

## Why Housing Reform Still Matters

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The 2008 financial crisis left a lot of challenges in its wake. The events of that year led to years of stagnant growth, a painful process of global deleveraging, and the emergence of new banking regulatory regimes across the globe.

But at the epicenter of the crisis was the American housing market. And while America's housing finance system was fundamental to the financial crisis and the Great Recession, reform efforts have not altered America's mortgage market structure or housing access paradigms in a material way.

This work must get done. Eventually, legislators will have to resolve their differences to chart a modernized course for housing in our country. Reflecting upon the progress made and the failures endured in this effort since 2008, we have set ourselves to the task of outlining a framework meant to advance the public debate and help lawmakers create an achievable plan. Through a series of upcoming papers, our goal will be to not just foster debate but to push that debate toward resolution.

Before setting forth solutions, however, it is important to frame the issues and state why we should do this in the first place. In light of the growing chorus urging surrender and going back to the failed model of the past, our objective in this paper is to remind policymakers why housing finance reform is needed and help distinguish aspects of the current system that are worth preserving from those that should be scrapped.

## Why Housing Finance Reform Is Needed, and What It Must Accomplish

Structural housing finance reform was never going to be an easy undertaking. But it can't be ignored. After years of debate, we understand that sensible reforms should seek to preserve the aspects of the old system that worked while ridding the system of its flaws. And we understand that transitioning to a new market infrastructure must be carried out without disruption—disruption that could upset mortgage availability in the near term or upset the processes and operations of the thousands of firms that make up the complex housing finance ecosystem.

So no, this was never going to be easy.

Still, nearly a decade after the financial crisis, housing finance is notable for its political and policy complexity as well as the passion that it stirs. Meaningful reform must be achieved, the vast majority of policymakers say, yet the decade anniversary of the conservatorships of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corp. (Freddie Mac) looms.

A home is the largest purchase most Americans will make in their lives. By some estimates, housing is the engine that propels nearly one-fifth of the American economy. Access to decent housing is crucial to a vibrant middle class. On top of all that, the system is enormously intricate; this is not your grandfather's housing market. No longer is the typical mortgage characterized by a 20 percent down payment and funded with community deposits from the local savings and loan. Today, the vast majority of America's mortgages come into existence via a complex financial infrastructure, not via local banks that simply take in deposits and lend them out. Instead we have a web of bank and non-bank lenders, bank and non-bank mortgage servicers, mortgage insurers, guaranteed securities, derivatives, credit investors, rate investors, and more that together connect savers across the globe with families across the country who seek to buy a house. All of this has led to structurally lower and less volatile interest rates. But it has also created complex terrain to navigate.

So here we are eight years after the financial crisis, with the two government-sponsored enterprises (GSEs) that sit at the heart of America's housing finance ecosystem—Fannie Mae and Freddie Mac—trapped in a state of legal limbo called conservatorship. The government life support given to them at the height of the financial crisis was meant to be temporary, followed by legislation replacing the toxic aspects of their activities and reforming our market structure. But a long-term decision about how to replace the life support with something better without disrupting the housing market requires political compromise and pragmatic thinking. Politically, members of Congress on both sides of the aisle will have to give on some issues to achieve an agreement. They will need to put ideology aside and ask, "Will this actually work?"

The challenge of finding sufficient political common ground to break the GSEs out of conservatorship has felt so daunting that it has led to doing nothing. But continued inaction is a de facto decision to stay with what we've got. Others have suggested we give up in a different way: return, hat in hand, to the old model that failed. These arguments are misguided and dangerous. Neither approach would address the failures of the past or the economic challenges of the present.

The former choice—remaining in conservatorship—would allow the entire housing system to rely almost entirely on the decisions of the Federal Housing Finance Agency (FHFA) director and the two CEOs he or she is meant to regulate. In the end, this “head in the sand” strategy is not a serious approach. Such a lack of legislative clarity turns market decisions, such as how to underwrite a loan or price its risk, into a bureaucratic exercise or worse. This is not the proper role for a regulatory agency. But until Congress acts, the FHFA is stuck in its role of regulator and conservator.

The latter idea—returning to the old model, in which the GSEs operate in a blessed state as government-sponsored enterprises that are tasked with a public mission but report to private shareholders, coupled with a management team incentivized to leverage all advantages not for the long-term health of the economy but instead for immediate financial gain—relies on the assumption that future congresses will also bail out Fannie and Freddie successor entities the next time there is a major market disruption. (And there will always be market disruptions.) This path, too, leaves the well-being of the housing market very much to chance.

As the events of 2008 demonstrated, the old model worked only because investors were confident that taxpayers stood behind the companies. If Fannie and Freddie were released from government control and, for all intents and purposes, returned to their pre-conservatorship quasi-private status, are we sure that a future Congress will inject emergency capital into them when they become insolvent or the mortgage-backed securities (MBS) market questions the strength of their guarantee?

Of course, the answer is no. Yet from Congress’ perspective, as much as it may never want to vote for taxpayer life support again, the pressure to keep two dominant players operating could very well lead to another vote to allocate emergency capital into successor entities.

All of this begs the question: Where, exactly, do we go from here?

There are notable, impressive successes inside America’s housing finance system. These must be preserved. Yet we must also reduce the likelihood that financial institutions will need emergency congressional action in the future. Additionally, incentives need to be properly structured and transparent, not comingled and opaque. Put another way, housing finance reform is about throwing out the dirty bathwater but keeping the baby. Fortunately, meaningful steps have already been taken, albeit slowly. And we are writing about these issues because it seems that meaningful policy debate in Washington may begin anew in 2017.

## **The Secondary Mortgage Market and Its Collapse**

While the Bailey Brothers’ Building and Loan from the classic movie *It’s a Wonderful Life* renders a heartwarming picture of local housing finance, only remnants of that system remain today. At least since the savings and loan debacle in the 1980s, the U.S. housing finance system has been dominated by the secondary mortgage market, that is, the marketplace where lenders, bond investors, and the infrastructure of securitization meet.

In simple terms, the secondary market is where individual mortgages made across the country are bundled into large groups of mortgages, called pools, and sold to global investors in a structure called a

mortgage-backed security. The process of pooling mortgages and issuing MBS is called securitization. This system can be very powerful and beneficial. Rather than relying on the availability and stability of local deposits at a savings (or building) and loan, the secondary market draws asset managers across the globe to invest in pools of hundreds or thousands of mortgages.

In this way, pension funds, college endowment funds, insurance companies, mutual funds, retirement savings plans, foreign central banks, foreign wealth funds, and other institutional money managers responsible for investing the savings of individuals and institutions provide the money a family needs to buy a house anywhere in America. Interestingly, these widely dispersed investors know very little about the risk characteristics of any individual borrower in their pool, nor do they know much about the condition of a particular house, the neighborhood in which it's located and the local economy. So why are they willing to fund these mortgages?

The answer lies in the structure and reliability of the secondary mortgage market and the institutions and legal arrangements at its center. In the run-up to the financial crisis, and still today, there are three distinct components that compose most of the secondary mortgage market and make this financial ecosystem possible.

