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Reforming the Housing Finance Sector

A Summary of Key Factors in Treasury's report on *Reforming America's Housing Finance Market*

Treasury's white paper on reforming the housing finance market provides a framework for discussions going forward. It is short on prescriptive recommendations but the overall direction being championed by the White House is evident. The report makes very clear that the administration wants to bring private capital back to the housing finance business and reduce the role of the government. The white paper, entitled *Reforming America's Housing Finance Market*, provides 1) an assessment of the recent flaws in housing finance, 2) a list of objectives for reforming the housing finance market, and 3) three potential models for the future of housing finance.

Most relevant for GSE debt investors, Treasury affirms very strong support for GSE debt already issued and issued in the future. Reform of the housing finance sector is proposed to include a gradual winding down of Fannie Mae and Freddie Mac. The proposal calls for their balance sheets to be reduced at a rate of no less than 10% per year which will result in a shrinking agency debt market. In the interim period before a new system of housing finance can be developed, Fannie and Freddie will continue to operate. However, as their fees are raised and loan limits reduced, Treasury hopes that private actors will increase their market share. The following summary highlights some key aspects of Treasury's report including the factors that will affect debt investors and the three potential models for reform.

KEY ASPECTS OF TREASURY'S REPORT

■ Quasi-private role championed by Treasury

"We must be careful not to let that debate keep us from the immediate task at hand: we need to scale back the role of government in the mortgage market, and promote the return of private capital to a healthier, more robust mortgage market."

All of the three proposed models for the future of housing finance rely most heavily on private capital. Equally noteworthy is that all three of the models contain at least some role for the government. The fact that Treasury has now taken full nationalization and full privatization completely off the table is surely the most surprising element of the proposal.

■ Fannie Mae and Freddie Mac to reduce market share over time

"Fannie Mae and Freddie Mac's profit-maximizing structure undermined their public mission, …perceived government backing conferred unfair advantages, …capital standards were unfair and inadequate, …regulator (OFHEO) was structurally weak and ineffective."

The heart of the reform process is the shrinking of housing behemoths Fannie Mae and Freddie Mac. Treasury proposes accomplishing this objective by increasing guarantee fees, lowering loan limits (set to occur in October 2011 absent Congressional action), increasing the required down payments, among other price increases. These objectives seem to be more feasible politically than implementing wholesale reforms immediately. As these are phased in, Treasury's hope is that private actors will recognize the opportunity to take market share because of better pricing power and gradually become a larger factor. Some of these

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changes have already occurred and private financing has re-emerged, albeit at a very slow pace. The same changes are proposed for FHA. However, FHA is proposed to eventually fulfill Fannie and Freddie's historic role of providing targeted government incentives for those who would be left out of private capital's net. Long term, FHA may not shrink as much as Fannie and Freddie as a result.

■ Stronger consumer protections

"Stronger underwriting standards, including requiring lenders to verify ability to pay."

One of the key objectives of the report is to provide stronger consumer protections. There is much verbiage dedicated to this goal and it is largely being accomplished through new regulations emerging from the Dodd-Frank Act.

■ A new commitment to affordable rental housing

"This does not mean all Americans should become homeowners."

The government has advocated for years the idea that homeownership is a worthy goal for Americans. An "ownership society" has benefits that are worth pursuing with government policies and economic incentives has been the mantra. However, Treasury's report seems to mark a shift in that focus to a new reality, that homeownership is not right for all people. The report calls for funding sources to be directed to rental opportunities. According to the report, "For every 100 extremely low-income American families, for example, only 32 adequate rental homes are affordable."

■ Basel III capital standards endorsed

"The Basel III Capital Accords will substantially increase the overall amount of capital that banks are required to hold on their balance sheets."

Part of the problem with the housing finance sector was a lack of capital sufficient to withstand the storm. Rather than recommending new capital standards, Treasury points to the Basel III capital standards as being appropriate.

FACTORS AFFECTING GSE DEBT INVESTORS

■ Strong support for GSE debt from Treasury

"Our commitment to ensuring Fannie Mae and Freddie Mac have sufficient capital to honor any guarantees issued now or in the future and meet any of their debt obligations remains unchanged."

"The Administration will not pursue policies or reforms in a way that would impair the ability of Fannie Mae and Freddie Mac to honor their obligations."

There are several important factors for investors in GSE debt to take from the report. First and foremost, Treasury signals a very strong commitment to GSE debt saying they will ensure sufficient capital to "honor any guarantees issued now or in the future" and "the Administration will not waver from its commitment," the report says. Investors in GSE debt should be re-affirmed by the strength of Treasury's commitment.

