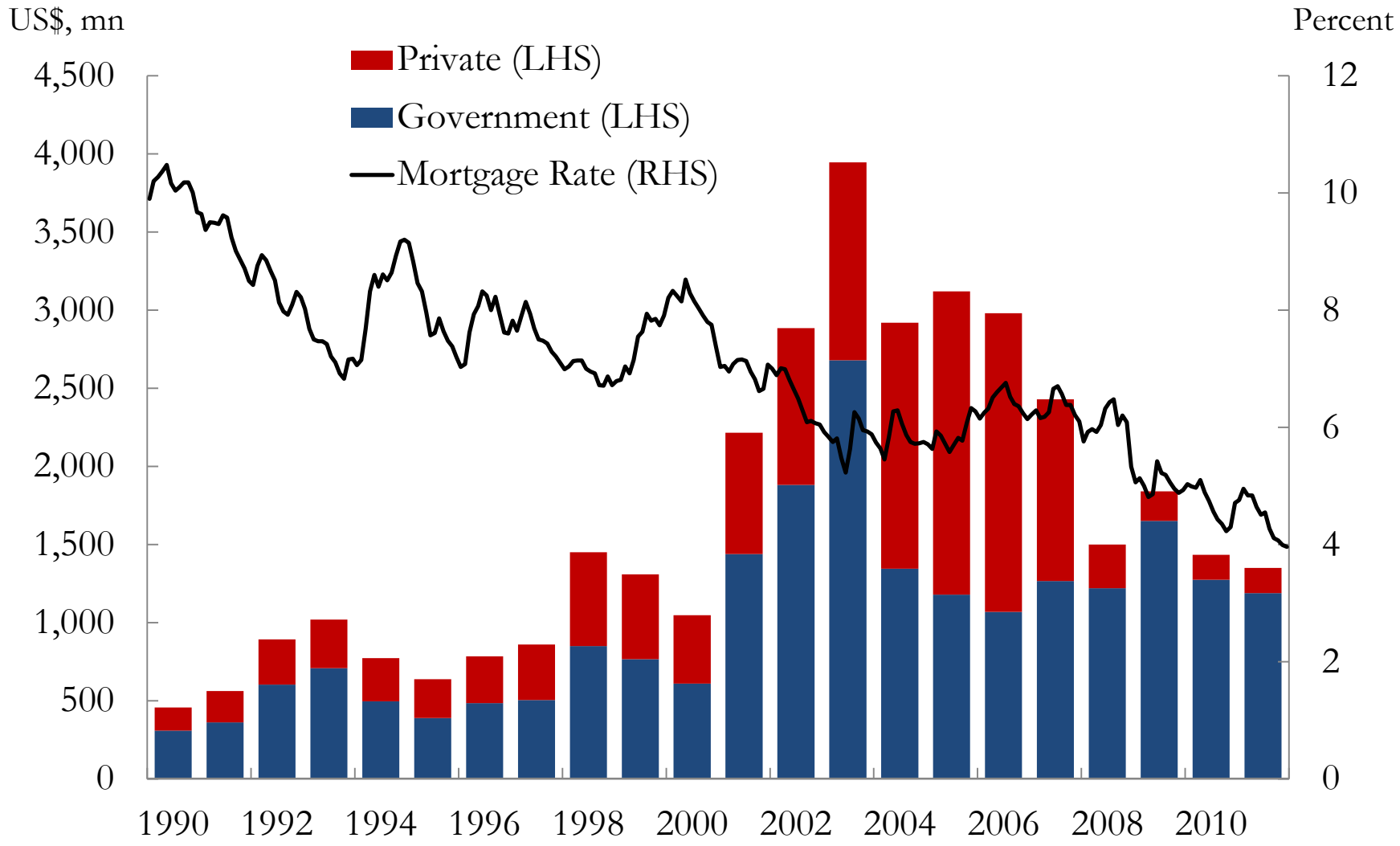
The Program on America and the Global Economy
"Are We Becoming a Nation of Renters?"
May 22, 2012

The U.S. Housing Finance System Is on Life Support

U.S. Residential Mortgage Originations and Rates



Sources: Federal Reserve Board; Inside Mortgage Finance.

Notes: One-to-four family mortgages. Contract rate on 30-year, fixed-rate conventional home mortgage commitments.

