Rethinking U.S. Housing & Mortgage Finance Policy

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Tuesday, June 10, 2014

Underlying Assumptions

- Meaningful housing reform is possible in 2014 and doesn't require Congressional action.

- There are consequences for lack of reform, or improper reform.

- Addressing GSE capital stack issues and reform go hand in hand.

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Why did Fannie & Freddie Fail?

- **The GSEs improperly used their portfolios:**
  - Beginning in the late 1990's the GSEs employed the lower costs of funds, conferred by an implied government guarantee, to increase their leverage and invest in each other's securities as well as investment-grade rated private label securities;
  - Prior to that period, their portfolios were only employed for liquidity purposes; and
  - Such use of their portfolios increased leverage, risk and increased their pro-cyclicality and correlation with the primary mortgage markets.
- **Strong capital requirements can and should be fixed:**
  - In the wake of the S&L crisis, as Congress was designing a new regulator and new oversight regime, for the GSEs, Fannie Mae successfully lobbied for and received the weak capital requirements embedded in the 1992 Act; and
  - How was it possible that GSE securities, backed by the companies' weak balance sheets and underpriced guarantee fees, received the lowest Basel risk weighting when GSE capital standards were lower than any other financial firms?
- **The GSEs improperly priced guarantee fees:**
  - Historically, the GSEs priced guarantee fees appropriately for the credit risk they accepted;
  - In the years between 2003 and 2007, in an effort to retain market share, the GSEs began offering significant discounts on Gfees for large volume customers. Pricing began to diverge from consideration of risk; and
  - Guarantee fees should reflect underlying, loan-level, mortgage credit risk.
- **The GSEs were created as a public utility to support the secondary mortgage market but not regulated as such.**

Is GSE a Dirty Term?

- **"Too Big to Fail" banks are the new GSEs.**
  - A GSE is merely a firm that the market believes to have an implied or explicit government guarantee as a result of its size, interconnectedness or charter; and
  - As a result of Dodd-Frank's different regime for the existence and resolution of our largest financial firms they, like the GSEs before them, are conferred the lower cost of funds that result from an implied government guarantee. As a result, market discipline of these firms is distorted and they have become increasingly able to compete with other firms based on this benefit rather than based on core economic competitiveness.
- **Banks and insurance companies are government sponsored but as long as they are disciplined by markets, able to be regulated and able to be resolved in failure, they pose no systemic risks.**
- **Other examples of GSEs are less disconcerting and are government sponsored as a result of the official chartering. We recognize their unique status and regulate them as such.**
  - Electric, Water, Gas and Sewer utilities are all examples of GSEs:
    - In return for their unique benefits, we subject these firms to a stringent regulatory regime which considers market power, requires meaningful capital and limits their growth by regulating their rates of return so that any returns above that rate to get plowed back into the building of capital; and
    - As a result, these GSEs, which are typically regulated by state and municipal authorities, have limited income available for excessive lobbying or legislative interference. This local market authority reduces the systemic risk of the failure of one of these firms.

What can or has been Accomplished without Congress?

- **FHFA has the authority to push forward with meaningful changes:**
  - As a result of HERA, the FHFA has the authority to set capital stronger standards for Fannie and Freddie;
  - As a result of the original conservatorship agreement, their has been no defined method for the GSEs to repay the government and no definition of whether repayment would be based on a return of capital or return on capital; and
  - As a result of the Third Amendment to the PSPA the GSEs have no ability to build capital.
- **The GSEs need reduce their portfolios to serve only for liquidity purpose:**
  - It is now widely recognized that the use of their portfolios for growth led to a blurring of lines between the GSEs intended secondary market purpose and the primary mortgage market. This increased the pro-cyclicality of the GSEs and reduced their ability to support the primary market when it failed; and
  - Congress and FHFA have made meaningful strides toward this end.
- **The GSEs have raised their g-fees:**
  - As a result, they are pricing credit commensurate with risk; and
  - If regulators or Congress took action to ensure adequate standards necessary to support a functioning private label market we would have a clearer basis on which to ensure adequacy of the GSEs' g-fees.

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- **Imagine a car getting rear-ended by another car as it is stopped at a stoplight. The damage is significant but repairable.**
  - **There are two obvious choices:**
    - Bring the Car to an auto repair shop and have it fixed (rational economic choice with benefits of limited downtime); or
    - Junk the car (uneconomic choice coupled with downtime while raising funds to offset depreciation and buy a new car).
- **Crapo Johnson found a third choice – Build a new auto assembly plant to produce a new car.**

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- **Is it an improvement?**
  - Does it protect the public?
  - Does it improve market discipline?
  - Does it reduce systemic risks posed by central players??
  - Does it create a strong divide between the utility-like function of the secondary mortgage market and the primary (private) mortgage origination market?
- **The answers are clear: "No!".**
- **Systemic risk:**
  - Increases the power of our largest banks as both primary market players and with an increasing ability to influence the secondary market;
  - Reduces the ability of smaller banks, that do not benefit from the lower cost of funds that are supported by an implied government guarantee, to compete;
  - Real questions remain about the viability of the TBA market under the Crapo Johnson bill; and
  - With the GSEs still central to mortgage funding the risks of replacing them with a complex and unproven system increases systemic risks.
- **Transition risks:**
  - HERA requires Conservator to conserve the assets of the GSEs;
  - Long transition away from GSEs impairs ability to retain key employees;
  - Conservatorship reduces GSE investment in systems and personnel (even reimbursement of most normal business expenses are impaired and must be paid out of employee pockets);
  - Transition risks the functioning of the TBA market;
  - Conservatorship is increasing the politicization of enterprise business (including through initiatives to price guarantee fees based on comments rather than credit risk pricing.); and
  - HERA demanded Conservatorship place GSEs back in a safe & sound condition or put them in receivership.

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- **First loss:**
  - It isn’t real, cant be enough private capital under this structure;
  - It creates incentives for market participants to withdraw liquidity as the market weakens in an effort to drive regulators to waive first loss requirements; and
  - It is an unworkable and inadequate replacement for meaningful capital standards.
- **Regulator:**
  - Rather than overseeing Fannie, Freddie and the Home Loan Banks the regulator would oversee:
    - Aggregators;
    - Guarantors;
    - Securitization platform;
    - First loss instruments;
    - Mission;
    - Safety and soundness;
    - Consumer protection; and
    - This would result in unprecedented complexity in cross-regulatory coordination.

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Better Options Exist

- **Fix the GSEs:**
  - Suspend the Third Amendment and allow the GSEs to build capital;
  - Define repayment of the government's investment;
  - Implement strict capital standards:
  - Eliminate portfolios for other than liquidity purposes;
  - Use stringent methods to price guarantees, separate from the GSEs and from political influence. This would create incentives for increased private market, unwrapped issuances on which investors would be forced to retain the risk (eliminating the broad government guarantee);
  - Regulate the GSEs as utilities with a guarantor of last resort mission;
  - Create down payment savings plan so that buyers can save for increased down payments and reduce their credit risk and costs of credit; and
  - Replace the MID with a progressive equity principal tax credit for first time buyers and renters as a means to reduce the need for private players to provide affordable housing goals.
- **This can be achieved in one of two ways:**
  - Through the conservatorship route, with Fannie and Freddie coming out the other side as purely private and adequately capitalized firms; or
  - By doing a "good bank"/"bad bank" receivership with the new entities coming out with a cleaner charter.
- **We shouldn't reinvent a wheel that has driven the secondary market successfully for generations. We should repair it well, just as we recognized the need to do, but failed to do, after the S&L crisis.**

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