



A Responsible Market for Housing Finance

A Progressive Plan to Reform the U.S. Secondary
Market for Residential Mortgages

Prepared by the Mortgage Finance Working Group January 2011
Sponsored by the Center for American Progress

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About the Mortgage Finance Working Group and this report

This proposal is a product of the Mortgage Finance Working Group sponsored by the Center for American Progress, with the generous support of the Ford Foundation, and the Open Society Institute. The members of this working group began gathering in 2008 in response to the U.S. housing crisis in an effort to collectively strengthen their understanding of the causes of the crisis and to discuss possible options for public policy to shape the future of the U.S. mortgage markets. Unless otherwise noted, this proposal represents the views of the members whose names are below, in their individual capacities. Affiliations are provided for identification purposes only.

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Relationship to earlier work by the Mortgage Finance Working Group

In December 2009, our group released a draft of this report. This version supersedes that draft.

In July of 2010, we submitted a Response to the Departments of Housing and Urban Development and Treasury’s notice and request for information (eDocket Number HUD-2010-0029) that included a slide deck describing our proposal in response to Question 4. This report supersedes that slide deck.

In October 2010, the multifamily subcommittee of the Mortgage Finance Working Group released a paper entitled “[A Responsible Market for Rental Housing Finance](#).” This report incorporates that paper by reference and does *not* supersede it, except to the extent it refers to terminology from earlier versions of the MFWG proposal that are not in this White Paper.

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Introduction and summary

In the years prior to the Great Depression, American housing finance was characterized by wild boom-and-bust cycles, regionally disparate prices, and short-term balloon mortgages that severely restricted opportunities for average Americans to own a home. For close to 70 years following the reforms of the 1930s, that all changed. Well into the late 1990s, mortgage finance was continuously available, under terms and at prices that made sustainable homeownership available. A critically important element of this system was the development, starting in about 1970, of an effective secondary market for home mortgages—a marketplace where individual home mortgages are sold by lenders and packaged into mortgage-backed securities that can be sold to investors in the United States and around the world. This pool of capital provided widening opportunities for wealth accumulation for many American families, and supported significant, although not necessarily sufficient, quantities of affordable rental housing.

For some communities in our country, however, credit was constrained, leaving credit worthy borrowers behind. During the 1980s and 1990s, Community Development Financial Institutions, Community Development Corporations, and nonprofit organizations of all types, in partnership with local governments, mortgage lenders, and secondary market institutions demonstrated successful ways to discern the credit-worthy borrowers in underserved communities and to extend them safe, affordable mortgages. Unfortunately, just as these good innovations were picking up speed, so too were predatory mortgage finance products such as adjustable-rate mortgages with pricing gimmicks designed to encourage potential homeowners to borrow far more than they could manage.

These disastrous products exploded in volume, stole market share from the mainstream housing finance system, launched a precarious race to the bottom, and drove out sustainable affordable lending. Most of the predatory products were packaged into so-called private label mortgage-backed securities—securities backed by home mortgages that were not eligible to be guaranteed by the U.S. government-sponsored entities Fannie Mae and Freddie Mac, the two mortgage

finance giants. In 2008, the system collapsed in a hail of badly designed loans, mispriced risk, excessive leverage, and lack of supervision, greatly exacerbating the Great Recession.

Today, the federal government backstops some 90 percent of all home mortgage loans. Nearly half of the new home loans are guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, or the Department of Agriculture's Rural Housing Services programs. Almost all other home mortgage loans and most mortgage refinancings are financed through Fannie Mae and Freddie Mac, both of which are now in government conservatorship. The private secondary market in home mortgages disappeared in 2008 and remains moribund. Fannie Mae and Freddie Mac also now purchase more than 80 percent of all multifamily mortgages, loans to owners, and developers of rental residential properties. This new status quo is unsustainable.

We have the knowledge and the tools to create an American housing finance system that will be stable over the ups and downs of the economy—a system that relies upon private capital to equitably serve homeowners, renters and landlords, lenders, investors, and the larger American economy while promoting residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing in all urban, suburban, and rural communities. The first step taken was Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, named after its two main sponsors, Sen. Christopher Dodd (D-CT) and Rep. Barney Frank (D-MA), which provides for creditable supervision of our nation's banking and securities system, including greater standardization and transparency of mortgage-backed securities, and enhanced consumer protection for home mortgages.¹

The next step is to move away from our current nationalized mortgage finance system toward a system that once again relies on private-sector capital, through both depository institutions and the secondary mortgage market, to provide the bulk of mortgage finance for American homeowners and owners of rental property. This new mortgage finance system should be guided by five overarching principles:

- **Liquidity:** Provide participants in the capital markets with the confidence to deliver a reliable supply of capital to ensure access to mortgage credit, every day and in every community, through large and small lenders alike

- **Stability:** Rein in excessive risk taking and promote reasonable products backed by sufficient capital to protect our economy from destructive boom-bust cycles such as the one we are now struggling to overcome, and the ones that used to plague our economy before the reforms of the 1930s
- **Transparency and standardization:** Require underwriting, documentation, and analytical standards that are clear and consistent across the board so consumers, investors, and regulators can accurately assess and price risk, and regulators can hold institutions accountable for maintaining an appropriate level of capital
- **Affordability:** Ensure access to reasonably priced financing for both homeownership and rental housing
- **Consumer protection:** Ensure that the system supports the long-term best interest of all borrowers and consumers and protects against predatory practices

These principles form the framework for this proposal. We also focus on three specific goals:

- Preserving the availability of 30-year fixed-rate mortgages, which allow families to fix their housing costs and thus better plan for their futures in an ever more volatile economy
- Rebalancing U.S. housing policy so that private markets are the primary source of decent affordable rental housing, with public support where deep subsidy is needed
- Ensuring that a broad array of large and small mortgage lenders (such as community banks, credit unions, and Community Development Financial Institutions) have access to secondary market finance so that they can continue to provide single- and multifamily mortgage loans in every community across our country

To develop a new mortgage finance system based on these principles and with these goals in mind, we approached the problem by dividing both the homeownership and rental housing markets into three parts:

- Underserved borrowers or tenants, whose housing needs (whether as homeowners or renters) may require some direct government support

- Middle-market borrowers or tenants whose housing needs require secondary market liquidity and long-term finance, both of which can be achieved through a limited government backstop of the mortgage finance marketplace
- Higher income and wealthy borrowers and tenants, whose housing needs require government financial intervention only when mortgage markets freeze

Purchasing a home is one of the most important financial decisions most Americans will ever make. But the transactions between borrower and lender that happen in this primary market represent only a part of the housing finance system. To fund mortgage loans for homeowners and support rental housing, lenders need access to a pool of capital that in turn depends on a transparent, effectively regulated secondary market. This paper is concerned primarily with the secondary market, and in particular, the mortgage-backed securities market, which currently has about \$9 trillion in securities outstanding.

Today (as before the crisis), the largest participants in this housing finance market are Fannie Mae and Freddie Mac. These two mortgage finance giants are currently in conservatorship and essentially owned by the federal government.² They perform an array of secondary market functions that together provide financing for a significant portion of our nation's rental housing and enable Americans to access long-term, fixed-rate mortgage finance. Access to stable, long-term mortgages is a key to household stability and a means to accumulate assets that support retirement, education, and other family responsibilities.

Specifically, Fannie and Freddie buy loans from lenders. They hold some of these loans, particularly multifamily loans, on their balance sheet. But for the most part, the companies issue securities backed by those loans—mortgage-backed securities, or MBS. They also guarantee investors the timely payment of interest and principal on those securities, relieving investors of concerns about credit risk.

Fannie and Freddie provide investors with a basis for confidence that the securities will perform, as their own credit guarantee is backed by an implied—and since conservatorship, effectively explicit—guarantee by the U.S. government against the corporation's failure. With that backstop, investors believe there will be a market for any MBS they may wish to sell later, regardless of economic conditions. The result is a deep and liquid market for mortgage-backed securities that was able to continue to operate in 2008 even when other capital markets were frozen. Fannie and Freddie, with their government backing, were able to provide

the countercyclical liquidity that kept mortgage money available when private firms without government backing could not do so.

The mortgage crisis occurred because we got away from the fundamental principles that guided the system for more than 70 years, and ignored the irresponsible actions of financial institutions and the dangers of unregulated, opaque markets. We know that when U.S. mortgage finance was essentially a purely private endeavor prior to the reforms of the 1930s, it failed. But we also know that the dominant role now played by the government through the conservatorship of Fannie and Freddie, and through federal agencies such as the Federal Housing Administration, which provides direct government guarantees, needs to be significantly reduced.

In short, we need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs. Any government guarantee must be explicit and paid for; we must avoid a repetition of the uncompensated implicit government guarantee that backed Fannie and Freddie before they collapsed into government conservatorship.

The challenge for policymakers is to reform the American housing finance system and create a new system that supports the American dream of homeownership, provides a sufficient stock of affordable rental housing, and restores integrity and accountability to the system. This new system must protect consumers and the broader economy from the predatory loans, excessive leverage, and lack of regulatory supervision that caused the recent financial crisis and led to an unsustainable reliance on federal government intervention in the mortgage market.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, with its reforms of the banking and securities systems, and enhanced consumer protections for mortgages and investor safeguards for mortgage-backed securities, was the first step. We build on these reforms and propose a system that preserves the traditional roles of mortgage originators but separates some of the functions previously provided by Fannie and Freddie, into the hands of three different actors: issuers, Chartered Mortgage Institutions, and a Catastrophic Risk Insurance Fund. These three actors would interact in this new system in the following way:

- Issuers are fully private entities that originate or purchase and pool loans, and issue mortgage-backed securities. Where the MBS themselves and the loans backing them meet certain standards, issuers may purchase credit insurance on the MBS from the new Chartered Mortgage Institutions for the benefit of their investors.

We need a new system that is capitalized with as much private capital as possible while still serving the nation's housing needs.

- Chartered Mortgage Institutions are fully private institutions, not owned or controlled by originators (other than potentially through a broad-based cooperative structure), chartered and regulated by a federal agency. These CMI's would provide investors in mortgage-backed securities a guarantee of timely payment of principal and interest on the securities, typically issued by others, backed by loans eligible for government support through the Catastrophic Risk Insurance Fund.
- The Catastrophic Risk Insurance Fund would be a government-run fund fully accounted for in the federal budget and funded by premiums on CMI-guaranteed mortgage-backed securities. The new fund would provide in exchange for these premiums an explicit guarantee of the Chartered Mortgage Institutions' obligations in the event of their financial failure. The government would price and issue the catastrophic guarantee, collect the premium for the guarantee, and administer the Catastrophic Risk Insurance Fund, much like the Federal Deposit Insurance Corporation's Deposit Insurance Fund. The new Catastrophic Risk Insurance Fund would set the product structure and underwriting standards for mortgages that can be put into securities guaranteed by the CMI's and securitization standards for MBS guaranteed by the CMI's.

To protect taxpayers and ensure that all requirements for the guarantee are met, the federal government also would regulate the Chartered Mortgage Institutions for both capital adequacy and compliance with consumer protection and other responsibilities. Finally, the government would serve as conservator or receiver for CMI's that fail, with responsibilities that include ensuring that the servicing of the remaining guaranteed securities is carried out by a qualified entity.

The primary function of CMI's would be to provide investors with assurance of timely payment of principal and interest on mortgage-backed securities that are eligible for the government guarantee. The CMI's would be allowed to hold some loans in their own portfolios, such as troubled loans removed from mortgage-backed securities as well as some multifamily mortgages, which are not easily securitized, but such on-balance-sheet activities would be limited.

The government would guarantee that in the event of the failure of the CMI investors would continue to receive timely payment of principal and interest on CMI-guaranteed mortgage-backed securities that meet product structure, underwriting, and securities structure standards. The government guarantee would be explicit and appropriately priced, and the proceeds would be held in a Catastrophic Risk Insurance Fund. The CMI's equity, which would be set by the government at significantly higher than levels required of Fannie Mae and Freddie Mac, as well

as borrower equity and, in some cases, private mortgage insurance, would stand ahead of the Catastrophic Risk Insurance Fund in the event of a CMI failure. The Catastrophic Risk Insurance Fund would only be exposed to losses if a CMI collapsed, wiping out its shareholders and most of its creditors. Neither the equity nor the corporate debt of the CMIs would have any government backing.

Under this proposal, we estimate the cost of a 30-year fixed rate mortgage would probably increase about one-half of 1 percent, or only 50 basis points. Based on today's market that would bring prices back to the level of July 2009—a small price to pay for a robust mortgage market supported largely by private capital.

Our reforms will create a system that will serve the needs of the vast majority of those households that are looking for the consistent availability of affordable credit and predictable housing costs, which can be achieved through a limited government market backstop. There will continue, however, to be underserved borrowers, tenants, and communities, whose housing needs (whether as homeowners or renters) may require some direct government support. To ensure a housing market that effectively combines private capital and public support in a continuum that effectively serves all, we propose three parallel strategies.

First, the Federal Housing Administration would be preserved and granted additional authorities to ensure that they have the talent, systems, and flexibility to meet their public purposes and protect taxpayers from risk. Housing programs run by these agencies provide a level of support, primarily through credit enhancement, to support homeownership opportunities for families with lower incomes and limited resources, as well as to enable landlords to provide affordable rental housing to low- and moderate-income households.

Second, each Chartered Mortgage Institution would have an obligation to provide an equitable outlet for all primary market mortgages (other than those with direct government insurance) meeting the standards for the guarantee of well-designed, sustainable loans, rather than serving only a limited segment of the business such as higher-income portions of that market. With respect to multifamily lending, CMIs that securitize multifamily loans would be required to demonstrate that they are providing housing for working households. In addition, CMIs would be required to provide service to areas of specific concern identified annually, such as shortages created by natural disasters, rural housing, and small multifamily housing.

Third, we propose the creation of a Market Access Fund, financed by a small fee on all mortgage-backed securities. The Market Access Fund would, on a competitive and shared-risk basis, provide credit enhancement and research and development funds to promising but untested mortgage finance products that could better serve underserved markets. Market Access Fund credit enhancements, unlike Federal Housing Administration guarantees would back only a portion of the risk of a loss and would be available only for a limited period of time. The fee on all mortgage-backed securities would also fund the National Housing Trust Fund and the Capital Magnet Fund, two funds that provide finance to states and Community Development Financial Institutions primarily to support affordable rental housing, and which were to have been funded by Fannie Mae and Freddie Mac before they fell into conservatorship.³

The new mortgage finance structure we propose will provide stable, broad-based, privately capitalized housing finance so long as the entire mortgage market is subject to strong and consistent regulation. The reforms to the broader mortgage market enacted in the Dodd-Frank Act must be implemented to adequately protect against another race to the bottom. Our paper recommends careful attention to the implementation of the new rules.