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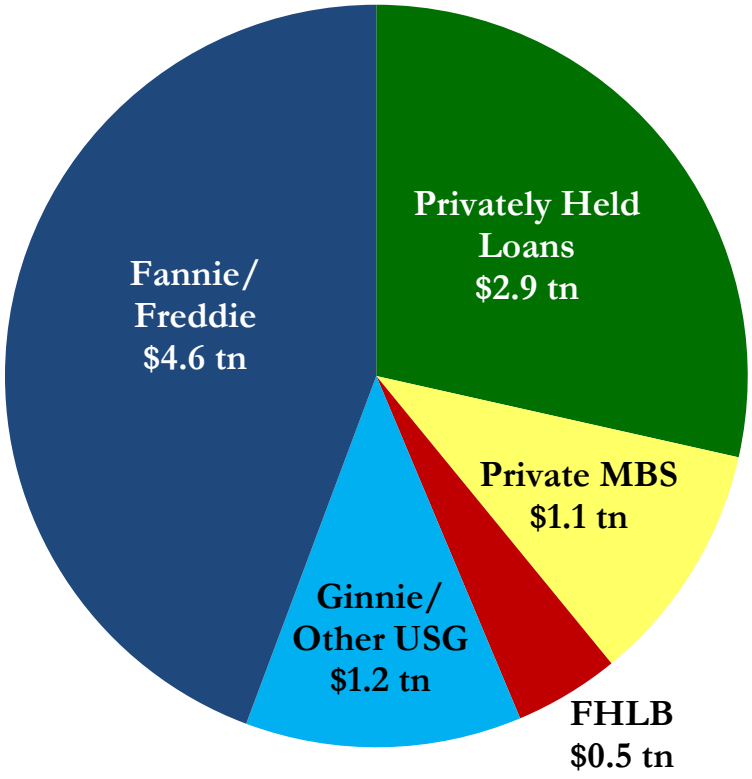
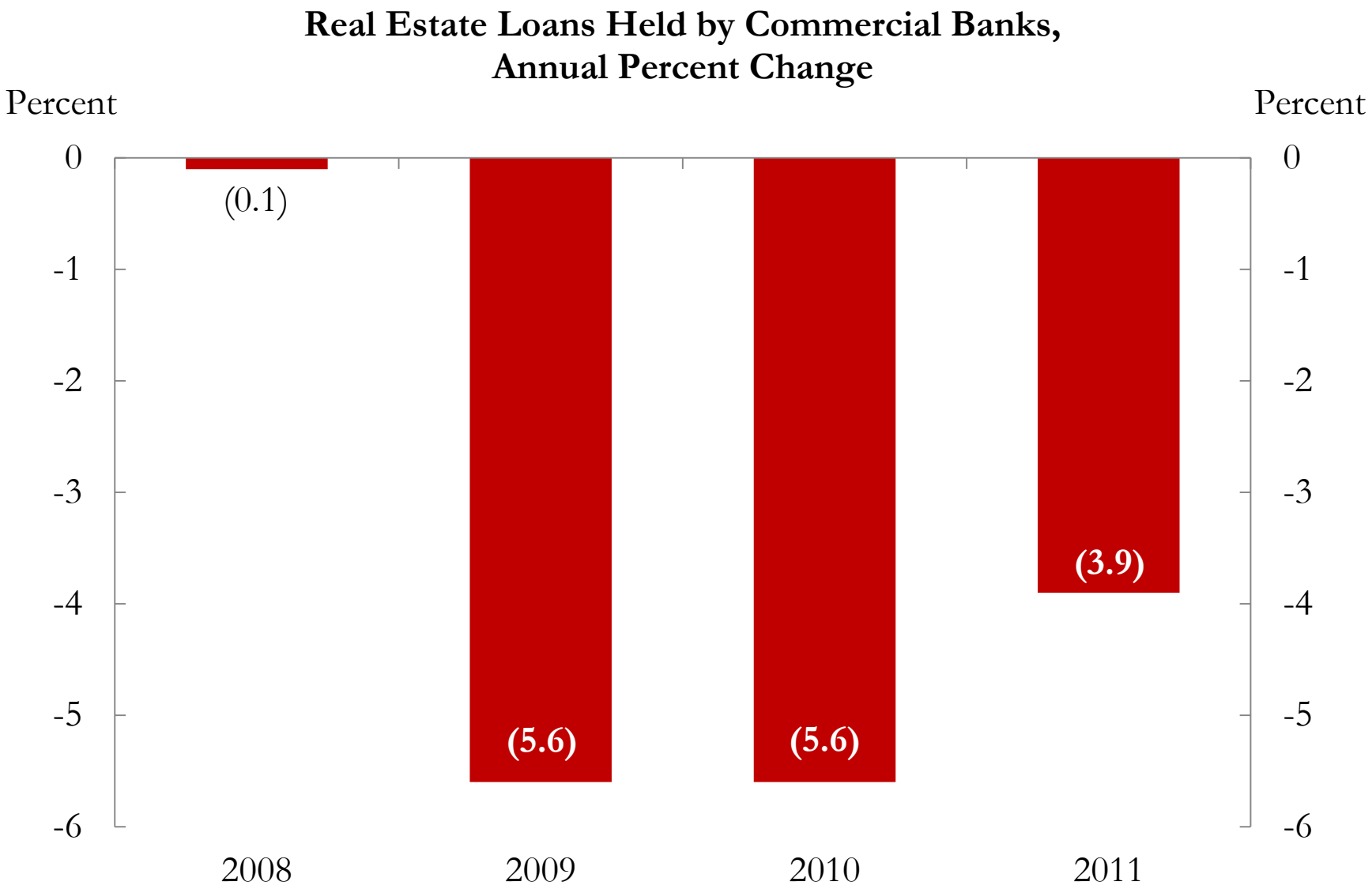
Exposure to Residential Mortages Outstanding, 2011



