



GSE REFORM PRINCIPLES AND GUARDRAILS

This paper serves as an introduction to MBA's recommended approach to GSE reform. Its purpose is to outline what MBA views as the key components of an end state, the principles that MBA believes should be incorporated in any future system, the "guardrails" we believe are necessary in our end state, as well as emphasize the need to ensure a smooth transition to the new secondary mortgage market. We intend to release our full paper later this year, providing additional details around the end-state model, affordable housing strategy and recommended transition steps.

Introduction

Comprehensive reform of Fannie Mae and Freddie Mac (the GSEs) remains the final piece of unfinished business from the financial crisis. Administrative reforms undertaken by the Federal Housing Finance Agency (FHFA) have made tremendous progress in stabilizing the companies while paving the way for future reform. Yet, the GSEs remain in conservatorship with no clear path forward. Over the years, various proposals introduced in both the House and Senate have yielded productive discussions but have stumbled for a variety of reasons, including complexity, fears of exacerbating the impact of credit or economic cycles, or the perceived lack of a sufficient affordable housing strategy.

Why Congress Needs to Act

At the time the GSEs were placed into conservatorship, congressional action was considered necessary for a definitive resolution and path forward. The Mortgage Bankers Association (MBA) believes this is especially true today. Comprehensive legislative reform is essential to reinforce the progress FHFA and the GSEs have made to date, preserve a strong public mission, and address the systemic issues that undermined the pre-crisis housing finance system while protecting these reforms from political winds, changing administrations or favoritism. Importantly, only Congress can create an insurance fund to support an explicit government guarantee for eligible securities — a feature that we believe is necessary for institutional and international investors to continue financing the U.S. housing market through all economic cycles and circumstances. While existing legal authorities, including those in the authorizing statutes for FHFA and the GSEs, can be leveraged to promote secondary market reform, there is no equivalent substitute for action by Congress. Only a legislative solution can provide political legitimacy and long-term market certainty for the housing finance system.

The extraordinary federal support of the GSEs, which began with conservatorship, continues today. This support, including the backstop provided through the U.S. Treasury's Preferred Stock Purchase Agreement (PSPA) with FHFA, will be essential to ensure ongoing confidence in the market during any transition period. However, calls for a piecemeal "recap and release" approach or the suspension or modification of the dividend owed to Treasury ignore the need for a permanent solution as well as the importance of structural reforms that would address the deficiencies that contributed to the failure of the GSEs. Retention of dividends alone, through an amendment of the PSPA, would be insufficient to provide an adequate cushion to absorb potential losses, undermining long-term stability.

End State

The importance of housing to the economic and social fabric of the United States warrants a federal government role in promoting liquidity and stability in the market for mortgage debt. Except in times of extreme duress, the federal government's role in the secondary mortgage market should be primarily to promote liquidity for investor purchases of

mortgage-backed securities (MBS), not to attempt to provide the capital for, or absorb, the risk itself.

MBA's Task Force for a Future Secondary Mortgage Market considered many potential models in developing its recommendation, ranging from the formation of a government-owned corporation to an approach that would restore the GSEs to their pre-crisis form. In evaluating the tradeoffs between various approaches, several key features stood out as critical to ensuring the long-term health of the secondary mortgage market:

- ★ Leveraging the benefits of competition and strong regulation;
- ★ Ensuring equal market access for lenders of all sizes and business models;
- ★ Preserving a strong public mission; and
- ★ Maintaining a deep, liquid market for long-term single- and multifamily financing options.

These are the bedrock principles on which a durable housing finance system should be built for future generations. Enacting reform through Congress allows for many of these principles to be achieved, including attaching an explicit government guarantee to



the MBS and allowing one or more new entrants to compete with the reformed Fannie Mae and Freddie Mac.

Therefore, in building on — and consistent with — the work of previous MBA task forces in 2009 and 2013, MBA's current task force supports an end state comprised of multiple privately owned guarantors, with preferably more than two. The guarantors would be organized as privately owned utilities with a regulated rate of return. They would have a public purpose of providing sustainable credit availability to lenders of all sizes and business models. Guarantors would also be responsible for executing on an affordable housing strategy to ensure broad access to credit, preserve and develop affordable housing options, and address underserved markets nationwide.

These guarantors would be chartered to acquire eligible single-family and multifamily mortgages and issue single- or multifamily mortgage-backed securities “wrapped” with an explicit guarantee provided by the federal government. The explicit

guarantee of the MBS would insure the timely payment of principal and interest in the event one or more of the guarantors failed during a crisis and became unable to remit scheduled pass-through payments to investors.

In many critical ways, this end state would build from the significant administrative progress already undertaken by the GSEs under FHFA's direction. For instance, the Common Securitization Platform (CSP) and Single Security are key elements of our envisioned infrastructure; the GSEs' credit risk transfer programs will be expanded upon and form an important source of private capital; and the expanded Seller/Servicer base, supported by parity in credit pricing across entity size and type, would be retained to ensure competition. All of these elements would be reinforced in our Guardrails below.

Security structures and operational processes around loan delivery, servicing and remittance would be preserved and maintained to ensure a smooth transition process and minimize switching costs to the reformed secondary market.

The federal guarantee would be funded by insurance premiums paid by the chartered guarantors to a dedicated, actuarially sound Mortgage Insurance Fund. Each guarantor would be required to leverage private-capital investors to share credit risk above and beyond the loan-level credit enhancement provided by the primary market.

Principles

MBA believes that any future end state needs to be built around the following core principles in order to ensure long-term stability and liquidity. These principles are critical to ensuring the broadest possible liquidity through economic cycles while protecting taxpayers.