First, in the government segment of the housing finance system, the Government National Mortgage Association, or Ginnie Mae, oversees the pooling of mortgages guaranteed by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), and a few smaller federal housing programs. The Ginnie Mae label on a mortgage-backed security tells investors that the full faith and credit of the United States government guarantees that they will receive timely payment of principal and interest each month and that investors will not lose any principal as a result of borrower defaults on the underlying mortgages.

In this case, the risk is largely borne by the federal government through its FHA, VA, and other mortgage insurance programs. Loan originators and loan servicers retain some risk as well, and Ginnie Mae bears the ultimate risk if these private-sector entities fail to fulfill their responsibilities. Ginnie charges the homebuyer six basis points per year (or typically less than \$1 per month) for this backstop guarantee. Today, Ginnie Mae MBS account for \$1.5 trillion of the roughly \$7 trillion in outstanding MBS, or more than 20 percent, which is a historic high.

Second, on the other end of the spectrum, in the purely private-label segment of the housing finance system, banks and other financial institutions (call them Wall Street firms if you must, although many are not located anywhere near New York) put together mortgage pools and sell the MBS to private investors. In this market segment, the nongovernment investors bear all the credit risk; that is, if borrowers default on their payments, investors suffer the loss. As a result, private-label MBS are broken into multiple subgroups, called tranches, which create a predetermined order for bearing credit losses. More subordinate tranches bear all the credit losses until they are wiped out, and then losses proceed to holders of more senior tranches of the pool.

In the decade or so leading up to the financial crisis, the private-label market (often referred to as the private-label securitization market, or PLS) exploded in size, often backed by subprime mortgages, which

were underwritten according to nonstandard guidelines. To name a few, documentation of income or assets was frequently not required, there were very few antifraud controls, and whether prospective borrowers could repay a loan was seen as a secondary question at best. The PLS market fanned the flames of these problems, but the government-sponsored enterprises, worried about losing market share, were quick to follow.

The private-label market is also where so-called “jumbo loans” are securitized.<sup>1</sup> By 2006, private-label MBS accounted for about half of outstanding MBS, but today that portion is down to less than 10 percent. In fact, there has been almost no new issuance in this market since the crisis. The reason is that the crisis exposed several deep, structural flaws in the PLS market, including a lack of standardization in disclosures, opaque and nonstandard legal terms from one PLS to another, and no functioning mechanism to ensure that servicers who determined whether and how to modify loans and enforce contracts did so in the best interest of investors. The U.S. Treasury Department and other entities are working to address these flaws in an effort to build a more sustainable PLS market, but this market segment remains moribund.

Third, and the largest by far, is the GSE market segment, composed of loans bundled, securitized, and guaranteed by Fannie Mae and Freddie Mac.<sup>2</sup> Chartered by Congress, endowed with unique benefits unavailable to any other private firm, and tasked with developing a liquid and stable market in which non-FHA mortgages could be bought and sold, Fannie and Freddie grew into behemoths in both their market power and political influence.

The market interpreted this package of benefits, including the GSEs’ federal charter and exemption from certain securities laws, as giving the two companies an implied government guarantee. In turn, these benefits and the associated implied guarantee allowed Fannie and Freddie to join Ginnie Mae in selling mortgage-backed securities in a forward market, called the “To Be Announced,” or TBA, market. Being able to trade MBS in the TBA market allows for easy trading and hedging of mortgages around the globe as well as the standardization of underwriting. But in 2008, our reliance on these entities as a public/private duopoly was exposed as a Faustian bargain.

A hybrid between public mission and private ownership, Fannie and Freddie often reaped the best of both worlds. Operating with numerous public benefits, the companies and their shareholders operated with lower costs, much lower capital requirements, and far weaker regulation than any bank or savings and loan.<sup>3</sup> In the end, their unique structure of private shareholders, private-sector salaries and benefits, and an implicit public guarantee came to symbolize “Heads we win, tails the taxpayers lose.” In this market segment, Fannie and Freddie bought mortgages, packaged them into MBS, and guaranteed the MBS holders payment of principal and interest if any borrower defaulted on a loan. They

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1. Jumbo loans have a principal balance greater than the conforming loan limit, that is, the largest mortgage Fannie Mae and Freddie Mac may purchase. Currently, the conforming loan limit is \$625,000 in high-cost areas and \$417,000 across most of the rest of the country.

2. Fannie Mae and Freddie Mac are two among a handful of GSEs, financial institutions chartered by Congress but owned and operated by private shareholders. GSEs have a public mission stated in their charter and receive such benefits as preferential tax treatment and cheaper access to capital markets, which are unavailable to other private firms.

3. For example, their capital levels were extraordinarily low, at times less than 100 basis points.

charged borrowers a guarantee fee embedded in the interest rate—effectively an insurance premium—for bearing this risk. With nearly \$5 trillion in MBS outstanding at the time of the crisis—50 percent of all U.S. mortgage debt—we can see in hindsight that this concentrated credit risk exposure was a systemic threat.

It was widely discussed before the crisis that this setup, combined with the two companies' importance to housing finance and their government support, meant that taxpayers, in all likelihood, "implicitly guaranteed" Fannie and Freddie MBS investors should the GSEs fail. While Congress routinely insisted that there was no government guarantee behind Fannie and Freddie, the market thought otherwise—and when the enterprises failed, that implicit guarantee was honored and became explicit. In the summer of 2008, Congress gave the Treasury Department unlimited authority to purchase Fannie and Freddie securities. The subsequent appointment of the FHFA as conservator backed by direct financial support from the Treasury protected the holders of Fannie and Freddie MBS.

Since the crisis, the private-label market mostly vanished, and Ginnie Mae, Fannie and Freddie have expanded their market shares. Despite Fannie and Freddie being on government life support, the conservatorship design supported by Treasury backstop financing enabled investors to continue buying their MBS, thereby ensuring ongoing liquidity in the U.S. mortgage market. Absent this life support, the country would have been without a viable secondary market to provide liquidity for new mortgages not backed by a government agency such as the FHA.

While there are other important considerations to the workings of this secondary market, two more background points—clear lessons from the financial crisis—are worth making here. First, to reap the benefits of a market like the one we have come to know, the mortgages in an MBS must be homogenous. That is, they need to share certain characteristics such as repayment term and whether the loan has a fixed or adjustable interest rate. Similar loans allow investors to analyze and estimate prepayment speeds, which affect MBS pricing. This is a critical component of how investors manage the interest rate risk of a long-term security with variable prepayment.

Second, Ginnie Mae, Fannie Mae, and Freddie Mac play an important role overseeing and enforcing certain contracts critical to the market's operations. Key among these are overseeing mortgage servicers on behalf of investors and taking appropriate remedial steps, including transferring mortgage servicing, in the event of problems. The private-label world, as we came to see in the crisis, lacks an effective mechanism for such oversight, which the Treasury Department and industry groups have wrestled with in recent years.