We believe our proposal will restore the opportunity of homeownership as one of the fundamental tenets of the American Dream, and to ensure that abundant rental properties are available so that all Americans have access to decent shelter at a reasonable price. From the 1930s to the late 1990s the United States enjoyed a vibrant, stable, housing market that evolved to provide mortgage money at all times, in all parts of the country, for sustainable homeownership and rental housing. The system was not perfect, but as we rebuild we have much to learn from what worked in the period before negligent oversight allowed market distortions to implode our economy.

Our proposal builds on those lessons to construct a housing finance system characterized by liquidity, financial stability, transparency, standardization, affordability, and consumer protection. In the pages that follow, we will examine why the current housing finance system is unsustainable, and offer a detailed proposal for reform that simultaneously can achieve these goals and put private risk capital back at the center of mortgage finance.

As policymakers in the Obama administration and Congress begin to debate the future of the housing finance system, we have the opportunity to transform the system so it serves this nation even better and longer than did the system established in the 1930s. The job is substantively complex and politically challenging but essential. Our proposal recognizes these challenges and offers a comprehensive approach to create an American housing finance system that will be stable over the ups and downs of the economy and will equitably serve homeowners, renters, landlords, lenders, investors, and the larger American economy.

Time for reform

Shortly, housing and finance policymakers in the Obama administration and on Capitol Hill will be deep in debate about how to reform the nation's housing finance system, which imploded by the fall of 2008 and is now functional only because the government effectively guarantees about 90 percent of all new mortgages. Major reforms are necessary, both to rein in the systemic risks to our housing and financial markets that became apparent over the past decade, and to recalibrate the balance between homeownership and rental housing. These reforms will have enormous impacts on U.S. households.

In the wake of the mortgage crisis, a consensus emerged that the new post-crisis housing finance system will require large changes to Fannie Mae and Freddie Mac and might even require their elimination. But for decades, Fannie and Freddie were critical to the efficient functioning of the nation's housing finance system, serving as the engine of mortgage finance for middle-class Americans. Policymakers must carefully consider how to ensure that the public purposes served by these entities continue to be achieved.

Lessons learned

The past decade exposed some major flaws in our housing finance architecture.⁴ The availability of mortgages was wildly cyclical, resulting in excessive mortgage credit during the housing boom, followed by a nearly complete withdrawal of credit when the bubble burst. The risk of many of the mortgages originated during the housing bubble was underpriced. At the same time, these mortgages were not sustainable for consumers, as low teaser rates and opaque terms masked their high overall cost over time.

The housing bubble was driven by the development of a “shadow banking system” in which mortgage lending and securitization was largely unregulated and certainly undisciplined, in time drawing quasi-governmental entities Fannie Mae and

Freddie Mac to increase their own overall risk during the “race to the bottom” that implicated almost all mortgage lenders during the 2000s. In particular, as Fannie Mae and Freddie Mac lost market share to private mortgage-backed securities issuers who were underpricing risk, the two mortgage finance giants lowered their own underwriting standards and increased their leverage in an attempt to compete. The result: Taxpayers were left exposed to major losses.

Among the lessons we should take away from this recent experience:

- Private mortgage markets are inherently procyclical, meaning they tend to provide too much credit during housing booms and too little credit during downturns, inflating bubbles and deepening downturns.
- In the absence of government strictures or incentives, private lending practices tend to customize products with shorter durations, adjustable rates, and other features that transfer risk to borrowers who are often unable to understand or manage the risk.
- The proliferation of nonstandard mortgage products such as those that flourished for a time amid the most recent housing bubble creates opacity and reduces market discipline, both for consumers and investors.
- Risk oversight must be imposed over the entire mortgage finance system because private capital will naturally go to those products, entities, or structures where capital requirements and regulatory oversight are lower or nonexistent, creating the kind of race to the bottom that we just experienced.
- Borrowers and lenders each have limitations in their ability to manage risk, but lenders are better equipped to deal with it as they have diversified portfolios, more resources to evaluate risk, and access to complex financial instruments for hedging against risk. Moreover, they are subject to supervision that should help to identify risk.
- Government support, where it exists, should be explicit, priced, and tailored to the purposes being served so that taxpayers are not unduly at risk.
- Gaps exist in the mortgage market—gaps that typically fail to direct sufficient affordable capital in a sustainable manner to underserved sectors, including low- and moderate-income borrowers, economically distressed regions and communities, and affordable multifamily rental housing.

- Affordability should be considered on a holistic basis, rather than in terms of short-term metrics (such as increases in the homeownership rate). The most problematic loans of the recent housing bubble were those that provided the illusion of affordability, such as through low “teaser rates” and negative amortization, but which were unsustainable over the long run.

Learning these lessons, the mortgage finance system of the future must be characterized by ample liquidity, financial stability, transparency, standardization, affordability, and consumer protection. Before detailing how these principles should be enshrined in a new housing finance system, let’s first step back to examine the reason why a government role in our mortgage markets, particularly secondary mortgage markets, is so critical to our national economic well being, our shared prosperity, and for the common good of everyone seeking affordable shelter.

A government role is necessary for smoothly functioning mortgage markets

Our proposal starts with the fact (drawn from experience) that a government role is necessary for a smoothly functioning mortgage market. Prior to the introduction of the modern housing finance system in the 1930s, U.S. mortgage finance was essentially a purely private endeavor—and it failed.

Mortgage products required extremely high down payments (often over 50 percent), and carried high rates of interest, with large regional disparities in pricing—as much as four percentage points between different parts of the country.⁵ Mortgages were short term (typically 5-to-10 years), interest-only, with a variable rate of interest, and “bullet” payments of principal at term. Unless borrowers could refinance these loans when they came due, they would have to pay off the outstanding loan balance.

Mortgage finance was effectively available only to a very narrow band of Americans. All others paid cash. The middle class was mostly shut out of homeownership.⁶ Even then, the strong procyclical tendencies of mortgage lending were unmitigated, either by regulatory restraints on risk-taking during housing booms or with sources of countercyclical liquidity during housing downturns. As a result, the purely private mortgage system was highly unstable, suffering wealth-destructive bubble-bust cycles every 5-to-10 years.⁷ As Federal Reserve economists Diana Hancock and Wayne Passmore observe, mortgage securitization also experienced these cycles in “what is now a familiar recurring history.”⁸

The inability of a purely private mortgage finance system to meet the housing needs of a modern economy is also evident from the experience of developed economies around the world. While the exact particulars vary from country to country, every advanced economy in the world relies on significant levels of government support, either explicit or implicit, in their mortgage markets.⁹

Modern U.S. housing finance policy was successful for nearly 70 years in promoting stability and prosperity

Despite its recently exposed flaws, the modern U.S. housing finance system, developed in the aftermath of the Great Depression, was largely successful in promoting stability and prosperity in the housing markets for nearly 70 years. This system relied on a mix of government support and regulation to encourage private capital to flow to sustainable mortgage products that were broadly available to all Americans. Regulatory oversight prevented the severe procyclicality that had manifested itself repeatedly before 1934, enabling a growing number of Americans to access reasonably priced, low-risk mortgages despite the inevitable ups and downs of local housing markets.

The establishment of new government (or government-sponsored) institutions such as the Federal Housing Administration, the Federal Home Loan Bank System, the Federal Deposit Insurance Corporation, and Fannie Mae led to the broad availability of affordable and well-designed mortgage financing options, opening up the possibility of sustainable homeownership or affordably priced rental housing to generations of lower- and middle-income Americans. By enabling working households to save and invest the bulk of their incomes, U.S. housing finance policy was a key part of the social mobility that characterized the second half of the 20th century.

As important, strong oversight of mortgage lenders and countercyclical mortgage credit generated many decades of unprecedented stability for investors and borrowers alike—until the ascendance of laissez-faire economic ideology led to a steep decline in prudent supervision over the housing and finance markets, resulting in the 2000s housing bubble and subsequent bust.

We note that the system in these decades was not as effective at ensuring that credit was available on equitable terms in all communities, although notable progress, consistent with safe and sound banking, was being made by the late

Strong oversight of mortgage lenders and countercyclical mortgage credit generated many decades of unprecedented stability for investors and borrowers alike.

1990s. But the introduction of predatory products and their rampant and unabated spread in the 2000s made a mockery of the values that drove earlier efforts at expanding access to homeownership. Indiscriminate credit on irrational terms—credit that was doomed to fail—instead resulted in high concentrations of foreclosures and destruction of equity in underserved communities that had taken generations to create.

These are the lessons we take away from the history of our mortgage markets since the progressive reforms in the wake of the Great Depression. They are central to the principles that underlie our current reform proposal, to which we now turn.

Goals of a modern privately capitalized housing finance system

A reformed privately-capitalized housing finance system for the United States must be based upon five key public policy principles:¹⁰

- **Liquidity:** Broad and consistent access to mortgage credit across all communities in our country and during all kinds of different economic conditions
- **Stability:** Financial stability in mortgage finance to minimize bubble-and-bust cycles such as the one we are now struggling to overcome and the ones that used to plague our economy before the reforms of the 1930s.
- **Transparency and standardization:** Transparency and standardization of mortgage products and mortgage-backed securities that can be understood and accurately priced
- **Affordability:** Affordability so that access to reasonably priced sustainable mortgage finance is available for both homeownership and rental housing
- **Consumer protection:** Consumer protection so that mortgage products and practices are fair and equitable and in the long-term best interests of borrowers

Public policy based on these principles served our country well over many generations. It was departure from these principles that led to the unsustainable mortgage bubble and ensuing crisis. A return to these principles must form the basis of comprehensive mortgage finance reform. Let's examine each of them briefly in turn.

Broad and constant liquidity

Mortgage credit should be broadly available, serving a wide range of communities and housing types, including those that have traditionally been underserved. This will enhance economic stability while promoting safe, decent, and affordable

housing for all, as well as residential integration and the elimination of housing discrimination. To achieve broad and constant liquidity:

- Quality housing finance should be available on a fair and equal basis to all suitable homebuyers, regardless of race, and should also be available to create and maintain sufficient stocks of rental housing.
- Mortgage credit should be available on a consistent basis to avoid exacerbating housing booms and busts, and to lessen the prospect of economic downturns.
- Both large and small lenders, including community banks, credit unions, and Community Development Financial Institutions should have consistent, equitably priced access to the secondary mortgage market.

Broad and constant liquidity requires effective intermediation between borrower demands for long-term, inherently illiquid mortgages and investor demands for short-term, liquid investments. Because long-term fixed-rate loans impose both interest rate and liquidity risk on lenders, they have become increasingly unwilling to hold these loans on their balance sheets. The capital markets therefore have become increasingly important to the intermediation necessary for mortgage finance. But as the past decade has stunningly demonstrated, left to their own devices, capital markets provide highly inconsistent mortgage liquidity, offering too much credit sometimes and no credit at others.

Standardized products help foster liquidity. The fungibility of standardized residential mortgages as well as of mortgage-backed securities based on these mortgages allows for the development of deep, liquid markets, increasing efficiency and improving prices.

It is also important to consider the distribution of mortgage originations. Currently, an estimated 70 percent of all mortgage originations flow through four lenders—JP Morgan Chase Co., Bank of America Corp, Citigroup Inc., and Wells Fargo & Co.—all of which benefit from federal deposit insurance and the perception that they are too big to fail. Without consistent and equitable access to a fairly priced secondary market, the country will be in danger of losing the services of community banks, credit unions, and other lenders that can meet the needs of their communities on a more tailored and targeted basis than can larger institutions, but need a well-functioning secondary market so they can access the capital they need to originate more mortgages.

Financial stability

A totally private mortgage market is inherently inclined toward extreme bubble-bust cycles, which cause the misallocation of capital and result in significant wealth destruction, with devastating repercussions not only for homeowners and lenders but also for neighborhood stability, the larger financial system, and the macroeconomy.¹¹ Mitigating the inherent procyclicality of mortgage lending requires reining in excessive risk-taking through strong, consistently enforced underwriting standards and capital requirements applied equally across all mortgage financing channels for the long cycle of mortgage risk. As we saw in the past decade, capital arbitrage can quickly turn small gaps in regulatory coverage into major chasms, causing a “race to the bottom” that threatens the entire economy.

Financial stability also requires that sources of mortgage liquidity be available during housing and economic downturns. Lenders are naturally inclined to minimize risk-taking during uncertain economic times, but the resulting absence of credit can severely exacerbate economic distress in a “vicious circle” of falling asset prices, increasing credit defaults, and reduced availability of loans. This problem is especially acute in economically distressed regions and communities. To stabilize the mortgage markets and the economy, sources of countercyclical liquidity are required.

Transparency and standardization

Transparency and standardization are essential to financial stability. Underwriting and documentation standards that are clear and consistent across the board enable consumers, investors and regulators to accurately assess and price risk and demand that institutions in the system hold an appropriate amount of capital. Similarly, when standardized securities trade in transparent markets, investors and regulators can understand the actual risk of both instruments and institutions and markets can price securities accurately.

During the housing bubble, the housing finance system experienced a seismic shift toward complex and heterogeneous products, from nonstandard mortgages that could not be understood by consumers at the bottom of the chain, to securities that could not be traded due to their complexity at the top. This lack of transparency and standardization resulted in opacity and adverse selection because the issuers knew more than the investors. The yields investors demanded to take on risk decreased while the risk of the underlying assets increased.

Financial stability
requires that
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and economic
downturns.

It is unlikely that a private mortgage-backed securities market will reemerge unless investors are convinced these problems have been resolved. Moreover, because the state of the whole secondary market affects the pricing of each packaged pool of mortgages in it, a safe and liquid securitization market can only exist if investors have access to information about all MBS in the market place. Mortgage-backed securities pooled together by our proposed Chartered Mortgage Institutions will not be priced properly if alternative investments that are in fact more risky are priced as if they had the same risk characteristics as the CMI pool. Standardized data fields with verification of data are necessary for all MBS, not just for CMI securities. Finally, no securitizer should be allowed to issue products that cannot be analyzed using standard financial models.

The Dodd-Frank Act establishes a framework for industry-wide regulation, transparency, and securitization. Effective implementation of the new law is a critical element in reestablishing a robust, privately-capitalized mortgage market.

Affordability

One of the most important accomplishments of the modern U.S. housing finance system is the broad availability of mortgage credit. Liquidity and stability are essential to affordability, but they will not do the job without specific attention to whether private mortgage credit is affordable to support sustainable homeownership and quality rental options for the vast majority of Americans.