Sources: Federal Reserve Board.; Federal Home Loan Banks Office of Finance.

Notes: One-to-four family mortgages. Fannie/Freddie estimate reflects MBS they guarantee and loans in their portfolios. Other USG includes Federal Housing Administration, Veterans Affairs, Federal Land Banks, and Federal Depository Insurance Corporation (FDIC). Federal Home Loan Bank (FHLB) estimate reflects advances outstanding and net mortgage loans in their portfolios. Private holders include commercial banks, savings institutions, life insurance companies, mortgage companies, real estate investment trusts, pension funds, credit unions, and finance companies. The majority of privately held loans are in banks whose deposits are largely insured by the FDIC.

A Transition Plan Must Be Realistic About the Availability of Private Capital



Source: Federal Reserve Board.

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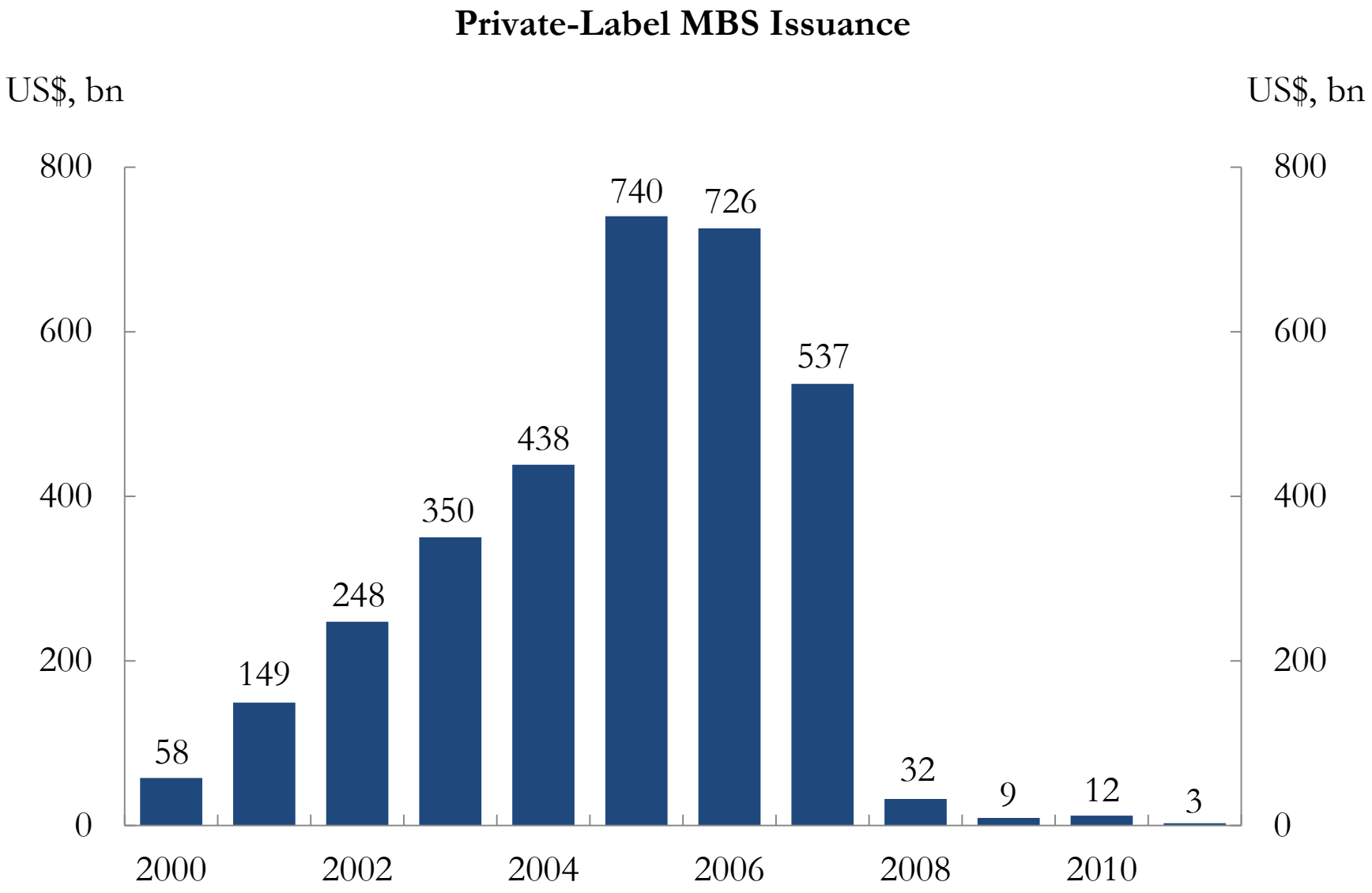