This brief review reminds us that the objective of strengthening the secondary market while avoiding future government bailouts means replacing what is broken in the Fannie/Freddie model. That includes the systemic risk caused by concentrating credit risk on two balance sheets. We also need to eliminate the features of their charters that concentrated risk and political power in two quasi-private companies. Not to be lost is the challenge and opportunity of strengthening the other two component parts of the secondary mortgage market—the government segment and the purely private segment—and modernizing critical infrastructures that support housing finance.

At the same time, we need to preserve the liquidity and capacity of an active, globally financed MBS market because it ensures lower mortgage rates and stable access to credit. And we need to better define the role of each segment of the housing market. The purely private, purely public, and hybrid parts of the system must operate as one ecosystem, not competitors in a race to the bottom.

## What Has Transpired So Far?

From a public policy perspective, it makes sense to begin policy analysis by examining the purely governmental programs and institutions involved in housing finance, especially the Federal Housing Administration. Nonetheless, the Fannie/Freddie space of the secondary mortgage market is by far the largest component of the housing market. So we address its flaws here, and we will return to the FHA and other government programs in a later paper.

Since Fannie and Freddie were put on government life support in 2008, the question, “What do we do with them and the housing finance system next?” remains unanswered. But to be entirely pessimistic about policymakers’ capacity to solve complex problems misses important points. Some helpful steps have been taken, and they are worth quickly reviewing.

The first of these policy initiatives occurred in 2012 with the introduction of the FHFA Strategic Plan for Enterprise Conservatorships<sup>4</sup> and its associated “annual scorecards.” The scorecards set the FHFA’s priority objectives for Fannie and Freddie to achieve over the subsequent calendar year.<sup>5</sup> The strategic plan and annual scorecards defined initiatives for Fannie and Freddie to modernize their operations and business practices while preparing the groundwork for a post-conservatorship secondary mortgage market. The two most significant results of these efforts are the development of credit risk-sharing, or credit-risk transfer (CRT) products that have helped shift risk away from Fannie and Freddie (and therefore taxpayers); and a common platform to replace each company’s outdated, proprietary securitization infrastructure and technology.

Beginning here with CRT, credit-risk transfer transactions began small in 2013—the scorecard goal was just \$30 billion in unpaid principal balance—but they have since become a substantive risk-shifting mechanism for the enterprises and, with a bit more work, can become a market asset class of their own. Credit-risk transfer accomplishes a number of key tasks on the reform agenda. CRT brings in market signals, ushers in private risk takers ahead of taxpayers, and focuses market practitioners on the development of models for continued improvement in mortgage credit risk management. In short, credit-risk transfer has helped form a foundation for a new mortgage credit market structure.<sup>6</sup> Importantly, we

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4. Federal Housing Finance Agency, A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending. February 21, 2012. The plan was written by one of the authors of this paper.

[http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221\\_StrategicPlanConservatorships\\_508.pdf](http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf)

5. In 2014, current FHFA Director Melvin Watt restated the strategic goals in an updated plan. See Federal Housing Finance Agency, The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, May 13, 2014.

<http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2014StrategicPlan05132014Final.pdf>. The FHFA continues to publish annual scorecards prioritizing efforts and setting targets for meeting the strategic goals.

6. For additional background on the steps taken to date and those still needed to fully develop a market for mortgage credit risk, see Edward J. DeMarco, “(Re-) Creating a Market for Mortgage Credit Risk,” October 28, 2015.

<http://www.milkeninstitute.org/publications/view/748>

also now know that the plumbing for credit-risk transfer works well—both “front end,” in which terms are arranged before loans are sold to a GSE, and “back end,” in which a GSE determines how and when to shed risk.

There is no doubt that the mortgage credit markets are slowly coming back to life. We should continue to foster this development by expanding the scope and depth of risk transfer and developing a legal and regulatory infrastructure that ensures transparency and investor protection. These steps are needed for credit risk investors to have confidence in this sector for the long haul and for the market to remain liquid during periods of economic difficulty. With a properly modernized architecture, these credit markets can be harnessed to measure and price credit risk, allocate credit, and insulate taxpayers in a targeted and effective way.

**TABLE 1: Credit-Risk Transfer (CRT) Has Evolved Since 2012**

**Category 1: ‘Back End’ CRT – Transaction Structured and Arranged After GSEs Acquire Loans for Securitization**

Structure	Particular Advantages	Possible Challenges
STACR – Structured Agency Credit Risk Securities	Scalable and repeatable. Market now knows the structure well.	Not REIT eligible. Relies on a strong, liquid market at time of issuance. GSEs at risk until bond is actually placed.
CAS – Connecticut Avenue Securities	Scalable and repeatable. Market now knows the structure well.	Not REIT eligible. Relies on a strong, liquid market at time of issuance. GSEs at risk until bond is actually placed.
ACIS – Agency Credit Insurance Structure	Insurance money is readily available.	Limited investor base, only insurers.
CIRT – Credit Insurance Risk Sharing	Insurance money is readily available.	Limited investor base, only insurers.

**Category 2: ‘Front End’ CRT – Transaction Structured and Arranged Before GSEs Acquire Loans for Securitization**

Structure	Particular Advantages	Possible Challenges
Syndication Transfer	GSEs never take on first-loss risk. Scalable. Fully collateralized.	Issuer, originator, and servicer retain no credit risk.
Recourse note held on book	Total alignment of incentives. Ability to lock in pricing for a longer period. Fully collateralized so no counterparty risk.	Thus far, only a few mortgage firms with comprehensive origination, servicing, and investment platforms can execute these transactions.
Deeper MI*	Mortgage Insurers have infrastructure in place. Leverage allows for competitive pricing.	Counterparty risk persists for the GSEs, as MIs are already their largest source of such risk.