For most Americans, the lower housing costs produced by the modern mortgage finance system facilitated wealth building, enabling them to build equity, save, and invest. This has contributed to the building of a strong middle class. That housing costs should ideally comprise no more than 30 percent of income is an important guiding concept in modern U.S. housing finance policy, and a key component of the American socioeconomic mobility of the 20th century. It should remain so in the 21st century.

A pillar of this housing system is affordably priced long-term, fixed-rate, fully self-amortizing, prepayable mortgages, such as the 30-year mortgage.¹² The long term of this loan provides borrowers with an affordable payment, while the fixed-rate, the option to prepay, and self-amortization features provide the financial stability and forced savings that are critically important to most families, while retaining the opportunity for mobility. Multifamily rental housing also gains stability from long-term, fixed-rate financing.

Banks and other lenders, however, are reluctant to offer long-term, fixed-rate mortgages to homebuyers or multifamily mortgage borrowers unless the lenders have a consistently available secondary market outlet.¹³ In the absence of government policies designed to explicitly support long-term, fixed-rate mortgages, it is likely that this type of mortgage would largely disappear from the U.S. housing landscape or become unaffordable to our nation's middle class, which has been so effectively served by them.¹⁴

Affordable housing finance must also be available for areas that are not well served by mainstream financial channels, including multifamily rental housing and nontraditional credit risks such as prospective first-time homebuyers with incomes sufficient to support a mortgage but who are unable to raise a large down payment. We have ample evidence that many households who may not fit the “20 percent down, established credit, 30 percent debt-to-income” model can become successful long-term homeowners, when given access to well underwritten, affordable, fixed-rate financing.¹⁵

Consumer protection

The purchase of a home is a far more complicated, highly technical transaction than any other consumer purchase and occurs only a few times in a consumer's life. Mortgage consumers are at a severe information disadvantage compared to lenders. In addition, a mortgage typically represents a household's largest liability. A mortgage foreclosure therefore has outsized consequences for the borrower. As the current crisis so sadly demonstrates, mortgage foreclosures also have devastating consequences on communities, the financial markets and the broader economy.

During the housing boom, unregulated and often predatory subprime lending not only failed to maintain or promote sustainable homeownership opportunities but also established a dual credit market where factors other than a borrower's creditworthiness—such as race or neighborhood location—determined the type and terms of the mortgages available. All too often, families were denied the best credit for which they qualified because their communities were flooded with unsustainable mortgage credit—in part because secondary market pressures created incentives to make and sell these loans.¹⁶

To address the persistent problem of information asymmetries that tilt the mortgage finance system to disadvantage consumers, the system should have a built-in bias towards the long-term best interests of borrowers. Origination and secondary market protections, such as those created in the Dodd-Frank Act, respond to this concern. We look forward to their effective implementation.¹⁷

Putting our principles to work

All five of these principles must be part and parcel of any new housing finance system for the 21st century. As we will demonstrate in the next section of our paper, these five principles are key to all segments of the mortgage finance market, including all parts of the single-family home market and the multifamily mortgage market. To this we now turn.

Defining the mortgage market

Within the U.S. mortgage system, there are two distinct mortgage markets that are served by (and rely upon) a vibrant secondary mortgage market. The larger of these, and the one with which Americans are more familiar, is the market for single-family loans. There is also a significant market for multifamily housing loans, such as those used to finance apartments. (See box)

Mortgage Market Segmentation

Under the housing finance system that existed prior to the implosion of the housing market, there were three secondary market mortgage financing channels that operated through securitization for both the single family and multifamily markets¹:

1. Loans originated with insurance from Federal Housing Administration, Department of Veterans Affairs, or other federal programs, and financed by the sale of mortgage-backed securities guaranteed by the government-owned Ginnie Mae
2. Loans originated to conform with guidelines set by Fannie Mae or Freddie Mac, and within mortgage limits established by government regulation, financed by the proceeds from sale of mortgage-backed securities issued and guaranteed by Fannie or Freddie (Fannie and Freddie also purchased loans, which they held on their balance sheets.)

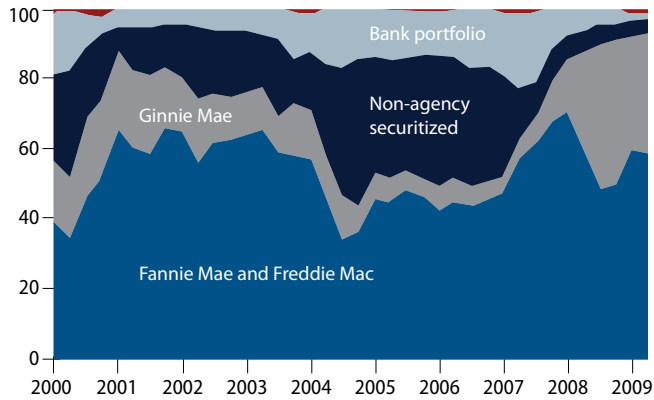
3. Loans originated to standards set by private financial institutions, including loans with balances above the limits set for Fannie and Freddie, and financed by the sale of mortgage-backed securities issued by MBS conduits created by these financial firms

In addition to these secondary market channels, there are of course lenders who hold the loans on their own balance sheets. These lenders are primarily funded through government-insured deposits. The share of depository-backed lending has steadily declined since the interest rate volatility of the 1970s, as mortgage financing has increasingly sought to transfer interest rate risk to investors, according to the Financial Crisis Inquiry Commission.

Private mortgage securitization grew from a small niche channel with about a 10 percent market share in 2002 to capturing nearly 40 percent of all mortgage originations—and accounting for over half of all mortgage-backed securities—in 2006. Just as dramatically, following the collapse of the housing bubble in 2007, private securitization essentially disappeared. Ginnie Mae, the government entity

Mortgage market share by channel

Market share percentage



Source: John Krainer, Federal Reserve Board of San Francisco (2009), available at <http://www.frbfs.org/publications/economics/letter/2009/el2009-33.html>.

that guarantees the timely payment of interest and principal on loans guaranteed or insured by federal agencies, Fannie Mae, and Freddie Mac now finance some 90 percent of all U.S. mortgage originations, with the rest being retained on the lender's balance sheet.¹⁸ The chart to the left shows the dramatic swing in the share of private (non-agency) securitization. (See chart)

The three-tiered system that existed prior to 2008 roughly corresponds to the natural segmentation of the housing market, and a similar three-tier system should be expected to emerge as the housing market is reestablished. Yet government support within a private mortgage finance system—essential to liquidity, stability, and affordability—should be limited, explicit, and transparently priced.

So with these facts in mind, let's first look at the single-family mortgage marketplace and its secondary market and then the multifamily mortgage marketplaces.

Single family market segmentation

The single-family residential mortgage market can be broadly divided into three types of borrowers: underserved borrowers, middle-market borrowers, and higher-income/higher-wealth borrowers. (See table on page 23) We'll examine each of them in turn.

Underserved borrowers

There is a broad segment of society, including but not limited to low- and moderate-income households and communities of color, which has historically been poorly served by the purely private mortgage markets, in that credit worthy borrowers were denied equal access to the government supported mortgage system. These markets were especially badly served in the past decade, as lenders

Single family housing finance market segments

Underserved	Middle market	Higher wealth/higher income
Who are they?		
<ul style="list-style-type: none"> • Low and moderate income (LMI) and minority borrowers • Residents of LMI communities, communities of color, and communities hard-hit by foreclosure crisis • Young adults, seniors, others with limited access to credit • Rural communities 	<ul style="list-style-type: none"> • Primarily middle-income households with some savings • Communities of color and communities hard-hit by foreclosure crisis • Middle-income households in high cost areas 	<ul style="list-style-type: none"> • Higher-income households with lots of savings
Types of housing		
<ul style="list-style-type: none"> • Lower-priced owner-occupied (often first-time home buyer) 	<ul style="list-style-type: none"> • Moderately priced owner-occupied (first-time and subsequent) 	<ul style="list-style-type: none"> • Higher-cost owner-occupied • Second/vacation homes • Investment properties
Challenges		
<ul style="list-style-type: none"> • Limited wealth often a bar to down payments • Limited access to credit • Limited consumer information 	<ul style="list-style-type: none"> • Predictable housing costs via long-term fixed rate finance • Consistent availability of credit allowing mobility 	<ul style="list-style-type: none"> • Limiting systemic risks posed by speculation

Source: Mortgage Finance Working Group

and brokers with an originate-to-sell business model steered borrowers towards unsustainable products that initially appeared attractive but were in fact high-cost, high-risk products that led to high foreclosure rates and devastated communities.

All of us inevitably pay the price when some segments are underserved. New homeowners successfully entering the housing market and then climbing the housing ladder are essential to robust housing supply and demand. Decades of exclusion, followed by the abuses of the subprime boom, knocked out some of the rungs of that ladder. These must be restored to stabilize the rest of the housing system.

Many families in this category of borrower remain candidates for homeownership using traditional underwriting and long-term, fixed-rate mortgage products.¹⁹ The government must ensure that these products remain available at reasonable prices in all markets, not allowing the development of dual markets as occurred during the boom. In addition, this group of borrowers is particularly dependent on strong regulatory oversight to prevent predatory lending practices, and to ensure that credit is being provided on nondiscriminatory terms.

While few of these borrowers will have sufficient wealth and savings to make large down payments (particularly in high-cost markets), some avail themselves of down payment assistance from local governments or other independent parties, and others utilize Federal Housing Administration mortgage insurance to access sustainable and affordably priced credit. Fannie and Freddie, too, have provided low down-payment mortgages, mitigating their risk through the borrower's purchase of private mortgage insurance.

High mandatory down payments, as some advocate in the post-crisis debate, could have a pernicious and potentially discriminatory effect on these borrowers and the communities in which they live. "Skin in the game" does reduce risk, but there are other proven ways to mitigate the risk of lower down payment lending. To serve these borrowers well, the system of the future must be flexible enough to ensure that the borrower's ability to sustain home ownership guides mortgage underwriting, rather than relying on crude proxies for risk mitigation.

Middle market

The second group of borrowers constitutes the so-called middle market, which historically had access to affordably priced long-term mortgages (such as the 30-year fixed-rate loan) with credit support from Fannie and Freddie. Given the inherent stability provided by long-term fixed-rate mortgage finance, and the large premiums required by purely private lenders to offer such products, particularly when the yield curve is steep, the government should continue its role of ensuring the broad and constant availability of affordably priced long-term fixed-rate products for owner-occupied housing.²⁰

These borrowers may also access affordably priced, shorter duration mortgage credit (such as an amortizing mortgage with a fixed rate for five years, with later rate increases capped) from other lending channels, such as lenders who hold loans in their own mortgage portfolio or mortgage bankers who access the private securitization market. As demonstrated in the recent mortgage crisis, a critical role for the government will be to ensure that access to such products is coupled with strong protection from misleading mortgage products.

Higher income/ higher wealth

The third group includes higher-income and higher net-worth borrowers who have sufficient capital and collateral to access credit without any support from the federal government. Many also have the financial sophistication to accept the risks associated with adjustable rate mortgages or nontraditional loans. Borrowers in this category have typically received private mortgages that are retained by the originating lender or resold into private securitizations, although some higher-income and higher net-worth borrowers do use government-supported channels for loans of limited size.

There is less public interest in or need to ensure constant availability of very large loans except under severe general mortgage market liquidity constraints, like those that occurred in 2008. Government credit support to this group of borrowers should be minimal, but government regulation should be robust. Several studies show that during the recent crisis, both serious delinquencies and foreclosures were positively correlated with loan size.

As of January 2010, for example, the serious delinquency rate on loans to owner-occupants that had balances over \$1 million was more than 5 percentage points higher than on owner-occupant loans with lower balances. This represented a dramatic shift from the period before August 2008, when the delinquency rate for loans over \$1 million was lower than for smaller loans.²¹ And with subprime loans, as loan size increases, so does the probability that the loan will default.²² High delinquency and default rates, no matter who the borrower, contribute to systemic risk. Appropriate regulatory oversight of both the primary and secondary markets for so-called “jumbo” loans is necessary.

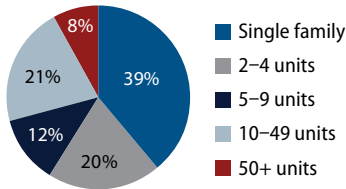
Multifamily rental market segmentation²³

Rental housing comes in the form of both single-family (traditionally 1-to-4 unit) and multifamily properties. Single-family rental financing has in the past largely been served by the same infrastructure that serves the single-family owner-occupied market, but multifamily rental is a notably distinct market, with distinct needs. Roughly 20 million American households live in rented units in 1-to-4 unit buildings, while 16.7 million American households live in apartments in multifamily buildings containing five or more units. The multifamily mortgage

Rental market segmentation by building type and subsidy

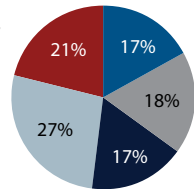
Share of renters living in unsubsidized units

Total=30 million units



Share of renters living in subsidized units

Total=6.7 million units



Source: Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008).

market is best defined by who is served by the rental housing (those who live there) and by the types of buildings financed (building size, age, and type of owners). (See chart)

A combination of federal and state direct subsidies (such as housing created by the low income housing tax credit, public housing, or subsidized by Section 8 rental assistance) allows many households earning less than 60 percent of area median income to access affordable rental housing. But because the current system is targeted at promoting affordable rental housing for households with less than 60 percent of area median income, many households find themselves shut out of the market for affordable workforce housing.

As a result, many of these households pay more than 30 percent of their income for housing, a commonly used threshold for affordability, and millions of these households spend more than 50 percent of their income on housing. This is a very large segment of the population, for whom an improved multifamily finance system could provide real benefit without necessarily requiring more direct subsidy.