Source: Securities Industry and Financial Markets Association.

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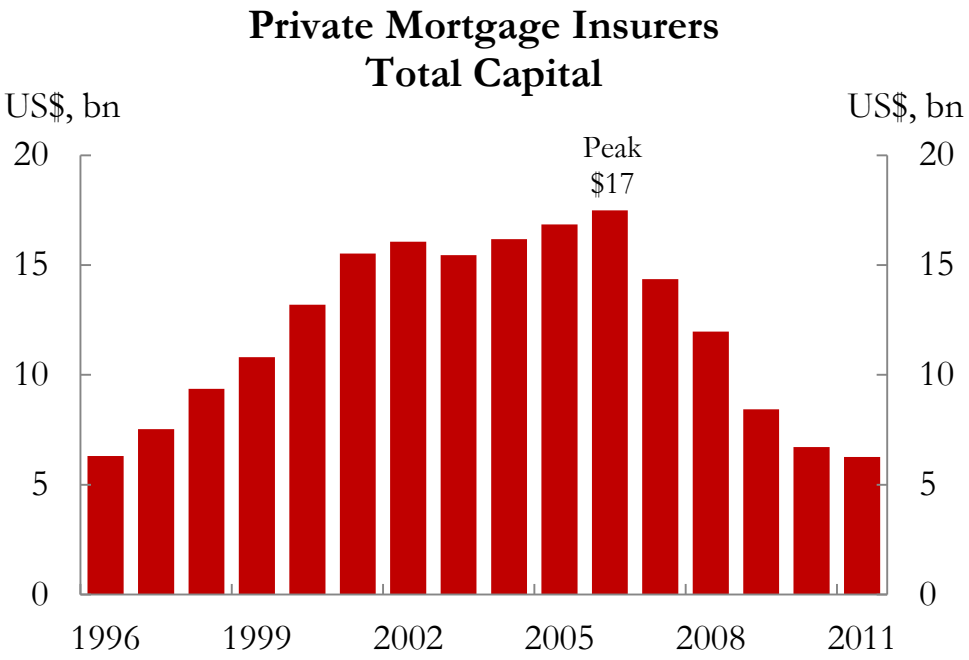