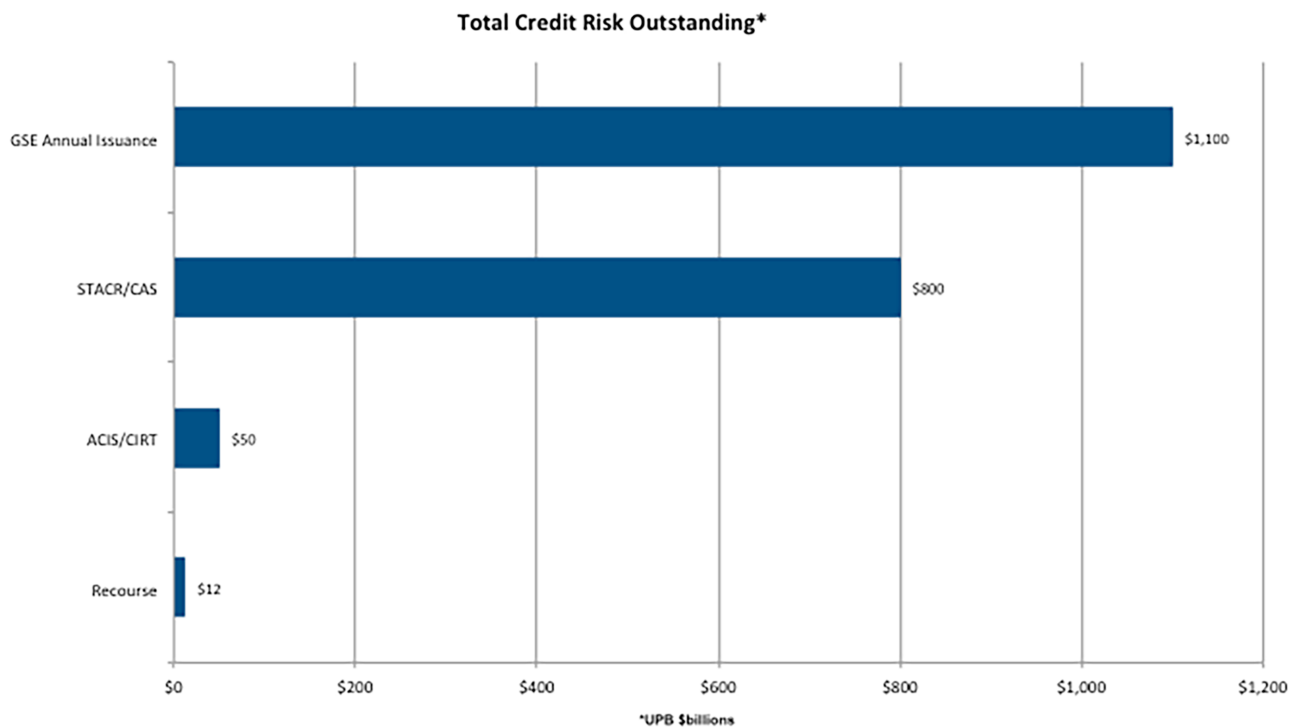
\*Note: As of December 2015, deeper MI, a conceptual tool, had not been tested or utilized.



**TABLE 2: CRT Has Become a Permanent De-Risking Feature of the GSEs**

<b>2012</b>	<ul style="list-style-type: none"> <li>Scorecard required the GSEs to “shrink enterprises dominant presence via credit risk transfer.” Scorecard required some initial CRT transactions in 2012 and for GSEs to establish a timeline for growth.</li> </ul>
<b>2013</b>	<ul style="list-style-type: none"> <li>Scorecard again required the GSEs to “shrink enterprises dominant presence” via “CRT structures that in aggregate were at least \$30bn UPB” by the end of 2013.</li> </ul>
<b>2014</b>	<ul style="list-style-type: none"> <li>Scorecard for the first time explicitly referenced STACR and CAS and required these deals to collectively reach \$90bn of UPB in 2014.</li> </ul>
<b>2015</b>	<ul style="list-style-type: none"> <li>Required overall CRT to be \$150bn for Fannie, \$120bn for Freddie.</li> <li>Also said, “GSEs must each utilize at least two types of risk transfer.”</li> </ul>

**CHART 1: The System Is Making Progress**



\*Approximate  
Source: SIFMA

In 2012, the FHFA announced that work would begin on a common securitization platform, that is, the systems technology that governs payments from borrowers to MBS investors. The agency had deter-

mined that neither Fannie nor Freddie had a securitization platform capable of being built on for the future. Moving from the outdated, proprietary securitization infrastructure each company used to a shared utility provides numerous benefits. Among them, it creates the opportunity to standardize disclosures, data terms, and even bond administration functions between the two entities.

We now know that many of the functions that underpin MBS securitization can be managed as a common utility, which is being called the CSP or CSS.<sup>7</sup> If done properly, a common platform for securitization could remove a significant barrier to entry for potential competitors. Unfortunately, thus far the focus of the CSP project has been the adoption of a single security for use by only the GSEs, and not as a means to allow new entrants into the market. However, despite this unfortunate dynamic, in the end we now know that the plumbing of the CSP could operate as a standalone market utility or, more promisingly, it could be folded into a government agency that provides the catastrophic guarantee for MBS (such as a Federal Mortgage Insurance Corp., a National Mortgage Reinsurance Corp., or simply Ginnie Mae).

Either way, both of these initiatives—the CRT and the CSP—are meaningful undertakings that faced skepticism in the beginning but are now largely recognized as worthwhile endeavors. These changes alone, so long as they are continued, help ensure that the post-conservatorship secondary market segment traditionally served by Fannie and Freddie will not look the same as it did before the crisis. Congress, for its part, has done more than immediately meets the eye as well. It is true that we have not had a Rose Garden signing ceremony for a major reform law. But progress has occurred. Consider that both the House and Senate committees of jurisdiction passed reform bills in 2013 and 2014. Alternative bills were also crafted in both chambers, and all were done with a great deal of thought applied to a highly complex topic. Passions sometimes flared as various approaches were offered. But such is to be expected when discussing legislation that will forever impact the market structure that enables Americans to purchase homes. It's clear, though, that both sides of the aisle and both chambers of Congress—with administration input—have nudged their way forward. In the end, we do not think political consensus is as far away as some would suggest.

To many Americans, owning a home is a quintessential element of the American dream. How the housing market should serve families is a question to be answered by our elected officials. Congress and the White House must and, in our view will, set the four corners of how the future secondary mortgage market will operate. After all, an act of law chartered the enterprises, and an act of law injected nearly \$200 billion of taxpayer money into them to keep them solvent since 2008. An act of law will ultimately resolve the conservatorships and decide the secondary mortgage market's future structure and participants. To think that something of this magnitude should be done simply via regulatory action is, to us, an insult to Congress and the American democratic process.

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7. On Oct. 7, 2013, the FHFA announced a joint venture between Fannie Mae and Freddie Mac to implement the CSP. The new entity was chartered as Common Securitization Solutions, LLC<sup>SM</sup> (CSS). The idea of directing the enterprises to initiate joint work on a common securitization platform, or CSP, first appeared in the 2012 Strategic Plan for Enterprise Conservatorships, and the idea was subsequently developed in various FHFA white papers, speeches, and announcements. See <http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Common-Securitization-Platform-Background.aspx>.

We understand the difficulty, but this is a debate about the role of government and market forces in nearly one-fifth of the American economy. The responsibility for resolving this debate falls squarely on the shoulders of our elected officials. So we believe the debate will shift back toward legislators and the next administration. Here, for their consideration, we offer answers to two critical questions.

## **What Parts of the Currency Secondary Mortgage Markets Are Worth Preserving?**

If reformers are to be guided by the principle “Don’t throw the baby out with the bathwater,” it is worth clearly identifying which is which.

There are many aspects of how the current model works that are worth keeping, and any reform plan should take care to not damage these. We believe there are three broad aspects of the current system that all parties want to preserve. One aspect concerns the investors—the suppliers of the money used to buy homes. The second aspect concerns the homebuyers and lenders—the parties who rely on that source of funds to make new mortgage loans. And the third aspect concerns the number and reliability of the pipes connecting borrowers and lenders to investors.