There is also an important difference between smaller multifamily properties (5-to-50 units), which currently house one-third of all renters, and larger apartment buildings that house about 10 percent of all renters. Smaller buildings tend to have a higher proportion of lower income occupants, for whom rent stability is especially important. Yet owners of smaller properties have far greater difficulty accessing stable mortgage finance. In 2001, 86 percent of larger (over 50 units) properties had a mortgage, and of these mortgages, 65 percent were longer-term and fixed-rate. In contrast, only 58 percent of buildings with 5-to-9 units had a mortgage, and just one-third of these had level-payment, fixed-rate loans.²⁴

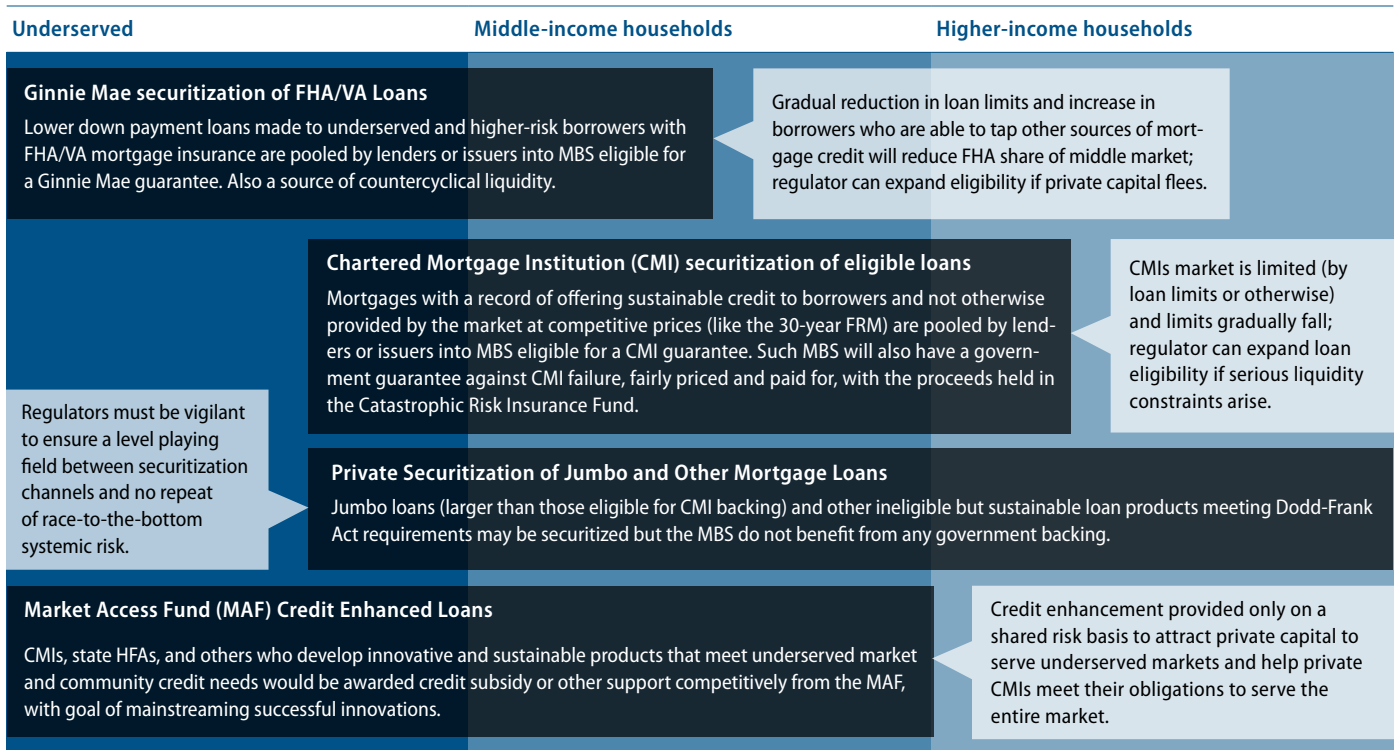
Fannie Mae and Freddie Mac currently play a large role in ensuring that housing finance is available to all multifamily rental properties (through both securitization and direct investment), as do the Federal Housing Administration, state housing finance agencies, and private financial institutions such as banks and insurance companies. Since the housing bubble began to deflate, Fannie's and Freddie's role has been absolutely essential; in 2009 they purchased or securitized over 84 percent of all multifamily mortgages.

A framework for reform

Our new framework for mortgage finance in the United States is guided by the principles of liquidity, stability, transparency, standardization, affordability, and consumer protection. We also draw upon lessons of the recent past. Our framework has four primary sources of secondary market mortgage liquidity. (See chart)

Under our proposed framework, the existing system of loans insured by the federal government through the Federal Housing Administration, the Department of Veterans Affairs, and the Rural Housing Services programs of the Department of Agriculture, which are bundled into securities enjoying a federal Ginnie Mae

Lending channels in a reimagined secondary mortgage market



Source: Mortgage Finance Working Group

guarantee, would remain largely the same. We contemplate important reforms to FHA to revitalize that agency and improve its operations. We also expect that the market share of this government-backed financing channel will decline significantly from its current level, which has been elevated due to the lack of private lending sources following the bursting of the housing bubble.²⁵

A wholly private secondary market without any government support would also exist. It is essential that this market—unlike the past—operate according to rules of consumer protection, capital backing, limited leverage, transparency, and realistic pricing, to prevent the “race to the bottom” that characterized the first decade of this century. Full disclosure of the characteristics of mortgage loans backing securities is essential. Our assumption is that the strong statutory and regulatory requirements established under the Dodd-Frank Act will fill this function. This market would primarily be for “jumbo” loans and certain adjustable rate mortgages.

The portion of the market between that in which individual loans carry a government guarantee and the market with no government backing whatsoever is the area that requires the most new thinking. Implementing the principles of liquidity, stability, transparency, standardization, affordability, and consumer protection requires some degree of government intervention. How can this be done in an efficient manner that also harnesses private capital, business, and operational skill and dexterity while significantly reducing the scope of government involvement and limiting the government’s exposure?

We propose that the government’s primary involvement in the private mortgage market be to provide a properly priced, explicit guarantee against catastrophic risk to mortgage securities backed by specific types and sizes of loans that the private market would not otherwise consistently and affordably provide. Over time, as the economy improves and a private secondary mortgage market begins to reemerge, we envision the percentage of the market backed by the government being gradually reduced. To some extent this will result from the reemergence of safe and sustainable adjustable rate products. But even in the fixed-rate market, the current share that is government-backed is excessive.

The reduction in government backing could be accomplished by limiting the maximum size of a loan eligible to be in a guaranteed security to, for example, a lower multiple of the median home sale price in more tightly delimited markets than is currently the case for the so-called conforming loan limit set by the Federal Housing Finance Administration that limits the size of loans Fannie and Freddie

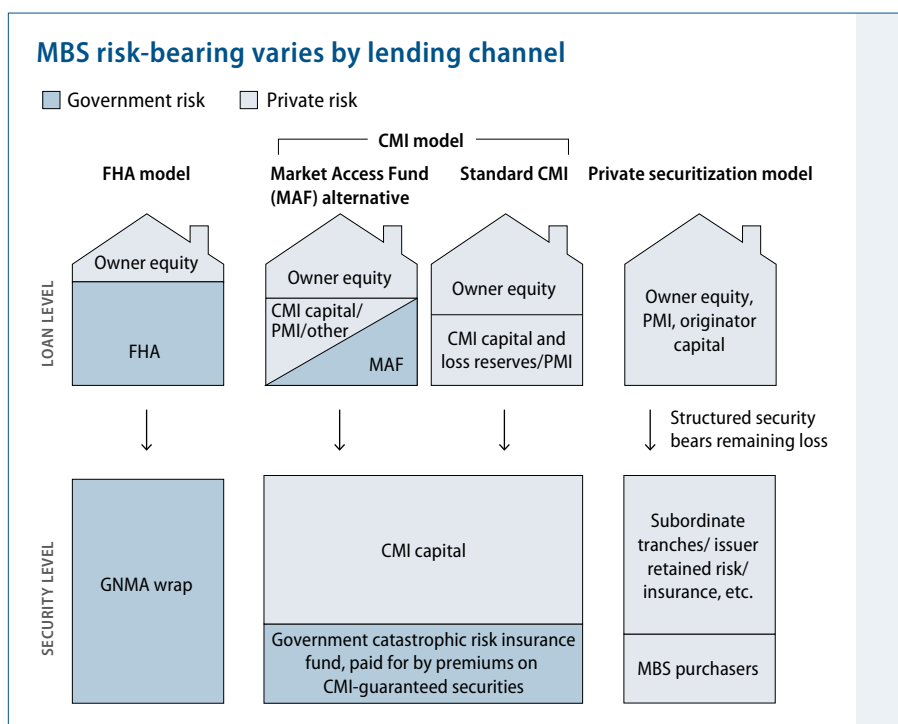
may purchase, securitize, and guarantee. Another alternative would be to start with a series of decreases in the limit to reflect declines in home prices since 2006.²⁶ With respect to multifamily loans, we propose that at least 50 percent of the units financed by the loans securitized by a Chartered Mortgage Institution in a given year be available at rents no greater than 30 percent of 80 percent of area median income at the time of securitization. (See chart)

The proposed Market Access Fund²⁷ would be a secondary market complement to the Affordable Housing Trust Fund and Capital Magnet Fund, two funds that provide funds

to states and Community Development Financial Institutions primarily to support rental housing. The goal of the Market Access Fund would be to “mainstream” products that provide access to sustainable mortgage finance to borrowers and communities that have historically been underserved. By providing research and development funds, credit enhancement, and an opportunity for a product to test the market, the Market Access Fund would enable niche products to gain access to the capital provided by the secondary markets.

A Market Access Fund credit subsidy would be awarded competitively to partners, including Chartered Mortgage Institutions, state and local housing finance agencies, and large nonprofits that can bear a significant share of the risk of loss on the loans and deliver products to the market at scale. Loans with some risk sharing with the Market Access Fund could be eligible for either CMI or Ginnie Mae securitization.

The Market Access Fund would provide access to the secondary market for loans that need a level of government support between the Ginnie Mae securitization channel and the CMI securitization channel. For FHA-insured loans eligible for Ginnie Mae securitization, lenders are protected by a government-backed insurance fund against almost all of the risk of loss from default on loans originated to



Source: Mortgage Finance Working Group

FHA standards. For CMI securitization, the CMI and other private entities such as private mortgage insurers bear 100 percent of the risk of loss and the government-backed insurance fund is called upon to make investors whole only upon the failure of the CMI. The Market Access Fund would share the risk of loss on a loan or pool level for products that meet underserved needs, but only where private capital is also at significant risk.

By sharing the risk of loss, the Market Access Fund will make it easier for private capital to serve otherwise underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a share of the housing market through the direct guarantees of the FHA, VA, and USDA's rural housing programs, exposing taxpayers to risk that could, through the MAF, be shared with the private sector.

The Market Access Fund also counters the potential private-sector argument that serving moderate-income communities, communities of color, and communities hard-hit by the foreclosure crisis and other adverse conditions holds risks that are inconsistent with their fiduciary duty to shareholders. The Market Access Fund will help CMIs and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private-risk capital for new products that serve underserved communities. And it will do so while limiting the government's role and exposure to risk.

Our proposed structure preserves a mortgage system that is both local and national, and includes the features that have enabled our mortgage market to attract capital from around the world. Our proposal builds on recent statutory and regulatory accomplishments, including the Dodd-Frank Act. And it ensures that American homeowners, renters, and lenders of all sizes and types, in all parts of the country, at all times, will have access to appropriately-riced, low-risk mortgage finance.

Our new market structure

Originators, issuers, Chartered Mortgage Institutions, and government catastrophic risk insurance

The portion of the U.S. mortgage market backed by Fannie Mae and Freddie Mac has operated efficiently because the two institutions provide an array of essential functions. First, Fannie and Freddie buy loans from lenders, including long-term

fixed rate loans that lenders would not make absent a reliable way to off-load the risk posed by such long-term obligations. Loans that they purchase with lower down payments must have private mortgage insurance (paid by the borrower) that gives Fannie and Freddie protection against loss, up to a set amount.

Second, Fannie and Freddie issue mortgage-backed securities backed by many of these loans—the process of “securitization.” Third, they also hold some of these loans on their balance sheet. This practice is necessary to aggregate loans for securitization, to hold and test new products before they can gain secondary market acceptance, to provide liquidity for loans that are difficult to securitize (as is the case with some multifamily loans), and to provide lenders with liquidity so that they can continue to make loans when capital markets are constrained.

Fourth, for a fee, Fannie and Freddie guarantee investors against credit risk, providing their MBS investors with assurance of the timely payment of interest and principal on those securities, relieving investors of concerns about borrower default. Fifth, they deliver to investors a further guarantee—a basis for confidence that the mortgage-backed securities they offer for sale will perform as promised—as their own credit guarantee is backed by an implied (and since conservatorship, effectively explicit) guarantee by the U.S. government against their failure. Neither the investors nor Fannie and Freddie currently pay the government for providing this guarantee.

Sixth, these functions also enabled the development of deep liquidity in the so-called “To be Announced,” or TBA, market, a type of futures market for mortgage-backed securities that allows lenders to provide consumers with interest rate forward commitments or “locks” on their mortgage interest rates before the final mortgage is signed and sealed. Finally, Fannie and Freddie delivered countercyclical liquidity so that mortgages were available for consumers no matter current housing market conditions or the direction of the broader economy.

Through much of the past 70 years, including the period since the capital markets froze in 2008, this system has resulted in mortgage money being consistently available, contributing substantially to broader economic stability. It has done so by connecting the local demand for mortgages with the international capital markets by creating a fully liquid investment attractive to a wide range of risk adverse investors. With the government standing behind mortgage-backed securities issued by Fannie and Freddie (whether implicitly before 2008 or effectively explicitly since conservatorship), investors believe there will always be a market for any MBS they buy now and may wish to sell later, regardless of economic conditions.

Through much of the past 70 years this system has resulted in mortgage money being consistently available, contributing substantially to broader economic stability.

The result is a deep and liquid market for mortgage securities that has been able to continue to operate since 2008, a period when other capital markets froze. In the future, all these functions need not be provided by the same entity. Indeed, separating them could reduce the risks of overconcentration in the market, enhance competition, and ensure access to all sizes of mortgage originators, including community banks and credit unions, while preserving the transparency, standardization, and scale that make for a broadly efficient and liquid market. Most importantly, the catastrophic risk guarantee must be separated from the other functions.

Thus, we envision a system with the following actors performing the key functions:

- **Originators**—lenders of all types would originate loans, as in the current system.
- **Issuers**—originators of individual mortgages as well as aggregators of those mortgages who would issue securities backed by mortgages originated by themselves or others.
- **Chartered Mortgage Institutions**—institutions not owned or controlled by originators (other than potentially through a broad-based cooperative structure), chartered and regulated by a federal agency, would guarantee timely payment of principal and interest on securities, typically issued by others, backed by loans eligible for a government guarantee against catastrophic risk.
- **Government catastrophic risk insurance**—an on-budget Catastrophic Risk Insurance Fund, funded by premiums on CMI-issued MBS, would be managed by the government to protect investors in the event of the failure of a Chartered Mortgage Institution; the government would price and issue the catastrophic guarantee, collect the guarantee premium, and administer the Catastrophic Risk Insurance Fund.