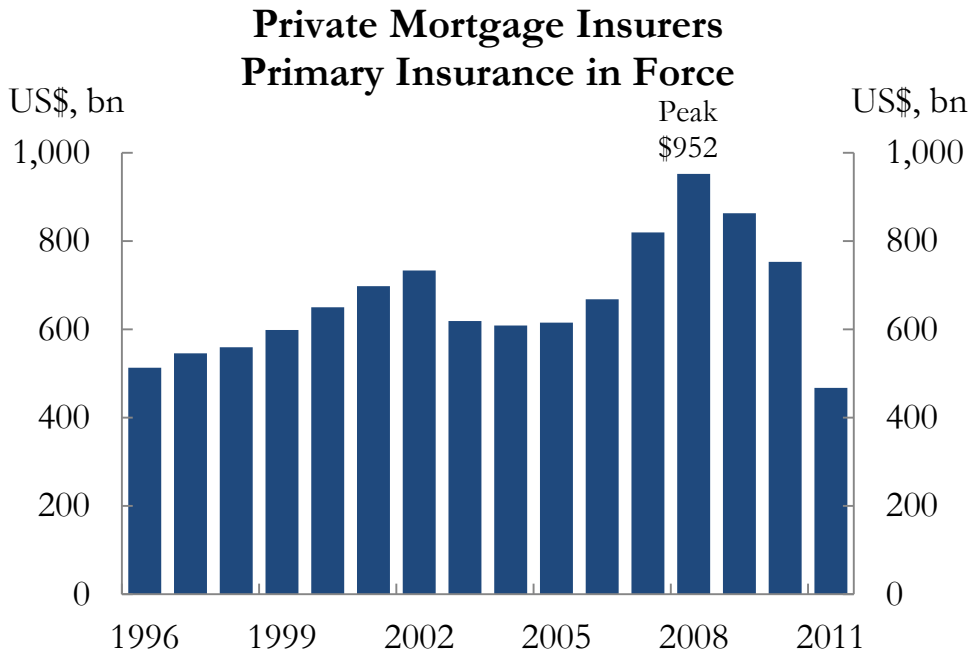
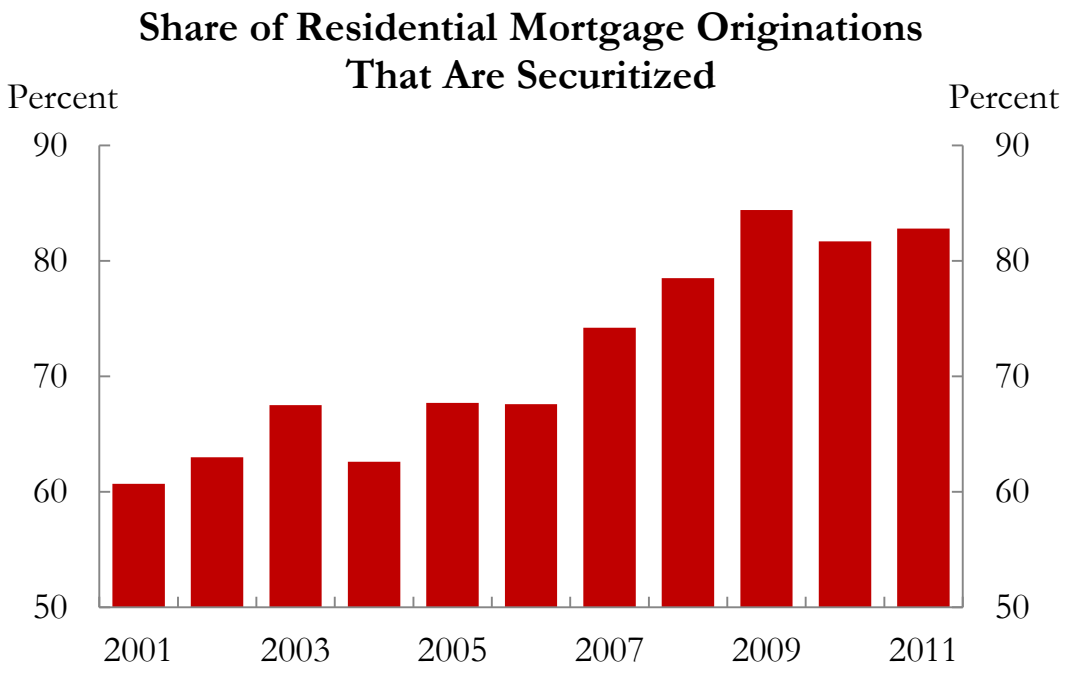
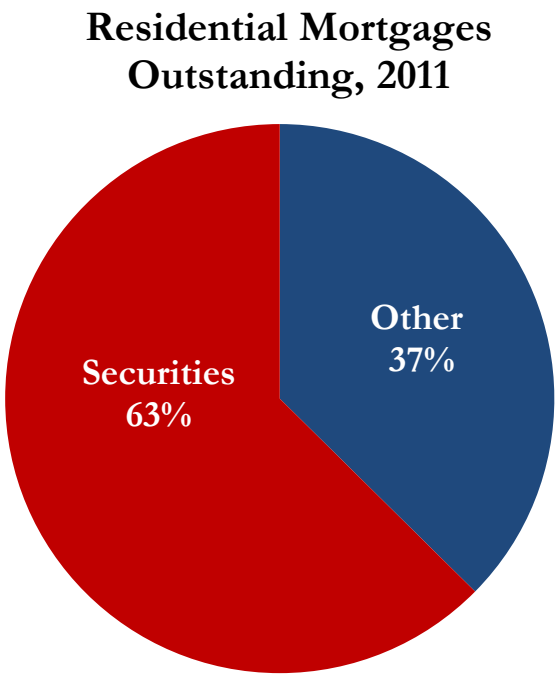




Sources: Mortgage Insurance Companies of America; company reports.