■ Reform will be slow

"Given the still-fragile state of the housing market, implementing these reforms fully will take time."

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Treasury is very cautious about the pace of change, frequently warning that moving too fast will disrupt the housing market and broader economic recovery. This means than any changes will be slow to occur and it could be several years before there are significant shifts in the debt markets.

■ FHLB system will be included in the reform process

"But these institutions also developed significant weaknesses as the housing market evolved that should be addressed as part of housing finance reform."

Treasury indicates that the FHLB system suffered from some of the same foundational problems that plagued Fannie and Freddie. As such, they recommend including the FHLBs in the reform process as well.

■ Agency debt markets will shrink

"The PSPAs require a reduction in this risk-taking by winding down their investment portfolios at an annual pace of no less than 10 percent."

The agency debt market (callables and bullets) will feel the effect of the wind-down of Fannie and Freddie which calls for a 10% per year reduction in the size of their investment portfolios. Given that Fannie and Freddie's investment portfolios are funded by their debt issuance, there should be roughly 10% net negative issuance of their debt securities annually. In addition, other GSEs should not be expected to pick up the slack as the administration is calling for a reduction in FHLB's investment portfolio and limits on its lending to large institutions. Both the agency debenture (bullets and callables) and MBS sectors will likely shrink in the coming years. Both sectors stand to benefit from scarcity and should see spreads tighten.

THREE MODELS OF REFORM TO CONSIDER

■ The model should not be a fully nationalized nor fully privatized system of finance

"The Administration believes that the right course falls between these two extremes."

"While each of these approaches has positive attributes, the Administration does not believe that either represents a viable long-term strategy for the nation's housing market."

■ *Option 1: Privatized system of housing finance with the government insurance role limited to FHA, USDA and Department of Veterans' Affairs' assistance for narrowly targeted groups of Borrowers*

Pros

- Minimizes distortions in capital allocation across sectors (less incentive to invest in housing so capital flows to other sectors of the economy)
- Reduce moral hazard in mortgage lending (private actors are not as inclined to take on excessive risk without government assurance)
- Drastically reduces direct taxpayer exposure to private lenders' losses (only exposure would be to FHA and narrowly targeted government loan programs)

Cons

- The cost of mortgage credit for those who do not qualify for an FHA-insured loan – the majority of borrowers – would likely increase.
- Notably higher mortgage rates
- 30-year mortgages may be difficult to find

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- Small lenders and community banks could struggle to compete outside of the FHA segment (they are better at lending in smaller communities than the large banks)
- Reduces ability of the government to effectively step in to ensure access to capital during a crisis (could exacerbate a downturn)

■ ***Option 2: Privatized system of housing finance with assistance from FHA, USDA and Department of Veterans' Affairs for narrowly targeted groups of borrowers and a guarantee mechanism to scale up during times of crisis***

Pros
- Allows the government to step in during times of crisis to ensure access to capital
- Minimizes distortions in capital allocation across sectors (less incentive to invest in housing so capital flows to other sectors of the economy)
- Reduce moral hazard in mortgage lending (private actors are not as inclined to take on excessive risk without government assurance)
- Drastically reduces direct taxpayer exposure to private lenders' losses (only exposure would be to FHA and narrowly targeted government loan programs)

Cons
- Hard to manage a framework that can sufficiently expand during times of crisis
- There would always be concerns as to how well this could scale up during tougher times
- Would likely cause 30-year mortgages rates to be even higher than Option 1

■ ***Option 3: Privatized system of housing finance with FHA, USDA and Department of Veterans' Affairs assistance for low- and moderate-income borrowers and catastrophic reinsurance behind significant private capital***

"A group of private mortgage guarantor companies that meet stringent capital and oversight requirements would provide guarantees for securities backed by mortgages that meet strict underwriting standards. A government reinsurer would then provide reinsurance to the holders of these securities, which would be paid out only if shareholders of the private mortgage guarantors have been entirely wiped out."

Pros
- This likely provides the lowest-cost access to mortgage credit of the three options
- The reinsurance would likely attract a larger pool of investors to the mortgage market, increasing liquidity (allowing for continuation of 30-year)
- Provides a more competitive playing field for smaller lenders and community banks
- The government reinsurer's broad presence in the market could put it in a position to scale up to provide credit during a time of stress (easier process than first two options)

Cons
- The increased flow of capital into the mortgage market would distort capital flows and could lead to another bubble in housing assets
- The reinsurance of private-lending activity, by its nature, exposes the government to risk and moral hazard

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