The government would set the product structure and underwriting standards for eligible mortgages and securitization standards for MBS guaranteed by Chartered Mortgage Institutions.²⁸ To protect taxpayers and ensure that all requirements for the guarantee are met, the government would regulate the CMIs for both capital adequacy—at levels significantly higher than required of Fannie and Freddie—and compliance with consumer protection and other responsibilities.

The government would serve as conservator or receiver for CMIs that fail, with responsibilities that include ensuring that the servicing of the remaining guaranteed securities is carried out by a qualified entity. Finally, the government would

manage the Market Access Fund, which would use credit enhancement and other tools to help CMIs and others test and bring to market sustainable mortgage finance products for borrowers and communities that have historically been underserved.

The different functions of aggregation, insurance, and delivery of government guarantee currently performed by both Fannie Mae and Freddie Mac thus would be separated. Private capital would bear the major responsibility for underwriting, aggregating, securitizing, and guaranteeing mortgage credit for both affordable homeownership and rental housing. The CMI guarantee would be supported by borrower equity, often private mortgage insurance and other forms of credit enhancement, and the CMI's own capital. The government backstop against CMI failure would be explicit, limited, and priced. Neither the debt nor equity of the CMIs would be government backed, unlike the current system. (See chart)

The proposed Chartered Mortgage

Institutions are likely to be significantly smaller than Fannie and Freddie are today, thus enhancing competition, reducing taxpayer risk, and improving access by smaller lenders to the secondary market. To further these ends, and to counterbalance the extreme concentration of the mortgage origination and servicing industries in entities that themselves have both an explicit government guarantee (on deposits) and implicit “too big to fail” backing, the only circumstance under which originating lenders would be allowed to have an ownership interest in a CMI would be as part of a broad-based mutually owned entity designed to ensure access, at equitable prices, to smaller lenders such as community banks, credit unions, and community Development Finance Institutions. In that context, and to assist in the achievement of public policy outcomes that may not coincide with the interests of private owners of CMIs, consideration might also be given to permitting CMIs established by government entities, such as housing finance agencies, individually or collectively.

Comparison of primary functional responsibilities in government-backed securitization (non-Ginnie Mae)

PROPOSED SYSTEM	CURRENT SYSTEM
LENDING	
Originators	Originators
INDIVIDUAL MORTGAGE INSURANCE FOR BENEFIT OF LOAN OWNER	
Private mortgage insurers	Private mortgage insurers
BUYING LOANS FOR SECURITIZATION	
Issuers	Fannie Mae and Freddie Mac
ISSUING MORTGAGE BACKED SECURITIES	
Issuers and CMIs (to limited extent)*	Fannie Mae and Freddie Mac
HOLDING WHOLE LOANS ON BALANCE SHEET	
Originators and issuers and CMIs (to limited extent)*	Fannie Mae and Freddie Mac
CREDIT GUARANTEE FOR BENEFIT OF MBS INVESTORS	
Chartered mortgage institutions (CMIs)	Fannie Mae and Freddie Mac
GUARANTEE OF GSE OBLIGATIONS	
Government catastrophic risk insurance fund, funded by premiums on CMI-guaranteed securities (explicit)	Government (implicit and not paid for)

* Not a primary CMI responsibility, but they would need authority to do for certain purposes.

Source: Mortgage Finance Working Group

Chartered Mortgage Institutions can have a variety of ownership structures

The failures of Fannie Mae and Freddie Mac raise the question whether public purposes and private ownership can be successfully mixed. Some advocate that the government have no role in housing policy, other than through agencies such as the FHA. For the many reasons discussed, we believe this is the wrong answer.

Conversely, excluding the benefits of private capital and entrepreneurship from implementation of federal housing policy is both unwise and unnecessary. We believe a variety of ownership structures can be successful. What is essential is that CMIs hold sufficient capital and be subject to robust regulation to limit losses and taxpayer exposure. Potential ownership structures include:

- Mutual associations, which are managed as corporations but where profits flow to customers, rather than outside shareholders
- State and local government ownership, such as through state housing finance agencies
- Cooperatives owned by lenders

Cooperative advocates suggest that such a structure can ensure broader lender access and by sharing risk among many parties, create an incentive to limit and better manage risk. It is important to recognize, however, that a cooperative is no more inherently inclined to serve interests beyond those of its members than is any other private ownership structure.

In particular, a CMI cooperative owned by mortgage lenders would be no more able or willing to provide countercyclical liquidity without government support than would any other financial market participant.²⁹ And a cooperative owned by very large originators could potentially become so dominant as to crowd out other CMIs.

Single mortgage-backed security product for a robust “To Be Announced” market

A critically important element of the current mortgage market is the “To Be Announced,” or TBA market. This is actually two separate but similarly huge markets, in which approximately \$3 trillion of Fannie Mae MBS and \$2 trillion of Freddie Mac MBS trade.³⁰ In recent years, approximately 90 percent of all MBS issued by the two companies have been TBA-eligible. These markets take their

name because investors can trade securities that are announced for issuance at a future date without settling the trades until the issuance occurs.

In the TBA market, two contracting parties agree on making or taking delivery, at a future date, of a certain number of Fannie Mae or Freddie Mac securities that meet certain limited parameters (such as the interest rate and the term of the mortgage). As a result, this market allows lenders to offer borrowers a rate lock—a firm commitment to close on a loan in the future at a certain rate—already knowing that secondary market capital will finance the loans. The TBA market also allows investors a unique product through which they can plan or hedge investments, because the bonds' yields are known well in advance of settlement.

The securities in this market are highly fungible, creating exceptionally deep liquidity, which in turn lowers prices to consumers. As discussed in a recent paper by staff economists at the Federal Reserve Bank of New York, the securities can trade this way because of their high degree of homogeneity (due to the standardized underwriting and securitization practices required by Fannie and Freddie), the two mortgage finance giants' credit guarantees (eliminating credit risk), and the exemption of MBS from the registration requirements of the Securities Act of 1933.³¹

Maintaining a TBA market is extremely important to market stability, efficiency, and liquidity. It keeps mortgages constantly available and prices low, and enables consumers to “lock in” mortgage rates so they can be certain of a mortgage's cost even if market interest rates increase after they have qualified. The structure we have proposed, with a unified government guarantee, a single set of government-defined underwriting and securities structure standards, and CMIIs with substantial government oversight, should result in the development of a single, new TBA market, in which all MBS guaranteed by CMIIs, with the additional catastrophic government guarantee, no matter who issues the security, could trade.³²

The effect of this system on the price of a mortgage

How much will this proposed system raise the price of single-family mortgages that receive the benefit of the government guarantee against catastrophic risk? Even with significantly higher capital standards for CMIIs than Fannie and Freddie were subject to, the answer is “not very much.” The limitation of default risk through quality standards on the mortgages and securities; the explicit government guarantee that will reduce securities' investor return requirements; and returns on CMI capital that, while reasonable, are below the outside returns

received by holders of all financial institution equity in the years prior to 2008, should together result in an increase in mortgage interest rates of about one-half of one percent (50 basis points). To put that in perspective, interest rates on 30-year fixed rate mortgages were one-half percent higher than their December 2010 level in July 2009.³³ Each mortgage supported by the government guarantee will be required to bear the cost of:

- The capitalization of the CMIs
- The operation and credit risk to the CMIs
- The premiums paid to the Catastrophic Risk Insurance Fund
- The funding of the National Housing Fund, the Capital Magnet Fund and the Market Access Fund

While opinions differ on what the levels of these elements should be—the most important of which is the level of capital the CMIs would be required to hold—we can work off certain benchmarks.

One benchmark could be the FHA Mutual Mortgage Insurance Fund, which is required to hold capital (in addition to loan loss reserves) at 2 percent against higher loan-to-value mortgages. Private mortgage insurers, similarly exposed to high loan-to-value mortgage risk, must maintain 4 percent of capital for each dollar of risk insured, which works out to about 0.8 percent of the mortgage balance, and they must also hold loss reserves and set aside half the premiums received for 10 years.

The actual credit losses at Fannie and Freddie stemming from the crisis are very roughly projected at around 4 percent to 5 percent of loan balances, nearly half of which is attributable to so-called Alt-A and other subprime-type loans that would not be eligible to be insured by the CMIs. And banks are, in general, required to hold 4 percent capital against mortgages on their balance sheets. This implies that a capital requirement of between 2 percent and 4 percent of the balance of guaranteed loans for the CMIs, with an additional 1 percent to 2 percent ultimately being built up in the government's Catastrophic Risk Insurance Fund against the risk of CMI failure, should be sufficient.³⁴ Even a 2 percent capitalization requirement for the CMIs is many times higher than the capital requirement of just 0.45 percent required of Fannie and Freddie against securitized loans.

Assuming a reasonable rate of return to investors in these new Chartered Mortgage Institutions on an increased capital base as well as operating costs and credit losses comparable to Fannie and Freddie on prime loans; a 10-basis-point fee for the

National Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund; and a government guarantee premium of 10 basis points; the total ongoing annual guarantee fee would be approximately 70 basis points.³⁵ This compares to the pre-2008 benchmark guarantee fee for Fannie and Freddie of approximately 20 basis points,³⁶ a difference of 50 basis points. The actual likely difference, however, would be reduced (in the neighborhood of 10 basis points) by the improved price the CMI-guaranteed securities should command because of their now-explicit government guarantee. The result is a safer system, backed by far more private capital, at a small increase in the price of mortgage credit to consumers.

Ensuring fair and nondiscriminatory access to credit

Chartered Mortgage Institutions in our new housing finance system will be responsible for equitably serving the primary mortgage market as well as responding to areas of special concern where housing finance needs are not being effectively met, with potential assistance from the Market Access Fund.³⁷ CMIs primary obligation would be to provide an equitable outlet for all primary market loans meeting the standards for the guarantee, rather than serving only a limited segment of the business, such as higher income portions of that market.

In other words, Chartered Mortgage Institutions will not be able to “cream” the primary market. With respect to multifamily lending, CMIs that securitize multifamily loans will be required to demonstrate that they are providing housing for working households. In addition, CMIs would be required to provide service to areas of specific concern identified annually, such as shortages created by natural disasters, rural housing, and small multifamily housing. The Market Access Fund would be available to help them meet these responsibilities.

This obligation would have four parts:

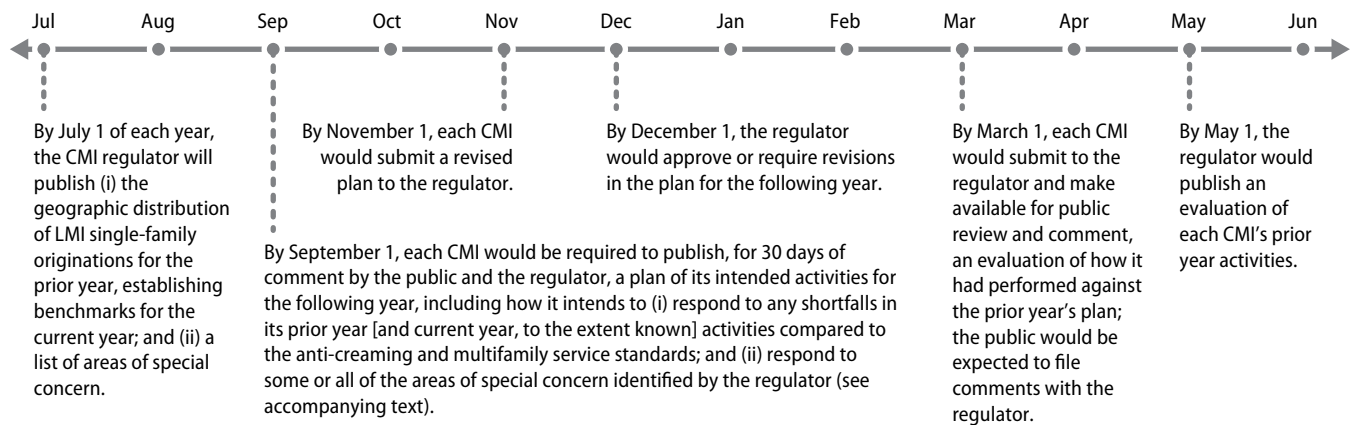
- CMIs would be expected to roughly mirror the primary market in terms of the amount and the geography of single-family low- and moderate-income loans (other than those with direct government insurance) that are securitized and are eligible for the CMI guarantee. They would not be allowed to “cream” the market by securitizing limited classes of loans. This assumes that the primary market will be appropriately incentivized through the Community Reinvestment Act, which requires banks and thrifts to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.³⁸

Chartered
Mortgage
Institutions in
our new housing
finance system will
be responsible for
equitably serving
the primary
mortgage market.

- CMIIs that guarantee multifamily loans would be expected to demonstrate that at least 50 percent of the units supported by securitized multifamily loans during the preceding year were offered at rents affordable to families at 80 percent of the relevant area median income, measured at the time of the securitization.
- CMIIs would be required to provide loan-level data on securitizations to the government (which will be required to make these data public) that is no less robust than that of the Public Use Database currently produced by the Federal Housing Finance Administration.
- All CMIIs would participate in a yearly planning, reporting, and evaluation process covering their plans for and performance against both the single- and multifamily performance standards and government-identified areas of special concern, such as rural housing, small rental properties, and shortages created by special market conditions such as natural disasters. (See chart below for a hypothetical schedule)

Like all other secondary market participants, CMIIs would be required to abide by nondiscrimination and consumer protection laws. Substantial underperformance by a CMI could lead to fines and possible loss of its CMI license.

Hypothetical annual planning, reporting, and evaluation schedule for CMIIs' obligation to ensure fair and nondiscriminatory access to credit



Source: Mortgage Finance Working Group

How is this structure similar to Federal Deposit Insurance?

The proposed structure for government support of a limited portion of the mortgage securities market is similar to the deposit insurance system overseen by the Federal Deposit Insurance Corporation. Investors in mortgage-backed securities guaranteed by an eligible Chartered Mortgage Institution and receiving the government catastrophic risk guarantee will have the comfort of knowing their investment is ultimately backed by the full faith and credit of the U.S. government, preventing shadow banking runs and ensuring liquidity for this financing channel. Taxpayers are protected by CMI capital and loss reserves, and then by an on-budget Catastrophic Risk Insurance Fund, similar to the FDIC's Deposit Insurance Fund. (See chart on page 40)





This guarantee will be paid for by premiums set at rates designed to cover losses should a CMI fail. As with FDIC insurance of a limited level of deposits, the proposed government guarantee of MBS would be specific and limited, in this case to investment in specific mortgage-backed securities. As with FDIC insurance of bank deposits, the catastrophic risk insurance would not cover general creditors or shareholders of the CMI. Unlike the current system, in which the government ended up rescuing Fannie and Freddie, including in effect their creditors, without having received any insurance premiums to cover the risk, the government's risk in our system would be limited and paid for in advance. (See box)

How does the government's guarantee of CMI securities differ from the government's support of Fannie Mae and Freddie Mac?