The Government Cannot Abandon Housing Finance Completely





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Notes: One-to-four family mortgages.

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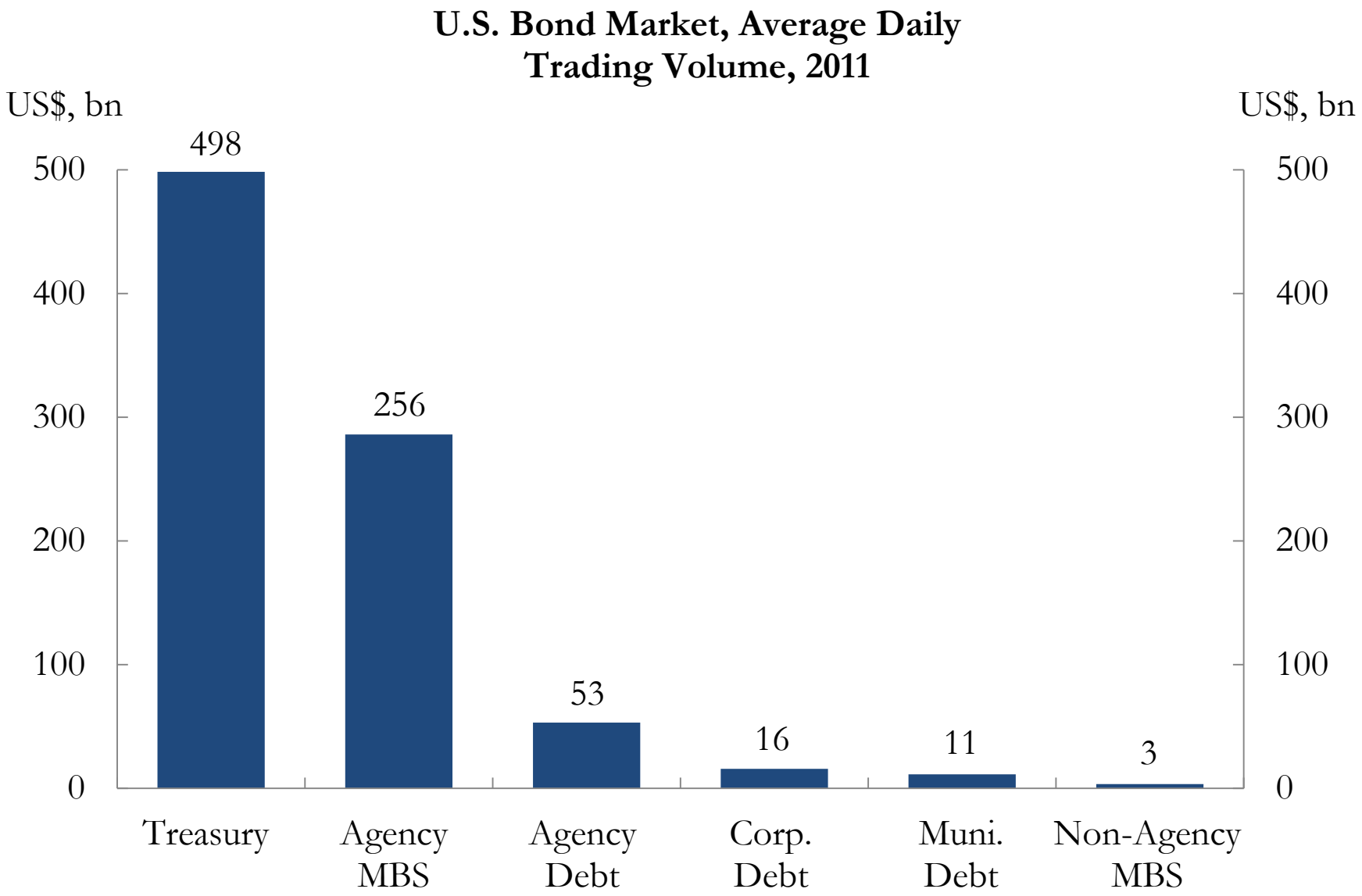

Sources. SIFMA; Federal Reserve Bank of New York..

Notes: Treasury and corporate debt transactions exclude trading in issues of one year or less.