- ★ The 30-year, fixed-rate, pre-payable single-family mortgage and long-term financing for multifamily mortgages should be preserved.
- ★ A deep, liquid TBA market for conventional single-family loans must be maintained.

- ★ Eligible MBS backed by a well-defined pool of single-family mortgages or multifamily mortgages should receive an explicit government guarantee, funded by appropriately priced insurance premiums, to attract global capital and preserve liquidity during times of stress. The government guarantee should attach to the eligible MBS only, not to the guarantors or their debt.
- ★ The availability of affordable housing, both owned and rented, is vitally important; these needs should be addressed along a continuum, incorporating both single- and multifamily approaches for homeowners and renters.
- ★ The end-state system should facilitate equitable, transparent and direct access to secondary market programs for lenders of all sizes and business models.
- ★ A robust, innovative and purely private market should be able to co-exist alongside the government-backed market.
- ★ Existing multifamily financing executions should be preserved, and new options should be permitted.
- ★ The end-state system should rely on strong, transparent regulation and private capital (including primary-market credit enhancement such as mortgage insurance [MI] and lender recourse, or other available forms of credit risk transfer) primarily assuming most of the risk.
- ★ While the system will primarily rely on private capital, there should be a provision for a deeper level of government support in the event of a systemic crisis.

- ★ There should be a “bright line” between the primary and secondary mortgage markets, applying to both allowable activities and scope of regulation.
- ★ Transition risks to the new end-state model should be minimized, with special attention given to avoiding any operational disruptions.

Guardrails

MBA recognizes that a privately owned, multi-guarantor secondary mortgage market supported by a federal government wrap of eligible MBS carries certain risks. In attempting to mitigate these risks, we have developed the following guardrails, which are envisioned as part of a statutory framework designed to protect taxpayers, preserve what works today, and align incentives across both the primary and secondary markets.

- ★ The reformed end state should allow more than two guarantors to become approved to issue guaranteed MBS. The new regulator, FHFA or its successor,

should be authorized to grant regulatory charters subject to statutory requirements and guidelines, and the charters should not be limited in number.

- ★ The federal guarantee should apply only at the MBS level.
- ★ Charters should expressly maintain a “bright line” between the primary and secondary mortgage markets, with the guarantors’ allowable activities being limited to the secondary mortgage market, to guard against systemic risk concentration and to facilitate competition.
- ★ Guarantors must ensure equitable, transparent and direct access for lenders of all sizes and types — pricing and program access should not be based on the loan volume or asset size of participating lenders.
- ★ Guarantors must be standalone companies and prevent undue influence by a controlling shareholder. Lenders, including bank holding companies (BHCs), may not own shares of a guarantor.





- ★ Guarantors should be regulated as Systemically Important Financial Institutions (SIFIs).
- ★ Guarantors' return on capital should be regulated, with guarantors supporting an affordable housing strategy.
- ★ Guarantors may not hold investment portfolios. They may hold a liquidity and contingency portfolio for delinquencies and loss-mitigation purposes, and a limited multifamily portfolio. Guarantors should also be permitted to maintain a short-term portfolio for cash window operations.
- ★ New firms should be able to apply for a Guarantor Charter — either single-family, multifamily or joint (allowing the firm to operate in both markets).
- ★ As part of comprehensive reform, Congress should make the CSP an independent, government-owned corporation and must be made available to new guarantors once chartered.
- ★ To reduce barriers to entry for future guarantors, the CSP should own all GSE historical single-family data. Market participants should be able to access and analyze this information for an administrative fee.

- ★ The CSP should operationalize and manage to the government's "QM-like" single-family eligibility parameters for purposes of receiving the guarantee. Guarantor credit parameters within the QM-like eligibility framework, pricing engines and customer interfaces should remain proprietary.

Transition

Transitioning to a new end state remains among the most critical components of comprehensive reform. The path toward reform must minimize disruption to the housing finance system during the transition to a new secondary market, while leading to real reform through congressional action. This means that the existing operations of the GSEs could be reformed and repurposed to serve as initial guarantors. It is worth noting several principles that we believe should inform any transition to a new end-state model.

- ★ The PSPAs should remain in place until the new end state is fully functioning and capitalized.
- ★ The transition should occur over several years, with implementation occurring gradually to avoid market disruption and to build required capital.

- ★ The transition path should allow new entrants to develop as soon as possible in order to encourage competition.
- ★ Existing human capital and operational processes at both GSEs should be kept in place where possible to ensure smooth, ongoing service to the housing market.
- ★ Congress should, where possible, utilize existing legal authorities under Housing and Economic Recovery Act of 2008 (HERA) and consider separating the existing books of business from the newly guaranteed books.
- ★ Congress should establish the transition framework. However, the regulator should be given sufficient flexibility to adjust the execution based on market conditions or other critical factors.

A vibrant housing market is a key component of a healthy and growing national economy. This demands a strong and stable secondary mortgage market that ensures liquidity, affordable mortgage credit and serves consumers. MBA will elaborate on the concepts above in its full paper, anticipated later this year, that will also include a more detailed end-state reform recommendation as well as a transition plan.

About This Paper

This paper represents the first work product of MBA's Task Force for a Future Secondary Mortgage Market. The members of this task force are made up of individuals from MBA member companies representing a broad cross-section of the residential and multifamily real estate finance sectors, including entities of varying sizes and business models. MBA is the national association representing the real estate finance industry. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, securitization conduits, life insurance companies and others in the mortgage lending field.

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