### **1. MAINTAINING A LIQUID MBS MARKET**

In today’s secondary mortgage market, there are \$6.3 trillion in outstanding government and agency MBS, led by Fannie Mae (\$2.8 trillion), Freddie Mac (\$1.8 trillion), and Ginnie Mae (\$1.7 trillion).<sup>8</sup> These securities trade in global capital markets. The vast scale and liquidity of these markets mean there is a reliable flow of money from around the globe to fund American home buying. As a result, homebuyers can obtain mortgage loans through the ups and downs of the economy. Indeed, mortgages remained available even as other parts of the credit markets endured considerable strains during the financial crisis. On the investors’ side, a deep and liquid MBS market is certainly a characteristic of the current system to be maintained.

There are two aspects of this deep and liquid MBS market that warrant special mention.

#### **a. The TBA Market**

One of modern finance’s more interesting and important innovations was the MBS futures market, referred to by traders and investors as the To Be Announced, or TBA market, as mentioned earlier. It enables mortgage lenders to lock in a forward price for mortgages, which, in turn, allows a homebuyer to lock in his or her interest rate in advance. Absent the TBA futures market (or some equivalent), customers may not know their interest rate until the day they close on a loan.

This market serves as a foundational pillar of the American home buying process and should be reformed but kept intact. It also provides the means for hedging a large portfolio of mortgages against fluctuations in interest rates, thereby allowing asset managers of various stripes to support homeownership via liquid investments. It is important to recognize that the TBA market has not emerged in non-

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8. SIFMA, US Mortgage-Related Issuance and Outstanding. Feb. 18, 2016.

governmental asset-backed securitization. Its functioning rests on the elimination of credit risk to MBS investors due to either an explicit or implicit government guarantee combined with the government exempting the issuing agencies from certain securities laws.<sup>9</sup>

#### **b. Standardization**

MBS investors rely on a set of standards to ensure their ability to model and price these securities. The degree of standardization varies across the Ginnie Mae, Fannie and Freddie, and PLS segments of the MBS world. Where standards were weakest—the PLS market—is where the most severe problems arose during the crisis. The past several years have seen much effort to enhance standardization in all three market segments, and these efforts should continue.

*Data standards*—The FHFA directed that Fannie and Freddie release substantial amounts of historical loan-level data for analysis by market practitioners. In May 2010, the agency launched the Uniform Mortgage Data Program, in which Fannie and Freddie have been working with the industry standard-setting body to develop common data definitions and an industrywide method for electronic reporting of mortgage-related information. A mechanism for ensuring the continued standardization and public release of mortgage data going forward should be established, building on this recent effort.

*Servicing standards*—Two homeowners who experience similar life circumstances that lead to the inability to pay a mortgage should not be treated differently because one had servicing rights sold to a more responsive servicer than the other. It took years of effort in the wake of the financial crisis to develop more uniform mortgage servicing practices, particularly as they relate to working with delinquent borrowers. Investors need to know the servicing rules to estimate their potential costs and recoveries when a borrower defaults. In addition, since servicers are the agents for enforcing the mortgage contract, investors need to ensure not only that there are standards for servicing practices, but that those standards are enforced. Clearly, there is a need for effective management and oversight of servicers.

*Security structure and disclosures*—The more uniform the contractual terms from one MBS to another, the less security-by-security review investors must perform when deciding whether to make a purchase. So MBS uniformity adds liquidity, which ultimately lowers borrowing costs. A key FHFA scorecard goal today is moving Fannie and Freddie to a common security, thereby eliminating differences between the two that may hamper liquidity and lead to differential pricing between the companies' MBS. The Treasury and industry groups are also working on a more standardized security for the PLS market.

Beyond the terms of the security, standardization of the disclosures made to investors also enhance liquidity and investors' confidence in the expected performance of the underlying mortgages. Here again, the FHFA has been driving efforts to deepen and standardize disclosures between Fannie and Freddie MBS. A common security might also facilitate other firms' eventual entry into the securitization business

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9. For more information on the TBA market, see James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York Economic Policy Review, May 2013.

<https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf>

and Center for American Progress, *The Importance of the To-Be-Announced, or TBA, Market*,

[https://cdn.americanprogress.org/wp-content/uploads/2013/10/HousingFinanceReform\\_4.pdf](https://cdn.americanprogress.org/wp-content/uploads/2013/10/HousingFinanceReform_4.pdf).

with a government guarantee, since the MBS issued by a new firm would trade in a common pool with existing assets rather than bearing a massive liquidity disadvantage.

## **2. MAINTAINING NATIONWIDE ACCESS TO THE SECONDARY MORTGAGE MARKET AT ALL TIMES**

From the point of view of homebuyers and mortgage lenders, the secondary market needs to provide reliable access for all eligible borrowers and lenders, without regard to loan size, property location, and type or size of lender.

But achieving this equitable access can be challenging because many of the costs to underwrite a loan are fixed, which means they represent a higher percentage of the loan amount on smaller loans than on larger ones. Additionally, these incentives generally push lenders to focus on the loans that are easiest to make. As a result, communities with relatively few or low-priced houses (mostly rural and lower-income communities) often face origination costs that are higher as a share of loan value than more urban and well-off communities. A mortgage credit system that supports a consistent guarantee fee nationwide can provide lower-dollar-amount loans with equitable access to the secondary MBS market. Reform should ensure that these smaller and more challenging loans have equitable access.

## **3. COMPETING OUTLETS CONNECTING THE PRIMARY MARKET TO THE SECONDARY MARKET**

While this element of maintaining a liquid MBS market might not draw universal agreement, in our view the mechanisms that connect the primary market (where lenders make loans to borrowers) and the secondary market (where global investors buy and sell MBS) should themselves be subject to competition. There are thousands of lenders and millions of borrowers out there. Forcing them into just one or two gatekeepers that control the securitization process (as we did with Fannie and Freddie) diminishes innovation and customer service while increasing systemic risk associated with the operational or financial failure of the gatekeeper.

If anything, it is remarkable that Fannie and Freddie still compete with each other for business while under government control. They should be lauded for continuing to innovate in developing tools and technologies to assist their seller servicers. But as we embrace the forces of competition, we should remember that in housing, such rivalry can cut both ways. We believe that competition should be segmented into areas that are beneficial and those that are damaging.

For example, proprietary data standards at Fannie and Freddie served to reduce data quality. They were not, or should not have been, a source of competitive advantage. Competition in pricing can be helpful if it reduces mortgage rates for consumers but harmful if it leads the firms to underprice risk. Moreover, insufficient competition can distort markets, such as in the old system in which Fannie and Freddie offered insurance premium (i.e., the guarantee fee) discounts to large-volume lenders that undermined overall underwriting quality. On the other hand, competing on customer service in working with seller servicers did and should continue to promote efficiency and better outcomes. The future secondary market should maintain incentives for participants to innovate in technology and infrastructure, to be as responsive as possible and increase the quality of their interactions with participants in the origination

market. These “competitive” aspects of the old and current systems are worth preserving and enhancing—and apply to additional firms competing in the securitization market.

Finally, as noted above, having multiple firms participate in securitization ensures a buffer in case any of them fail. No individual firm should be so essential to the functioning of the market or the economy that it must be rescued from financial distress. A market structure that allows new participants to enter can address some of the systemic risk concerns arising from a world with just one or two securitization gatekeepers.