Reform Criteria – A Path to Restarting Private Mortgage Markets

- **The end state and transition are equally important and must be realistic**
  - Acting on thought exercises about theoretically ideal end states untethered to current market realities could lead to massive economic dislocation and further government losses
- **Any responsible transition by the government from the status quo must meet five objectives**

1. **Protect the economy**
   - A rapid withdrawal of government support for mortgage credit will drive down house prices and destabilize the broader financial system
2. **Fulfill the government's promise to holders of Fannie and Freddie MBS and debt securities**
   - These are the same investors that fund Treasury debt
   - We cannot afford to undermine the credibility of the full faith and credit of the United States, given our mounting debt burden and continuing borrowing needs
3. **Provide an explicit, appropriately-priced government backstop for qualified mortgage products, not entities**
   - The government should regulate financial entities involved in mortgage finance, not underwrite their balance sheet risks
4. **Ensure adequate private capital**
   - Private mortgage insurers and securitizers must be adequately capitalized to absorb all losses in most downturns, protect the government against losses on its backstop, and avoid the need for future government bailouts
5. **Get the taxpayers' money back**
   - Taxpayers should be repaid for supporting the housing market to date and during the transition to a new system

Establish a Federal Mortgage Insurance Corporation (FMIC)

- **The FMIC would ensure stable credit for the housing system and protect taxpayers against loss by:**
  1. Establishing standards for qualifying mortgage products and practices
  2. Reinsuring MBS comprised of mortgages that meet stringent underwriting and disclosure criteria
  3. Supervising participating MBS securitizers and new private MBS insurers for safety, soundness, and capital adequacy
- **The corporation would be independent**
  - It must be insulated against political interference on the model of the Federal Deposit Insurance Corporation (FDIC)
- **Nature of FMIC's reinsurance and fees**
  - Securitizers and private MBS insurers are first in line to cover losses on a conforming MBS pool
  - The FMIC would charge a fee to guaranty incremental shortfalls in payments on the MBS pool and force the securitizer and/or MBS insurer to hold sufficient capital to cover losses up to the point at which the FMIC's reinsurance attaches
  - Reinsurance fee would be determined by reference to private markets and adjusted to smooth transition to the new system, address stress in financial markets, and recoup losses over time, like other successful public insurance programs
  - Similar to the FDIC Deposit Insurance Fund, fees collected by the FMIC would be placed in a reserve fund that builds over time and could be used to offset losses from any periods in which the reinsurance was underpriced
- **Conditions for FMIC reinsurance**
  - Available for qualified MBS for a fee from any securitizer that issues through a new market utility and meets minimum capital requirements, subjects itself to FMIC supervision, and provides a limited warranty on underwriting
- **Successful precedent**
  - FDIC, Terrorism Risk Insurance Act, Florida Hurricane Catastrophe Fund, Japanese Earthquake Reinsurance Co
- **The FMIC's structure would allow the government's role in housing finance to be reduced smoothly over time**
- **The FMIC could be born out of the existing Federal Housing Finance Agency**

Recapitalize Fannie and Freddie Guarantee Businesses for Private Sale

- **To allow for a smooth transition, the government should recapitalize and reorganize the mortgage guarantee businesses of Fannie and Freddie for private sale**
  - Fannie and Freddie are the "only game in town" for mortgage credit, so their reorganization is the critical bridge to a more balanced housing finance market
- **The government should take advantage of their in-place infrastructure, dominant market position and government financing in conservatorship to rebuild their capital base**
- **But their government sponsorship must be severed, and the legacy of the hedge funds that they ran for years at taxpayer expense must be destroyed**
- **These actions will allow the government to end the conservatorships and privatize two reorganized insurance companies that will preserve mortgage credit in the US, protect the FMIC and taxpayers against future loss, and provide a way for Treasury to recoup its invested capital in the old Fannie and Freddie**
- **The government can accomplish this in nine steps**