The CMIs' primary function would be to provide the first-level pool guarantee function that Fannie and Freddie have performed since the 1980s. Until 2008, Fannie and Freddie' guarantee also included an implicit government guarantee against catastrophic risk for which the government was uncompensated. Since 2008, that guarantee has in effect been explicit, but the government is still not being compensated for it. In contrast, the CMI guarantee would serve as the condition precedent to the explicit, and fully-paid for government catastrophic risk guarantee and would only be available to securities that also had the CMI guarantee.

CMIs would be expected to set and enforce standards for the financial and operational strength of issuers, as Fannie and Freddie have always done for seller/servicers. The capital standards for CMIs would take external supports such as private mortgage insurance into account, providing an incentive for the CMIs to share risk with others interested in the performance of the mortgages. And the government catastrophic risk guarantee should enable continuation of a deep and liquid market for privately-issued securities backed by mortgages deserving of public support.

Our proposal adopts elements of the FDIC model to address the flaws in the current system of mortgage securitization

Federal deposit insurance for deposit-backed lending	Proposed system for mortgage securitization	Current system for mortgage securitization
<p>Government guarantee is paid for and protected by sufficient capital, transparency, standardization, and a self-funded insurance fund.</p>	<p>Government guarantee is paid for and protected by sufficient capital, transparency, standardization, and a self-funded insurance fund</p>	<p>Government guarantee is not paid for, opaque, and not protected by sufficient capital or an insurance fund</p>
<p> REGULATION</p>		
<p>Banks are closely regulated as to capital, earnings, asset quality, liquidity, and management, in addition to compliance with consumer protection and other regulations. They are also obligated to serve all communities in which they are chartered, including low- and moderate-income communities, consistent with safe and sound operations.</p>	<p>CMI and issuers are closely regulated as to capital, earnings, asset quality, liquidity, and management, in addition to compliance with consumer protection and other regulations. They are also obligated to provide fair and non-discriminatory access to the secondary market.</p>	<p>For the government-backed portion of the market, regulators allowed excessively high leverage, and as a result, the GSEs held insufficient capital against their risks, exposing taxpayers to major losses. For the private portion of the market, a lack of regulatory oversight allowed risk-taking to reach astronomical levels, creating a high probability of a “run on the bank” situation and thus exposing taxpayers to major losses.</p>
<p> TRANSPARENCY AND STANDARDIZATION</p>		
<p>Regulators have complete access to all bank books and records at all times, and banks are subject to periodic (and sometimes continuous) on-site examinations. Much financial information about individual banks (including privately-held institutions) is made available quarterly by bank regulators. Products are not standardized.</p>	<p>Regulators have complete access to the books and records of all CMIs and issuers at all times.</p>	<p>A lack of transparency and standardization in the private-label portion of the market decreased efficiency, made monitoring more difficult, and greatly increased the level of systemic risk posed.</p>
<p> INSURANCE</p>		
<p>Depositors are insured up to \$250,000 per depositor, per insured bank. Banks pay risk-based premiums (assessments) to the FDIC, which holds them in the off-budget Deposit Insurance Fund. Neither bank equity nor other liabilities of banks (uninsured deposits, secured and unsecured debt) are insured by the FDIC.</p>	<p>Investors in CMI-guaranteed MBS are insured against CMI failure by the on-budget Catastrophic Risk Insurance Fund. CMIs pay assessments for each new issuance of MBS to a Catastrophic Risk Insurance Fund, administered by the CMIs’ primary regulator. Neither CMI equity nor other liabilities of CMIs (uninsured deposits, secured and unsecured debt) are insured under this scheme.</p>	<p>No insurance fund to protect taxpayers against GSE losses, or the costs of bailouts provided to prevent a “run on the bank” situation from occurring among private investment banks. Thus, if the amount of capital held is insufficient, the taxpayer is exposed to losses. Moreover, it is unclear which liabilities of the GSEs or large investment banks (such as equity, uninsured deposits, secured and unsecured debt) are insured, or to what extent.</p>
<p> GOVERNMENT GUARANTEE</p>		
<p>FDIC deposit insurance is backed by the full faith and credit of the US Government. However, banks are required to make up any shortfall in the Deposit Insurance Fund through increased assessments.</p>	<p>The explicit full faith and credit of the U.S. Treasury stands behind the Catastrophic Risk Insurance Fund. However, any shortfall in the Catastrophic Risk Insurance Fund may also be made up through increased assessments on existing CMIs.</p>	<p>Government backing is implicit and unpaid for.</p>

Source: Mortgage Finance Working Group

Countercyclicality

Left to its own devices, the mortgage market is inherently highly procyclical. As history, including the current crisis, repeatedly demonstrates, private capital experiences a “flight to safety” during market downturns, flowing towards safe sovereign-backed instruments such as U.S. Treasury bonds and away from mortgages and other private investments. Without a government guarantee, there is no reason to think that countercyclical liquidity will be available when needed.

In the recent past, countercyclical mortgage liquidity was largely provided by Fannie Mae and Freddie Mac through their portfolio purchases of mortgage loans and mortgage-backed securities. The two mortgage finance giants performed this function following the 1998 Asian and Russian debt crises and in the aftermath of the collapse of the hedge fund Long-Term Capital Management around the same time. And as discussed below, a potential source of countercyclicality in a reformed mortgage finance system could be the direct investments of the CMIs.

In the recent crisis, Fannie and Freddie were unable to fully meet the countercyclical needs of the market because of the size of the problem and constraints on their portfolios as part of their conservatorship. The Federal Reserve stepped in, committing to purchase up to \$1.25 trillion in Fannie- and Freddie-backed MBS, thus providing continued liquidity to the market. Relying solely on the Federal Reserve, however, may not be wise.

Why? Because the Fed’s existing mandates of maintaining price stability and maximizing employment already generate a good deal of conflict, with critics arguing that the Fed overly emphasizes one of the dual mandates over the other. A new third mission of providing countercyclical liquidity to the mortgage market would likely take a back seat to the Fed’s existing goals. Countercyclical capability, however, is critical for the smooth functioning of the mortgage market. The form it takes is less important than ensuring that it is provided for in an intentional and effective way.

The portfolio capacity of Chartered Mortgage Institutions

Critics of Fannie and Freddie have been concerned for many years about the size of the companies’ portfolios—the whole loans and securities on their balance sheets, in contrast to those they guarantee. The portfolios, which carry both interest rate and credit risk (the guarantee covers only credit risk) were the source

of outsized profits, largely because the implicit government guarantee on the companies' debt meant they could fund their balance sheets more flexibly and less expensively than corporations without this backing. Our proposal, separating the government guarantee of securities from the implicit backing of the CMI themselves would eliminate that benefit.

What's more, the CMIs would no longer be the principal purchasers and aggregators of loans. Instead, they would provide insurance to investors on securities issued by others. A regulatory limitation on the size of the portfolio that CMIs can maintain is appropriate to keep the CMIs focused on the guarantee business. But it is neither possible nor prudent to eliminate CMI portfolios altogether.³⁹ And for one purpose—countercyclical liquidity in a crisis—a backup government guarantee of a class of senior debt issued explicitly for this purpose should be available.

There are three key functions that a portfolio serves toward a stable and durable housing finance system: countercyclical liquidity, facilitating the credit guarantee, and financing loans that have features that make them difficult to securitize. While the first of these functions requires some government support, which can be effectively limited as described below, the second and third do not. Let's look at these functions in more detail.

Countercyclical liquidity

As discussed above, when capital markets freeze, mortgages become unavailable or excessively expensive, with adverse consequences not only for the housing market, but also generating and amplifying broader economic distress. But no entity without government direction and support has any incentive or capacity to provide liquidity when capital is fleeing the market.

While it might be possible for the Fed to serve this function, an additional and potentially potent source of countercyclical liquidity is the portfolio investment capacity of Chartered Mortgage Institutions. CMIs are close to the mortgage markets, and could easily step in by purchasing whole loans, mortgage securities, and other instruments to provide mortgage liquidity during housing downturns. But such capacity cannot be created overnight; a preexisting infrastructure in the form of an ongoing mortgage portfolio is required.

When countercyclical intervention is required, a CMI will be able to provide it only if it can finance the purchases on favorable terms. A government guarantee of a specific class of senior debt (similar to the limited FDIC bank debt guarantee program of 2009, which following a finding of systemic risk in the economy enabled banks to access the otherwise-frozen market for senior unsecured debt) could accomplish this without reinstating the implied U.S. government guarantee of all CMI debt. The terms and conditions of such senior debt would have to be carefully constructed to meet the potentially contradictory goals of quick intervention in the market and strictly limiting the guaranteed debt to only to those circumstances in which market conditions warrant it.

Management of guaranteed assets

Companies insuring mortgage-backed securities must deal with nonperforming loans. The most efficient strategy is to buy the loans out of the guaranteed pool, substituting a new loan where that is permitted. Portfolio capacity enables a CMI to acquire a nonperforming loan, fulfill its obligation to investors, and hold the loan while it is evaluated and cured or disposed of.

This strategy increases the ability of the guarantor to modify loans to bring them back to performing status and keep homeowners in their homes or multifamily properties from deteriorating to the detriment of entire neighborhoods. This function is a natural outgrowth of the guarantee, and the cost would be covered by the CMI's guarantee fee; no government backing of debt would be required.

Financing loans that cannot be securitized

Effective mortgage securitization requires relatively fungible and homogenous assets underwritten to consistent standards. It is therefore difficult to securitize certain kinds of loans that have substantial public policy benefits, such as loans with tailored terms (as is the case with some multifamily loans), loans that are designed to test new parameters or extend access, or those that are simply not susceptible to securitization (as is the case with reverse mortgages). Allowing CMIs to hold a portfolio will enable them to finance these loans, at a price that covers the CMI's cost of capital, without any government guarantee of the CMI's debt.

Effective mortgage
securitization
requires relatively
fungible and
homogenous
assets underwritten
to consistent
standards.

Support for multifamily housing finance

The fallout from the current mortgage crisis, coupled with strong demographic trends, necessitates renewed attention to the financing needs of multifamily rental housing. More than one-third of American households live in rental housing, and in general they have lower incomes than those who own. While at the very lowest income levels, there is some direct government support, neither the government programs nor the private market effectively serve working-class households whose incomes are just above the eligibility thresholds for many subsidy programs. These families need affordably priced rental housing near their workplaces but it is in very short supply.

The combination of CMIs and a government catastrophic guarantee of the securities backed by multifamily mortgages that meet minimum underwriting standards or have special credit enhancements should increase the availability of longer-term mortgages for multifamily housing. This in turn should help lower the cost of financing affordable rental housing and ensure a more stable supply of financing throughout business and credit cycles. This framework should also make it possible to work with state and local housing finance agencies or other sources of local credit enhancement to adjust underwriting to meet local needs.

Moreover, any CMI that engages in multifamily securitization (whether focused solely on multifamily or as part of a business that also includes single-family activities) would be required to demonstrate annually that, at the time of origination, at least 50 percent of the units financed by securities it guarantees are affordable to a family making 80 percent of area median income. Based on the history of multifamily financing by Fannie Mae and Freddie Mac, we believe this affordability measure is easily achievable without posing an undue burden on the CMI, and it provides an important social benefit in meeting the need for affordable rental housing units.

For more information about the MFWG's analysis of the needs of the rental housing market and how CMIs and the Market Access Fund might help serve those needs, see ["A Responsible Market for Rental Housing Finance."](#)⁴⁰

Reform of the Federal Housing Administration

The role of the Federal Housing Administration as an essential countercyclical backstop has been more than adequately demonstrated by its performance during the recent housing and financial crises. While it insured only 3.3 percent of

single-family mortgages originated in 2006, by 2009, after private capital fled the housing market, its market share increased to 21.1 percent. Over the past year, FHA provided access to credit for about 40 percent of purchase mortgages.⁴¹ In 2009, FHA insured 60 percent of all mortgages to African-American and Hispanic homebuyers, and mortgages for over 882,000 first-time homebuyers.⁴² Earlier in the economic and financial crises, these percentages were even higher.

FHA reported in November in its annual report to Congress that, under conservative assumptions of future growth of home prices, and without any new policy actions, FHA's capital ratio is expected to approach the congressionally mandated threshold of two percent of all insurance-in-force in 2014 and exceed the statutory requirement in 2015. In other words, if correct, FHA will have weathered the worst housing crisis since its creation in the aftermath of the Great Depression and have done so without costing taxpayers a dime. FHA's market share was small during the worst of the crisis and, while it is sustaining significant losses from loans insured prior to 2009, better performing loans are now helping to stabilize its financial position.

FHA, however, lacks the systems, market expertise, and nimbleness one would hope to see in an institution with over \$1 trillion of insurance-in-force.⁴³ Its product terms and many practices are prescribed by statute with such specificity that it makes prudent management of an insurance fund extremely difficult.

In 1994, the Joint Center for Housing Studies at Harvard teamed up with FHA Commissioner Nic Retsinas to conduct a series of public hearings and study the future of FHA. Their report and recommendations⁴⁴ concluded that Congress should reinvent FHA as a government corporation, under the direction of the Secretary of the Department of Housing and Urban Development, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design to meet those ends.

The Harvard proposal would have created a new Federal Housing Corporation with far greater flexibility in procurement and personnel policies in order to jumpstart the transformation to a more business-like agency with a public purpose. The proposal was adopted by President Clinton in a HUD Reinvention Blueprint released in March 1995.⁴⁵ Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002.⁴⁶ Each time, market, political, and inertial forces resulted in no action.

The thrust of these recommendations is on the mark. Most significantly, under these proposals, FHA could design loan products to help meet the needs of underserved markets. The FHA would need to charge premiums designed so that the insurance funds would be actuarially sound. These products would be subject to independent credit subsidy estimates approved by the Office of Management and Budget and additional private market-like measures of risk. And the overall portfolio of insurance would be required to maintain adequate capital reserves to continue to protect taxpayers from insurance losses, as FHA has since done the Great Depression.