## What Should a Reform Law Aim to Accomplish?

If the above is worth saving, what must we leave behind? That is, what change are we trying to bring about?

In our view, there are glaring needs. We believe the primary changes that housing finance reform must accomplish can broadly be bucketed into the following five categories:

- (1) **ELIMINATE EMERGENCY BAILOUTS.**
- (2) **BUILD SOME DEGREE OF CONSENSUS ON A MODERNIZED AFFORDABILITY AND ACCESS PARADIGM.**
- (3) **BRING MARKET SIGNALS, PRIVATE CAPITAL, COMPETITION, AND INNOVATION BACK TO THE MARKET, BUT WITH STANDARDS AND GUARDRAILS.**
- (4) **ELIMINATE HIDDEN OR IMPLIED GUARANTEES AND ALL VESTIGES OF THE CRONY CAPITALISM THAT CHARACTERIZE FANNIE AND FREDDIE’S CHARTERS.**
- (5) **ALIGN INCENTIVES AS MUCH AS POSSIBLE THROUGHOUT THE MORTGAGE ECOSYSTEM.**

In short, we advocate preserving the business functions provided by Fannie and Freddie that work and are needed in the secondary market. But the inherent conflicts need to go, and we need to rely far more on normal market mechanisms to analyze, price, and distribute risk across a wide set of participants rather than concentrate that risk in one or two entities. That brings us to change No. 1.

### (1) **ENSURE THAT WE HAVE NO MORE EMERGENCY BAILOUTS IN HOUSING**

The GSEs have been stuck in a state of limbo for the better part of a decade. That began with an emergency injection of capital in 2008, when Congress was forced to authorize the Treasury Department to do what many feared it would have to do in a crisis—use taxpayer money to make good on Fannie and Freddie’s guarantees because shareholder capital was woefully inadequate. Without the bailout, Congress would have risked a collapse of the housing market (not to mention the U.S. economy and the global financial system).

First and foremost, housing reform must design a system that ensures this will never happen again. One-fifth of our economy cannot rely on emergency congressional action to help the secondary market remain solvent. That’s not capitalism. We’re pretty sure it’s not socialism, either. It is crony capitalism. Labels aside, though, it’s not a smart systemic design, and it is not good public policy. So at its core, reform needs to minimize the likelihood of a situation in which Congress must bail out enterprises that enrich themselves with federal benefits, then send the bill to taxpayers when they get into trouble.

Of course, the injection of capital into Fannie and Freddie isn't the only thing that happened in 2008. Other major financial firms failed and were shut down (e.g., Lehman Brothers) or were merged out of existence by the government (e.g., Washington Mutual). Hundreds of banks, ranging from the largest megabanks to hundreds of small community institutions, received TARP funds to shore up their precarious capital positions or to help stabilize the financial system.

But in the aftermath, at least a law was passed that was designed to reduce the chance that the nation would go through this again. Dodd-Frank is certainly not perfect, far from it, and it remains to be seen whether the resolution authority in Title 2 would suffice to prevent bailouts in a future systemic crisis. But a significant step was taken for banks, and the debate about breaking them up remains a major part of today's policy conversation.

For the GSEs, however, no such reform has occurred. Yet we hear a growing chorus demanding that the companies be released from conservatorship and returned to the status quo ante.

We believe that would be a grave mistake. In 2008, Congress had to rescue Fannie and Freddie MBS investors (and the companies' debt holders). We can't have a system "capitalized" by shareholders in two institutions that are too big, too important, and too entrenched to fail. The risk concentrated in these entities must be distributed across the financial system so that markets can better manage risk and absorb losses when misjudgments are made.

We also need to be honest about certain economic and political realities. We cannot envision a world where Congress would allow a collapse of the nation's housing market without a meaningful response that involves taxpayers. The economic damage and follow-on costs such a collapse could impose and the systemic implications for financial markets make congressional action almost certain. So taxpayers already own the tail risk (or catastrophic risk). This put option was provided to Fannie and Freddie largely for free. It represents a failure of the old system and it needs to end. More than that, policymakers should include automatic stabilizers in the new system to act as shock absorbers in extreme economic conditions. With those in place, market participants would have greater certainty heading into a crisis, muting volatility.

## **(2) BUILD CONSENSUS ON THE OBJECTIVES OF ACCESS AND AFFORDABILITY POLICY, AND MAKE THEM TRANSPARENT AND ACCOUNTABLE**

Senate efforts to reshape the secondary market faltered in 2014 in no small part because some senators objected to changes made to the affordability paradigms that existed prior to conservatorship. As a reminder, the legislation would have replaced housing "goals"—the rules that govern what percentage of GSE guaranteed loans must be made to borrowers with low or very low incomes or who reside in low-income communities—with an off-budget, 10 basis point tax on mortgages flowing through the new system. This revenue would have directly funded homeownership and rental assistance programs.

Final negotiations never quite came to fruition, but the concept evolved into a "flex fee," with the tax increasing or decreasing depending on how much the private guarantors were servicing

designated markets. While the idea received high marks for transparency and accountability, time ran out before the concept could be finalized.

So reform should answer these questions: What is the goal of our affordability and access paradigm? Where do market mechanisms fail to work, and why? How do we most efficiently and effectively target and achieve homeownership access goals? How can we create a system that ensures equitable access for all Americans? Are area median income targeted goals the best way, or is there a better approach? Since real estate conditions are typically governed by local economic conditions, sometimes with differing laws, what roles should state and local housing agencies take? Most importantly, does the new secondary market structure ensure access for all eligible borrowers and lenders, or are additional mandates needed?

There can be both economic and social benefits to forcing some cross-subsidization of homeownership, thus lowering access costs for borrowers who are typically shown to be higher-risk. We should look first to programs that offer the most accountability, transparency, and opportunity for congressional oversight. If such programs are not working as desired, it is incumbent upon our elected officials to correct their shortcomings (or eliminate them). In addition, if the public policy goal of promoting homeownership for these families is to encourage long-term wealth building, we should think harder about whether our current approaches achieve that outcome. (For example, we incentivize debt over equity accumulation in many ways, including through the mortgage interest deduction.)

The fact is, the country has a regrettable legacy of redlining and discrimination in housing finance, some of it officially sanctioned in the early years of the FHA program. This history has imposed long-term costs on the victims. Low-income communities, in addition, often feel trapped between no access to credit and predatory lending. We would benefit as a country if we could envision a housing policy that not only ensured nondiscriminatory treatment but cultivated opportunities for those who face homelessness or struggle to find an affordable rental or confront enormous obstacles to starting on the wealth-building path of homeownership. Surely, with new thinking, we can find a more efficient approach to promoting affordable housing than what we have now.