Recapitalize Fannie and Freddie Guarantee Businesses for Private Sale

1. **Immediately raise the guarantee fees (g-fees) that they charge on MBS to increase reserves and build capital**
   - Raising g-fees to more market rates, while also streamlining refinancing opportunities for the entire book of guaranteed mortgage in this historically low rate environment, not only would serve to build capital faster to protect taxpayers from future loss, but also could provide a significant economic boost more broadly
     - Increasing g-fees could also accelerate the normalization of underwriting standards—particularly tight today—which would broaden the base of available mortgage credit for consumers
   - Raising g-fees, which compensate for credit risk, to a level that can achieve market rates of return would attract ("crowd in") competition from private capital for FMIC-reinsured MBS and create conditions where new private label securitization products might flourish
   - The FHFA is currently examining what g-fee increases are warranted in order to reflect the risk of loss and cost of capital allocated to similar assets held by fully private regulated financial institutions, an exercise that should result in significantly higher guarantee fees going forward
2. **Refocus on core guarantee businesses and wind down "retained portfolios" of mortgages and related securities**
   - Fannie, Freddie and the Federal Reserve should coordinate to manage the wind-down in order to maximize value to taxpayers, and mitigate conflicts with ongoing guarantee businesses
3. **Eliminate the dividend on the outstanding Treasury Preferred Stock so the reformed guarantee businesses can use revenues from the increased g-fees to rebuild their capital base and pave the way for taxpayers to recover their entire investment**
   - Initially, the existing Treasury Preferred should be converted into a non-cumulative preferred stock
   - It makes more sense to use earnings to build capital towards a long term solution for our nationalized housing finance problem than for short-term initiatives unrelated to solving the government's housing problem, such as paying for a two-month extension of the payroll tax deduction with a ten-year tax on the mortgage market
4. **Contribute infrastructure to establish a utility for issuing conforming MBS**

Recapitalize Fannie and Freddie Guarantee Businesses for Private Sale

5. **Build reserves at the FMIC to protect taxpayers from future losses**
   - Remit revenues from a portion of the g-fees charged by the guarantee businesses of Fannie and Freddie to the FMIC in exchange for reinsurance on all of their MBS outstanding, allowing the FMIC to begin to build its reserve fund
6. **Terminate the FHFA conservatorships once the reformed guarantee businesses at Fannie and Freddie have sufficient capital to give the FMIC comfort that, together with amounts on deposit in its reserve fund, the government is adequately protected against losses on outstanding MBS that the FMIC has reinsured**
7. **Install ordinary, non-politicized corporate governance by re-chartering the reformed guarantee businesses of Fannie and Freddie as Delaware corporations**
   - No special privileges would continue going forward (e.g., the right to borrow from Treasury), nor would certain policy-oriented burdens (i.e., affordable housing mandates or "goals" apart from those generally applicable to all financial institutions, such as Community Reinvestment Act requirements)
8. **Recover the taxpayers' investments**
   - After transforming the insurance businesses of Fannie and Freddie into profitable, adequately capitalized go-forward entities, Treasury can convert its preferred stock to common stock and divest its stake over time into the public equity markets
   - The liquidity of common stock positions in profitable, well capitalized entities will allow Treasury to recover its investments in Fannie and Freddie far more rapidly than waiting for its preferred stock to be redeemed over time
   - Treasury is using this strategy successfully to divest its ownership stake in AIG
9. **Once Treasury no longer owns a majority of the equity in the privatized guarantee businesses, the Financial Stability Oversight Council should designate them "covered financial companies," subject to enhanced supervision by the Federal Reserve**
   - As beneficiaries of the FMIC's reinsurance, the new privately-held MBS insurers would also be regulated primarily by the FMIC for safety and soundness

Taxpayers Could Recover All Investments in Fannie and Freddie

- **FHFA projects that Fannie and Freddie will out-earn the Treasury dividend through 2014**
- **Recent earnings reports are proving these projections accurate and highlighting the ability to build capital**
- **Treasury's net investment in Fannie and Freddie stands at $148 billion and will be reduced to $134 billion during the balance of 2012 if earnings continue to cover the Treasury dividend**

HYPOTHETICAL FUTURE REFORMED ENTITY ANALYSIS			
$ in billions	New Fannie	New Freddie	Total
Size of Guarantee Book	$2,542	$1,558	$4,100
Net Guarantee Income, % of Book	0.59%	0.59%	0.59%
Guarantee Income	**$15**	**$9**	**$24**
Size of Liquidity Book	$75	$75	$150
Fee Income	**$0**	**$0**	**$1**
Size of Multifamily Book	225,000	160,000	385,000
Investment Income, % of Book	0.60%	0.60%	0.60%
Multifamily Income	**$1**	**$1**	**$2**
Normalized Provision Rate	(0.05%)	(0.05%)	(0.05%)
Normalized Provisions	**($1)**	**($1)**	**($2)**
Taxes - 30% assumed rate	(5)	(3)	(8)
Net Income	**$11**	**$7**	**$18**
Assumed Valuation Multiple	10.0x	10.0x	10.0x
Implied Market Capitalization	**$108**	**$68**	**$176**
Treasury Ownership	85.0%	85.0%	85.0%
Treasury Share	**$92**	**$58**	**$150**
% of YE 2012E Net Investment	*107%*	*120%*	*112%*