Other reforms would let FHA pay salaries at levels paid by the banking regulatory agencies, as comparable financial market expertise must be attracted to better protect taxpayers from the risks inherent in insurance. And procurement and budget flexibility would make it easier for FHA to use insurance fund resources to develop new systems and procure them more easily to better assess and manage risk in the insurance fund.

It is time to revisit these ideas. It is now evident that FHA is indispensable for economic stability and housing market equity. In light of its continued importance, we should ensure that FHA has the tools it needs to best meet underserved housing needs and provide countercyclical liquidity while doing what works to protect taxpayers optimally from any risk.

Market Access Fund

Mortgage finance should ensure broad and sufficient mortgage availability on reasonable and sustainable terms. Yet some groups of borrowers and certain types of housing have not been well served by the system of the past. This can occur for a number of reasons, including perceptions of risk, smaller deal size, or higher origination costs. Rules against discriminatory lending and antireaming provisions, such as those we have proposed for CMIIs, will help, but are likely to be insufficient to fill all the gaps.

These gaps are especially important to fill in the aftermath of the housing crisis, where many communities saw equity stripped by subprime lending. Moreover, the larger economic downturn has hit underserved communities most heavily. These places most in need of capital to rebuild will be the last to get it from a private market left to its own devices.

Direct subsidies are critical where deep government support is needed, such as for low-income rental housing. In addition to existing programs like Section 8, the low income housing tax credit, and HOME, a fully-funded National Housing Trust Fund will help to meet these needs. But beyond cash grants to support affordable housing, we need the housing finance system to provide access to credit for affordable rental housing and homeownership. A relatively thin credit enhancement subsidy can help bring private capital to bear in meeting the affordable housing needs of many communities.

The whole loan mortgage insurance provided by FHA and other similar programs brings private capital into underserved communities. Under these programs, a taxpayer insurance fund takes on almost all of the credit risk. Lenders who make FHA loans get fee and servicing income, but they have very little capital at risk. Thus, FHA insurance ensures loans are available to markets and borrowers private capital will not serve.⁴⁷

Under our proposed system, with CMI's putting private capital at risk ahead of any taxpayer exposure, the CMI's are unlikely to make loans that they perceive too risky or that might provide below market rates of return. The danger would be that the private sector could see itself as having no responsibility to serve low- and moderate-income communities, communities of color, and communities hard-hit by the foreclosure crisis and other adverse conditions, claiming that the risks are inconsistent with their fiduciary duty to shareholders. The result could be a two-tiered system of housing finance, with FHA as the primary vehicle serving low- and moderate-income communities and communities of color and taxpayers absorbing all the risk, and private capital serving only the middle and upper parts of the market.

A large number of civil rights organizations recently wrote of their concern about overreliance on FHA without other competitive sources of mortgage capital to meet the needs of underserved markets. The Market Access Fund offers a way to help CMI's and other private actors meet their obligations to serve the entire market.

With some ingenuity, it is possible to build a system that maximizes the use of private capital and market solutions for all markets where high quality sustainable loans can be found. Some loan products that can successfully and sustainably meet underserved housing needs can eventually access the capital markets—if they can first gain a record of loan performance and market experience. Past examples include home improvement loans and guaranteed rural housing loans, as well as loans made less risky by quality housing counseling.

With some ingenuity, it is possible to build a system that maximizes the use of private capital and market solutions for all markets where high quality sustainable loans can be found.

A Market Access Fund would provide research and development funds (grants and loans) and/or a full-faith-and-credit government credit subsidy to enable entities including CMI and nonprofit and government (such as state housing finance agency) market participants, to develop and establish a market for these innovative products. Examples of new products might include lease purchase loans, energy efficient or location efficient loans, shared equity loans, and loans on small multi-family properties.⁴⁸

The Market Access Fund would provide “wholesale” government product support, in contrast to the retail insurance offered by the Federal Housing Administration at origination. The fund would be required to meet specific performance goals relating, for example, to financing for housing in rural areas or places with high foreclosure rates, unsubsidized affordable rental housing, and manufactured housing. And the fund’s credit subsidy would only be available for products on a shared-risk basis, meaning that other capital would need to be at risk as well, providing both market discipline and an opportunity for these actors to learn how to serve underserved markets well. This in turn would pave the way for private capital to “mainstream” the products, increasing sustainable homeownership and affordable rental housing, and eventually reducing or eliminating the need for public support.

Those who want to access the Market Access Fund would apply for allocation of the fund’s credit subsidy. Premiums could be charged and the subsidy costs could well be recovered from many if not most successful products. The fund would have broad latitude to design effective partnerships, including the setting of credit enhancement premiums, use of subsidy, how the risk was layered, and other components, within the limits of funding available. Credit subsidies granted by the fund would be managed under the Federal Credit Reform Act, which would establish and ensure budget discipline and transparency, and each program awarded Market Access Fund dollars would be assigned a credit subsidy rate based on projected revenue and cost estimates as with other federal credit programs.

The Market Access Fund would be funded by an assessment on all MBS issues. A portion of the assessment would go to the National Housing Trust Fund (for direct subsidy) and to the Capital Magnet Fund (for credit programs by Community Development Finance Institutions), as established under the terms of the Housing and Economic Recovery Act of 2008. It is important that the assessment be levied on both those issues guaranteed by CMIs and those without CMI guarantees to ensure that the responsibility to support better service to underserved markets primarily through private finance is supported by the jumbo market as well as the middle market. At 10 basis points, and assuming a

4-year average life of MBS, the annual incremental accrual to these funds from this fee should reach \$4 billion for every \$1 trillion of securities issued by year five of the program, and maintain that level in every subsequent year. The funds could thus achieve scale and effectively meet the HERA requirements and replace the public purpose activities of Fannie and Freddie.

By sharing the risk of loss, the Market Access Fund makes it easier for private capital to serve underserved communities. Without this mechanism, there is a significant risk that the taxpayer will continue to stand behind too large a segment of the housing market through FHA/VA and a two-tier housing finance system will develop. The Market Access Fund will help CMI's and other private actors meet their obligations to serve the entire market while simultaneously providing the market discipline of private risk capital for new products that serve underserved communities. And it will do so while limiting the government's role and exposure to risk. (See box)

How the Market Access Fund is distinct from other funds

The Housing and Economic Recovery Act of 2008 created the National Housing Trust Fund and the Capital Magnet Fund. The National Housing Trust Fund allows the states to expand the supply of rental housing for those with the greatest housing needs. The Capital Magnet Fund enables Community Development Financial Institutions (CDFIs) and nonprofit housing developers to attract private capital and take affordable housing and community development activities to greater scale and impact. As mission driven organizations, CDFIs and nonprofit developers are proven agents of public policy, forging partnerships with the private sector and government at all levels.

As originally envisioned, the National Housing Trust Fund and the Capital Magnet Fund would have received funding through assess-

ments on the GSEs. Each entity was to contribute 4.2 basis points of total new business purchases annually for two affordable housing funds: 65 percent to the National Housing Trust Fund and 35 percent to the Capital Magnet Fund. When the GSEs were put into conservatorship, their obligation to contribute to the National Housing Trust Fund and Capital Magnet Fund was suspended.

Unlike the National Housing Trust Fund or the Capital Magnet Fund, the Market Access Fund is not meant to provide project subsidy. Rather, this fund is meant primarily to share risk with private capital in a way that "mainstreams" responsible loan products that help meet the needs of underserved borrowers and housing types, thus paving the way for the private market to serve these markets more effectively.

Level regulatory playing field

In addition to regulation of mortgage products to protect consumers, consistent and comprehensive oversight of all mortgage market participants is essential to rein in the inherent procyclicality of mortgage lending and to prevent regulatory

arbitrage. Unless the entire market is subject to substantially similar rules in areas such as disclosure and transparency, CMIs will be at a disadvantage and subject to being driven into a race to the bottom.

In our December 2009 draft white paper, we proposed a regulatory system for private issuers of mortgage-backed securities that would include capital standards alongside a requirement that only mortgages that had been demonstrated to be safe and sustainable would have access to the secondary markets. Since then, the Dodd-Frank Act became law in July 2010, which creates a regulatory capital requirement for securitization. Financial institutions that sponsor asset-backed securitization (including for mortgage-backed securities) are subject to a 5 percent risk retention requirement against which they must hold capital.⁴⁹

Dodd-Frank also creates strong incentives to limit securitization to mortgages with safe and sustainable characteristics, through its exemption from the 5 percent risk retention requirement of “qualified residential mortgages.” The specific criteria for “qualified residential mortgages” will be defined jointly by the banking regulators, the Securities and Exchange Commission, the Department of Housing and Urban Development, and the Federal Housing Finance Agency according to statutory guidelines meant to create incentives to originate safe and sustainable mortgage loans. The guidelines include documented underwriting, ability to repay the loan, product features that reduce payment shocks on adjustable-rate mortgages, and the presence of mortgage insurance or credit enhancement that reduces default risk. Dodd-Frank also explicitly prohibits loans that have balloon payments, negative amortization, prepayment penalties, interest-only payments, and “other features that have been demonstrated to exhibit a higher risk of borrower default” from qualifying as “qualified residential mortgages.”⁵⁰

Finally, Section 942 of Dodd-Frank requires the SEC to adopt regulations to enhance disclosure requirements for asset-backed securities. The regulations may require loan-level data “if such data are necessary for investors to independently perform due diligence.” Given the impact of the lack of transparency that private mortgage-backed securities had on mispricing of risk during the housing bubble, such data would be extremely valuable.

Dodd-Frank creates a framework consistent with our December 2009 recommendations. We look forward to its effective implementation.

Conclusion

Planning for the transition to a new housing finance system

The transition from the pre-2008 housing finance system to the one we have today, in which 90 percent of newly originated mortgages have some sort of government backing, was done in crisis. We are fortunate to have the opportunity to plan for the next transition—a transition to a far greater share of the market being supported by private capital, with government backing limited, explicit, and fully priced. It is essential to do this in a thoughtful manner that will minimize market disruption and encourage maximum participation by private capital.

We do not have the blueprint for the transition, but there are three considerations that are essential to take into account. Specifically, policymakers must:

- Ensure the continued functioning of the single- and multifamily origination and TBA markets without interruption as the path to a new system becomes clear, as housing markets stabilize, and as personal balance sheets are repaired
- Maintain the liquidity of outstanding mortgage-backed securities and protect their value during the transition
- Preserve the human and technological capital that enables the mortgage securities market to work without failures in execution, delivery, or payment

With these considerations in mind, we can turn with confidence to reforming the current housing finance system, which is unsustainable. We have the knowledge and the tools to create an American housing finance system that will be stable over the economic cycle; rely upon private capital; and equitably serve homeowners, renters, landlords, lenders, investors, and the larger American economy, while promoting residential integration, the elimination of housing discrimination, and the provision of safe, decent, and affordable housing in all urban, suburban, and rural communities.

In this paper we have suggested a potential structure for a housing finance system that simultaneously can achieve these goals and while putting private risk capital back at the center of mortgage finance. We have both the time and the opportunity to transform the system so it serves this nation even better and longer than did the system established in the 1930s. The job is substantively complex and politically challenging. But we have the knowledge to accomplish the feat, if only we can come together to do so.

Endnotes

- 1 *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Public Law 111-203, 111th Cong., 2d sess. (July 21, 2010), hereinafter "Dodd-Frank Act."
- 2 While there are other government sponsored enterprises, most notably the Federal Home Loan Banks, in this paper the term "GSEs" refers solely to Fannie Mae and Freddie Mac.
- 3 The Affordable Housing Trust Fund and Capital Magnet Fund are two separate but complementary funds created by the Housing and Economic Recovery Act of 2008 and intended to be financed by a small levy on Fannie Mae and Freddie Mac, with the goal of expanding the stock of affordably priced housing. The Trust Fund distributes funds to the states, who oversee the actual allocation of those funds, primarily for the production, preservation, and rehabilitation of rental housing. The Capital Magnet Fund is a competitive grant program for Community Development Financial Institutions (often referred to as CDFIs) and not-for-profit-housing developers, administered by the Treasury Department with the goal of attracting private capital for low-income housing and community development activities. Buzz Roberts, "Housing Bill Taps Fannie, Freddie for Housing Trust Fund, Capital Magnet Fund," *Journal of Tax Credit Housing* 1 (IX) (2008), available at http://www.lisc.org/files/7476_file_sep_thebuzz_jtch.pdf.
- 4 See Markus K. Brunnermeier, "Deciphering the Liquidity and Credit Crunch 2007-08," *Journal of Economic Perspectives*, 23 (1) (2009): 77-100.
- 5 See Ben S. Bernanke, "Housing, Housing Finance, and Monetary Policy," (Jackson Hole: Speech at the Federal Reserve Bank of Kansas City's Economic Symposium, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070831a.htm>.
- 6 See Richard K. Green and Susan M. Wachter, "The American Mortgage in Historical and International Context," Research Paper No. 06-12 (Institute for Law and Economics 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=908976.
- 7 See, for example, Gary Gorton, "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007," Working Paper (Yale School of Management, National Bureau of Economic Research, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401882; David C. Wheelock, "The Federal Response to Home Mortgage Distress: Lessons from the Great Depression," *Federal Reserve Bank of St. Louis Review*, May/June 2008, p. 134-39, available at <http://research.stlouisfed.org/publications/review/08/05/Wheelock.pdf>.
- 8 Diana Hancock and Wayne Passmore, "An Analysis of Government Guarantees and the Functioning of the Asset-Backed Securities Market" (Washington: Federal Reserve Board, Finance and Economics Discussion Series, 2010), p. 3.
- 9 Some observers have claimed that Denmark and Germany, which rely upon covered bonds issued by private issuers, do not provide government support for their mortgage markets. See, for example, Michael Lea, "Alternative Forms of Mortgage Finance: What Can We Learn from Other Countries?" (Cambridge: Harvard University Joint Center for Housing Studies, 2010), p. 23, available at <http://www.jchs.harvard.edu/publications/MF10-5.pdf>. While it is true that Denmark and Germany do not have explicit government support for their mortgage markets, there is a consensus belief, particularly among investors, that these countries implicitly back their mortgage finance institutions, in much the same way that the United States provided implicit support for the government-sponsored entities Fannie Mae and Freddie Mac prior to their conservatorship in 2008. For example, the Danish government's implied support for its mortgage lending institutions has been consistently described by research firms and rating agencies. See, for example, Christian Meldinger and Ivanka Stefanova, "Danish Covered Bonds—A Primer," (UniCredit Global Credit Research, 2008), available at http://www.nykredit.com/investorcom/ressourcer/dokumenter/pdf/SR080608_DanishCoveredBonds.pdf. (Note that Denmark's 2008 bailouts "affirmed the systemic support within the Danish banking system."); "Moody's downgrades Danske Bank to Aa3/C and Sampo Bank to A1/C" (London: Moody's Investor Service Global Credit Research Rating Action, 2009), available at http://www.danskebank.com/da-dk/ir/Documents/Ratings/20090213_Moodys_Danske%20Bank.pdf. (Ratings action factored in Moody's "view on the very high probability of systemic support" from the Danish government.) Indeed, both countries recently provided strong affirmation of this implied guarantee when they provided major bailouts to troubled mortgage finance institutions during the credit crisis of 2008. In October 2008, Germany set up the "Special Fund Financial Market Stabilization" or SoFFin, a roughly 150 billion Euro fund meant to explicitly support the liabilities of 10 troubled German financial institutions, including one issuer of covered bonds and three Landesbanks (another type of German mortgage lender). See Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), "Annual Report of the Federal Financial Supervisory Authority" (2008), p. 13, pp. 117-18, p. 123, available at http://www.bafin.de/clin_152/nn_720486/SharedDocs/Downloads/EN/Service/Jahresberichte/2008/annualreport_08__complete,templateId=raw,property=publicationFile.pdf/annualreport_08__complete.pdf. Also in October 2008, Denmark announced a sweeping guarantee of all deposits and senior debt issued by its banks. See Neelie Kroes, "Guarantee scheme for banks in Denmark" (Brussels: European Commission, 2008), available at http://ec.europa.eu/community_law/state_aids/comp-2008/nn051-08.pdf. This blanket guarantee followed two major bailouts for individual Danish financial institutions. See Meldinger and Stefanova, "Danish Covered Bonds"; see also Kroes, "Guarantee scheme for banks in Denmark."
- 10 For a more detailed discussion of the principles of the housing finance system, see Center for American Progress, "Principles to Guide Redevelopment and Regulation of a Renewed Mortgage Finance System" (2009), available at http://www.americanprogress.org/issues/2009/03/pdf/mortgage_finance_principles.pdf.
- 11 While there has been considerable debate about the exact causes of the most recent mortgage crisis, it is undisputed that private mortgage securitization, unregulated for risk capital or product or underwriting standards, grew to capture nearly 40 percent of the mortgage market during the height of the housing bubble. See Financial Crisis Inquiry Commission, "Securitization and the Mortgage Crisis" (2010), pp. 10-11, available at http://www.fcic.gov/reports/pdfs/2010-0407-Preliminary_Staff_Report_-_Securitization_and_the_Mortgage_Crisis.pdf. Loans originated for this "shadow banking system," as it became known, have subsequently suffered defaults at rates exponentially higher than for other types of mortgages. See Andrew Jakabovics, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, "The Future of the Mortgage Market and the Housing Enterprises," Oct. 9, 2009, available at http://www.americanprogressaction.org/issues/2009/10/pdf/jakabovics_mortgage_testimony.pdf. As a result, many leading scholars believe that private mortgage securitization was a primary cause of the mortgage crisis.