In our view, an example of misguided assistance is approving a mortgage for someone who lacks the basic preparation for the responsibilities of homeownership. A better long-term approach would entail helping such a person to get prepared. That can include financial counseling, programs designed to repair credit, assistance in establishing a household budget, and assisting with a savings plan focused not just on a down payment but to help the future homeowner build a rainy day fund. And we must recognize that we have a serious problem when almost a quarter of renter households spend more than half of their income on rent.<sup>10</sup>

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10. <http://blogs.wsj.com/economics/2016/06/22/middle-income-families-are-increasingly-losing-ground-on-affordability-despite-a-housing-recovery/>.



Rather than maintain the standoff this type of policy discussion normally produces, we need to find new approaches. We submit that there may be room for agreement in the realms of using pre- and post-purchase counseling for first-time homebuyers; disbursing some funds to state and local entities that have proven successful as sustainable homeownership models; focusing on making rent more affordable; working with would-be homeowners to help them succeed, and making sure that access is maintained for low-dollar-amount loans and loans that require more underwriting resources but can be successful. Republican or Democrat, no one wants the taxpayer to support a system that only serves borrowers who would have received a loan anyway. We also do not want taxpayers to support a system focused on high-end rentals. We need a housing system that works for American households of all income levels. It starts with dialogue and openness to reform.

### **(3) BRING PRIVATE CAPITAL, COMPETITION, AND INNOVATION BACK TO THE MARKET, BUT WITH STANDARDS AND GUARDRAILS**

The government today dominates the secondary mortgage market. It sets the rules, prices the risk, and determines what products are acceptable or otherwise. We have lost many of the market forces we rely on in the rest of our financial system. Taxpayers continue to provide almost all of the capital that supports the secondary mortgage market. Yet before advocating for, and moving back to, a more market-based system, we must come to grips with how that market system contributed to the financial crisis and ensure that our reforms recognize and account for those failings. Here again, we need to separate baby from bathwater.

We do not subscribe to one-sided views of the cause of the financial crisis. We believe that strenuous efforts by policymakers to promote homeownership—such as housing goals in 2004 that encouraged subprime lending—contributed to market innovations that failed spectacularly. What is most regrettable is that these failures inflicted enormous damage on vulnerable households the policies and programs were supposed to help.

Yet while responding to government incentives and encouragement, mortgage originators and secondary market participants also pursued their own self-interest and operated in a remarkably predatory manner that hid risks as those risks were shifted around the system. And whatever one thinks about the government's culpability in promoting risky mortgage lending, no one forced the managers of these businesses to abandon their fiduciary responsibilities or their common sense. The end result, of course, caused enormous damage to homeowners and neighborhoods, but also harmed MBS investors, including regular folks such as families saving for retirement or for their children's education.

So in returning to a more market-based system, the government has a role promoting both consumer and investor protection. In particular, this means ensuring that markets operate transparently and competitively and are accessible to all. It also means markets should evolve to meet new circumstances and be allowed to innovate to better meet consumer needs. The hard lessons of the financial crisis also should instill in us a measure of humility as to the efficacy of efforts to promote market outcomes that are incompatible with the dynamics of risk and re-

ward. We should not ask private market participants to achieve social policy goals through a web of hidden subsidies and penalties. For starters, more transparency can be helpful.

The good news is we have already started down the road to such an outcome. Progress since 2013 in the credit-risk transfer market—the selling of mortgage credit risk away from Fannie and Freddie and back to private capital market—is the foundation. If reformers want to see more price signals to indicate where national mortgage rates should be, then the continued development of the credit-risk transfer market is essential. But its progress depends on the willingness of the FHFA (and Fannie and Freddie) to direct this risk away from taxpayers and back to market participants. Congress should make it clear that these programs are a permanent feature of the secondary mortgage market.

If government saw its role more as providing direct subsidies where needed and otherwise ensuring transparent and open markets supported by consumer and investor protections, the power of private markets to innovate and provide capital for housing would be unleashed. The root word of “capitalism,” of course, is capital, and today’s market relies largely on taxpayer capital, not private capital. But for now, with taxpayers guaranteeing roughly three of every four mortgages, the federal government is occupying the field. Market signals, innovation, and competition are stifled, precluding the full return of private capital to manage mortgage risk and heaping that risk on the backs of taxpayers.

#### **(4) ELIMINATE HIDDEN OR IMPLIED GUARANTEES AND ALL VESTIGES OF THE CRONY CAPITALISM THAT CHARACTERIZES FANNIE AND FREDDIE’S CHARTERS**

Of course, while market signals are important, housing is a critical human need, so it should come as no surprise that market failures, real or perceived, draw the government into this sphere. The FHA program is just one example. The mortgage interest tax deduction and GSE housing goals also reflect elected officials’ judgment that the socially optimal amount of housing finance is greater than what a purely market-based system would provide.

FHA is funded by its users and has direct access to the Treasury Department for revenue, so losses that exceed the program’s self-funding are transparently the responsibility of taxpayers. The program is managed by government officials who are paid at government pay scales, and the program is overseen by Congress.

As explained earlier, Fannie and Freddie operate in a different world. Pre-conservatorship, they were in a world of crony capitalism, privately owned but endowed with special privileges that enriched their operations. They regularly lobbied for more while fiercely protecting what they had. They were close to the government when it suited them (as when borrowing money in capital markets) and fully private when it didn’t (compare, for example, the salaries of Fannie and Freddie CEOs to that of the FHA commissioner).<sup>11</sup>

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11. In 2007, the year before the conservatorships, Fannie Mae’s CEO took home \$12 million and Freddie Mac’s CEO received \$18 million. The FHA commissioner earned less than \$200,000.

It is not illogical to look at the 78-year history of Fannie Mae and the 46-year history of Freddie Mac and conclude that a) they advanced their public mission and made positive contributions to creating a stable and liquid secondary mortgage market and b) their operating structure was horrendous for the systemic risk it built up and the corrosive effect it had on the body politic.<sup>12</sup> The challenge of reform is to ensure a stable and liquid secondary market as well as the systematic removal of all vestiges of the flaws inherent in the heads-I-win-tails-the-taxpayers-lose structure.

That means no more implied guarantees, no more exclusive charters that erect barriers to entry while granting operating advantages that reinforce such barriers. That means the new secondary mortgage market institutions must be able to fail without throwing our housing finance system, and indeed the global financial system, into turmoil. That means the system must be transparent and all market participants must face the same capital and operating requirements.

#### **(5) ALIGN INCENTIVES THROUGHOUT THE HOUSING SYSTEM**

The lack of incentive alignment has been a significant failing of the old and current models. These misalignments came in all sorts of flavors: originators who had no skin in the game on mortgage performance; second-lien holders who serviced first liens owned by someone else; homeowners who used their houses as ATMs to take out equity through second mortgages and equity lines of credit; brokers who had incentives to help investors commit fraud and lenders who helped borrowers do the same; appraisers who lost their jobs if they didn't hit their numbers; servicing compensation rules that didn't help troubled borrowers when markets became unglued; no one helping homeowners understand the costs along with the benefits.... We could go on.

The bottom line is that mortgage credit risk should not be a "hot potato" passed from one institution to the next, where it is always someone else's problem (and ultimately becomes the responsibility of government). Lenders and secondary market firms can't be in the business of getting rich by handing the government the burden. GSEs can't be in the business of getting rich by gambling that the taxpayers give them a free put option. Shareholders can't be in the business of getting rich by knowing that the companies they own can never go under.

There is a way to help right these wrongs, and it involves aligning incentives. Reform should help everyone who operates in the mortgage ecosystem have a stake in its collective success. It should incentivize the buildup of equity, not just debt. It should put everyone's skin in the game—borrowers, servicers, lenders, guarantors, and the government.

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12. See, for example, Owen Ullman, "Crony Capitalism: American Style," *The International Economy*, July/August 1999. [http://www.international-economy.com/TIE\\_JA99\\_Ullmann.pdf](http://www.international-economy.com/TIE_JA99_Ullmann.pdf).

## Consequences of Inaction

Before concluding, we should remind readers of some potential consequences of inaction. The 114th Congress has been largely absent from the debate about housing finance reform. With the notable exception of two laws that actually passed—one that restricted CEO compensation at Fannie Mae and Freddie Mac and one that placed limitations on the sale of Treasury-owned shares in the enterprises (the so-called “Jumpstart GSE Reform” bill)—little has occurred.

This was perhaps a consequence of “housing finance exhaustion” after the previous Congress saw two efforts stall after devoting much time and resources. Such exhaustion is understandable, but dangerous. It is fortunate that efforts to bring in market signals and unify the enterprises’ securitization functions have continued during this time. But it should not be taken for granted that we will remain on this trajectory absent congressional oversight.

The first glaring consequence of inaction could be Fannie and Freddie’s entrenchment into our economy in some barely evolved version of their old selves. Without more guidance from Congress, for example, the FHFA and the GSEs could very well choose to position themselves as the gatekeepers of mortgage credit for the entire market. We are concerned that congressional inaction could lead the enterprises to further embed themselves into the markets, not further move them and taxpayers out of harm’s way. Unless lawmakers are involved, this will be left to chance.

Which brings us to the next risk of inaction: The FHFA was never envisioned as the permanent manager of the enterprises. It was meant to be their regulator. While the Housing and Economic Recovery Act of 2008 gave the FHFA more authority than the previous Fannie/ Freddie regulator (the Office of Federal Housing Enterprise Oversight) had, we could be on a march back to the days when Fannie and Freddie had more political influence than did their regulator. Politicizing FHFA leadership positions could, for example, easily neuter the agency and give the GSEs even more sway than they held in the 1990s. Such an outcome should terrify policymakers on all sides.

The current FHFA director and his predecessor (a co-author of this paper) have repeatedly spoken of the need for Congress to provide direction to the agency and, more importantly, to the entire market. As we noted earlier, we are talking about one-fifth of the American economy. Our elected representatives are responsible for crafting a vision for the future of housing markets and housing policy.

The third risk is that another economic downturn could lead to large losses at the enterprises, another round of taxpayer assistance, potential market disruptions, and legislation crafted in a crisis with decisions made in the heat of the moment. No one who cares about housing should want such an outcome, not even those who believe it would put the political wind at their backs. And besides, waiting for such a moment is a dangerous strategy, in part because...

...inaction could thwart the nascent development of the credit markets, which have shown signs of life in recent years. These markets have even begun developing modernized infrastructure to price, hedge, and manage mortgage credit risk.

What worries us most is that a lack of meaningful supervision by Congress creates a dynamic in which the players do not act with the good of the broader ecosystem in mind. It is not difficult to envision people fighting to protect their turf, allowing egos to drive decisions, and making speeches designed to provide political cover in the event of a capital shortfall rather than doing the hard work to structurally redirect risk away from the Treasury Department's backstop. All of this is corrosive to not only the functioning of the markets but to Congress' ability to monitor the functioning of our economy.

## **Incremental Administrative Steps While Reform Percolates**

There are a series of steps that the FHFA and the GSEs should take while policymakers wrestle with the contours of long-term reform. The FHFA should continue to embrace various forms of credit-risk transfer to bring in private capital and identify price signals. The recent FHFA scorecard moves in this direction but could do so much more forcefully. It also builds on these efforts substantively by proposing that a formal request for information be disseminated to gather market feedback. We hope that the FHFA and market participants continue to advocate for risk transfer and, in particular, the kind that lessens dependence on Fannie and Freddie's GSE structure and is aimed more at long-term solutions. To us, if there is one incremental reform that is crucial to continuing the momentum we have, this is it.

Two other steps stand out. The common securitization platform should be broadened beyond Fannie and Freddie in anticipation of other issuers' accessing this platform in the future. And the conforming loan limit should not be allowed to increase. There is no justification for expanding GSE subsidies and taxpayer protection at the upper end of the price distribution as the market recovers and the enterprises remain supported by taxpayers.

What makes no sense to us whatsoever is the idea that the enterprises themselves should be returned to their prior role and structure. Prior to conservatorship, there was a long history of warnings from analysts that this GSE structure was bound to fail at taxpayer expense. With those forecasts realized, we should not fall back on that broken system just because achieving political consensus is hard and will need more time.

## **Conclusion**

This initial paper in our series outlines the objectives of reform as we see them because we believe it is important to identify what we are trying to accomplish before we craft a comprehensive reform plan. We recognize that achieving these objectives will require hard work. We also recognize that they won't attract universal agreement, although we believe most of what we have set forth is closely aligned with objectives in many other reform proposals. We are also well aware that the system needs to get from point A to point B without disruption. Transition matters. Any reform legislation should allow for a sufficient transitional period.

We believe, however, that reform is possible. As we stated earlier, important steps have already been taken to move our housing finance system down this path.

There are going to be tradeoffs and compromises along the way. Some of these objectives may prove politically challenging at first. But lawmakers need to get serious about these issues, and they need to get going.

## Next Steps

In forthcoming papers, we intend to define an approach consistent with the goals described here, addressing what we see as the three broad categories of housing finance reform that Congress must tackle. Specifically, we will present:

- A detailed proposal for a secondary mortgage market structure that enables capital markets to operate efficiently, safely, and soundly. This structure would replace the failed GSE structure while combining market mechanisms with appropriate government standard setting, oversight, and transparent support to ensure a deep and liquid market.
- A modernized framework for housing policy that would allow federal programs to address market failures, achieve socially and economically desirable outcomes, and innovate to deal with challenges families face finding affordable rental properties or reaching that first rung on the ladder of homeownership.
- An inventory of legal and institutional structures that support our housing finance system but are in great need of modernization. From appraisals to mortgage registries and beyond, we need legislative changes to bring important components of our housing finance system into the digital age.

## About the Authors

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Ed DeMarco is a senior fellow in residence at the Milken Institute. Prior to that, he was a 28-year civil servant, culminating with his role as acting director of the Federal Housing Finance Agency from September 2009 to January 2014. There he dealt with the challenges of managing the mega-institutions Fannie Mae and Freddie Mac. DeMarco crafted the 2012 FHFA Strategic Plan for Enterprise Conservatorships and the associated scorecards and set into motion the credit-risk transfer and common securitization initiatives that underpin administrative efforts today.

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