- 12 See David Min, "Future of Housing Finance Reform: Why the 30-Year Fixed Rate Mortgage is an Essential Part of our Housing Finance System" (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2010/11/housing_reform.html.
- 13 For example, during the past decade, "non-agency" lenders (lenders originating loans not meant to be securitized by Fannie Mae, Freddie Mac, or Ginnie Mae) originated a markedly lower percentage of fixed-rate mortgages than agency lenders. See Andrew Davidson and Anthony B. Sanders, "Securitization after the fall" (2009), p. 10, available at <http://merage.uci.edu/ResearchAndCenters/CRE/Resources/Documents/Davidson-Sanders.pdf>.
- 14 Mark Perry, an AEI Visiting Scholar, is among the near consensus of experts who believe that long-term fixed-rate prepayable mortgages would not exist in the absence of government support, stating that "The 30-year fixed-rate mortgage has to be a creation of government intervention, and not the market, [because] it is a one-sided loan arrangement that bestows huge benefits on the borrower, but with almost no compensation benefits for the lender/bank/thrift..." Mark J. Perry, "Should We End the 30-Year Fixed-Rate Mortgage?" Carpe Diem Blog, comment posted May 30, 2010, available at <http://mjperry.blogspot.com/2010/05/should-we-end-30-year-fixed-rate.html>. Arnold Kling, an adjunct scholar at the Cato Institute, has stated that the interest rate risk on a 30-year fixed-rate mortgage is essentially unhedgeable and therefore is not a market-based product. Arnold Kling, "More on the 30 Year Fixed Rate Mortgage," EconLog Blog, comment posted May 31, 2010, available at http://econlog.econlib.org/archives/2010/05/more_on_the_30.html.
- 15 See Lei Ding and others, "Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Scores," Working Paper (Center for Community Capital and Center for Responsible Lending, May 17, 2010), available at <http://www.ccc.unc.edu/documents/Risky.Disagreg.5.17.10.pdf>.
- 16 See Eric S. Belsky and Nela Richardson, "Understanding the Boom and Bust in NonPrime Mortgage Lending," (Cambridge: Joint Center for Housing Studies, 2010), available at <http://www.jchs.harvard.edu/publications/finance/UBB10-1.pdf>.
- 17 See in particular, Title IX, Subtitle D; Title X; and Title XIV of the Dodd-Frank Act.
- 18 There has been one small private residential mortgage-backed securities deal in the last two years, totaling \$238 million. See Jeff Hiltbrand and Mark Hughes, "Private market for mortgages shows signs of life," *Currency* (2010), available at http://www.gt.com/stat-articles/GTCom/Financial%20services/Currency/2010/Currency%20June%2010%20securitizations_FINAL.pdf. That compares to \$789 billion in RMBS issuances in 2006 alone. See Charles Wallace, "Unlocking the Asset-Backed Securities Market," *Institutional Investor*, Nov. 16, 2010, available at <http://www.institutionalinvestor.com/Popups/PrintArticle.aspx?ArticleID=2716788>.
- 19 See Ding, "Risky Borrowers or Risky Mortgages."
- 20 See Min, "Future of Housing Finance Reform."
- 21 See graphic in David Streitfeld, "Biggest Defaulters on Mortgages are the Rich," *The New York Times*, July 8, 2010, available at http://www.nytimes.com/2010/07/09/business/economy/09rich.html?_r=2&ref=business.
- 22 See Shane M. Sherlund, "The Past, Present, and future of Subprime Mortgages" (Washington: Federal Reserve Board, 2008), Table 5, available at <http://www.federalreserve.gov/pubs/FEDS/2008/200863/200863pap.pdf>.
- The current conforming loan limit is significantly higher than would be justified under the traditional formula, and has been the same (with additional increases in high cost areas under the Economic Stimulus Act of 2008) since 2006, notwithstanding the Federal Housing Finance Administration's finding that house prices have been declining. See Federal Housing Finance Administration, "Maximum Loan Limits for Fannie Mae and Freddie Mac to Remain Unchanged for 2010," (2009), available at http://www.fhfa.gov/webfiles/15180/CLL_November_Release_11_12_09.pdf. These limits will remain applicable for loans originated prior to October 1, 2011. See Federal Housing Finance Administration, "Conforming Loan Limit," available at <http://www.fhfa.gov/Default.aspx?Page=185>. Under the Housing and Economic Recovery Act of 2008, the conforming limit cannot decline even if house prices decline. The special limits for high cost areas established under the Economic Stimulus Act and subsequently renewed are scheduled to expire in September 2011. Ibid.
- 23 See also Center for American Progress, "A Responsible Market for Rental Housing Finance" (2010), available at http://www.americanprogress.org/issues/2010/multifamily_rental_housing.html
- 24 See Joint Center for Housing Studies of Harvard University, "America's Rental Housing: The Key to a Balanced National Policy" (2008) p. 14.
- 25 In 2009, nearly half of all the purchase money mortgages originated were backed by the full-faith-and-credit of the federal government through the Federal Housing Administration, the Veterans Administration, the Farm Services Administration or the Rural Housing Service. See Federal Financial Institutions Examination Council, "Home Mortgage Disclosure Act Aggregate Report" (2009). National Summary Table A1, available at <http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx>.
- 26 The current conforming loan limit is significantly higher than would be justified under the traditional formula, and has been the same (with additional increases in high cost areas under the Economic Stimulus Act of 2008) since 2006, notwithstanding the Federal Housing Finance Administration's finding that house prices have been declining. See Federal Housing Finance Administration, "Maximum Loan Limits for Fannie Mae and Freddie Mac to Remain Unchanged for 2010," (2009), available at http://www.fhfa.gov/webfiles/15180/CLL_November_Release_11_12_09.pdf. These limits will remain applicable for loans originated prior to October 1, 2011. See Federal Housing Finance Administration, "Conforming Loan Limit," available at <http://www.fhfa.gov/Default.aspx?Page=185>. Under the Housing and Economic Recovery Act of 2008, the conforming limit cannot decline even if house prices decline. The special limits for high cost areas established under the Economic Stimulus Act and subsequently renewed are scheduled to expire in September 2011. Ibid.
- 27 In previous iterations of our proposal, we referred to this institution as a "Housing Finance Innovation Fund."
- 28 It is possible that these standards will become de facto standards for the non-CMI market as well, which should increase the liquidity of those securities.
- 29 As discussed in an upcoming paper by Guy Stuart, a lecturer in public policy at Harvard University's Kennedy School of Government, the Federal Home Loans Banks are a notable example of a cooperative structure in housing finance, and one that enjoys an implied government guarantee as well. While many advocates of the cooperative structure have noted the relatively small loss levels for the FHLB system, they have generally ignored the FHLBs' significant protections against losses in their core activity of advance lending. FHLBs enjoy a first line on all collateral they claim against their advances, with the right to swap out defective collateral and to require overcollateralization at any time. As such, the FHLBs have never lost money on advances, but this does not speak to the cooperative structure. However, the FHLBs have suffered large losses on their direct investment activities which are not protected by the special collateral rights the FHLBs enjoy on their advances. These losses suggest that the cooperative structure may not be as risk-curtailing as some of its advocates suggest. Stuart also discusses the system's relative lack of affordable lending or countercyclical lending compared to Fannie Mae and Freddie Mac.
- 30 A TBA market for Ginnie Mae securities also exists, and operates similarly.
- 31 James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market," Staff Report No. 468, (Federal Reserve Bank of New York, 2010), available at http://www.ny.frb.org/research/staff_reports/sr468.pdf.
- 32 As with Ginnie Mae securities, individual mortgage originators could issue securities (analogous to Ginnie 1 securities) or pool them into multi-issuer securities (analogous to Ginnie 2 securities).
- 33 "30-Year Fixed-Rate Mortgages since 1971," available at <http://www.freddiemac.com/pmms/pmms30.htm> (last accessed January 2011).

- 34 Loans held on balance sheet, and thus subject to interest rate, as well as credit risk, would be required to be capitalized at a higher level than loans guaranteed. All these entities are also required to hold loan loss reserves, as would the CMLs. Loss reserves, under GAAP accounting, are procyclical, a particular problem in a bubble-and-bust cycle. Private mortgage insurers must also hold 50 percent of all premiums received for 10 years (which constitutes a counter-cyclical cushion), and must also hold loss reserves. See Mortgage Insurance Companies of America, "2008-2009 Fact Book and Directory" (2009), p. 24, available at <http://www.privatemi.com/news/factsheets/2008-2009.pdf>. Consideration should be given to other reserve structures, such as this premium reserve requirement.
- 35 The CMLs may act as fiscal agents to collect the guarantee premium for the Catastrophic Risk Insurance Fund, but the premium would be immediately paid over to the government. The goal is to bring the Catastrophic Risk Insurance Fund—over a reasonable period of time—1 to 2 percent of the principal value of all securities outstanding that are subject to the guarantee. Given that the fund will only be tapped in the event of a CMI failure, it is backstopped by CMI equity (which the government will regulate), PMI (in many cases), borrower equity, and collateral. Moreover, the mortgages guaranteed will be lower risk than those guaranteed by FHA. Therefore, a fund level of half the required FHA level should be adequate.
- 36 This is also consistent with the current guarantee fee level. See Freddie Mac, "Third Quarter 2010 Financial Results" (2010), Table 7A, available at http://www.freddiemac.com/investors/er/pdf/2010fintbls_3q10.pdf.
- 37 There have long been in place measures to create this outcome among federally regulated depository institutions, such as through the Community Reinvestment Act and other measures meant to ensure nondiscriminatory lending practices. But as mortgage financing has increasingly shifted away from depository institutions and towards the secondary markets, these laws have become increasingly less effective. For example, the share of outstanding mortgage originations attributable to CRA was only 5 percent between 1994 and 2002 in large metropolitan areas. See Neil Bhutta, "Giving Credit Where Credit is Due? The Community Reinvestment Act and Mortgage Lending in Lower-Income Neighborhoods," (Washington: Federal Reserve Board, Finance and Economics Discussion Series 2008-61, 2008), available at <http://www.federalreserve.gov/pubs/feds/2008/200861/200861pap.pdf>.
- 38 12 U.S.C. 2901 et seq.
- 39 These could be built on the foundations of the current GSE portfolios, scaled down through a gradual sell off of the current assets and maintained at a minimal level.
- 40 For more details on our proposal for multifamily rental securitization reform, see Center for American Progress, "A Responsible Market for Rental Housing Finance" (2010), available at http://www.americanprogress.org/issues/2010/10/multifamily_rental_housing.html.
- 41 See Department of Housing and Urban Development, "US Housing Market Conditions" (2010), available at http://www.huduser.org/portal/periodicals/ushmc/fall10/hist_data.pdf.
- 42 See Department of Housing and Urban Development, "Financial Status of the FHA Mutual Mortgage Insurance Fund FY 2010" (2010), pp. 5-6, available at http://www.hud.gov/offices/hsg/rmra/oe/rpts/actr/2010actr_subltr.pdf.
- 43 Ibid, p.1.
- 44 See Department of Housing and Urban Development & Harvard University's Joint Center for Housing Studies, "Creating a New Federal Housing Corporation" (1995), available at <http://babel.hathitrust.org/cgi/pt?view=image;size=100;id=mdp.39015034895089;page=root;eq=3>.
- 45 See Department of Housing and Urban Development, "HUD Reinvention: From Blueprint to Action" (1995).
- 46 See The Millennial Housing Commission, "Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission Appointed by the Congress of the United States" (2002), available at <http://govinfo.library.unt.edu/mhc/MHCReport.pdf>.
- 47 FHA's history of service to low income and minority communities has not, however, been without controversy, as in some communities and in some time periods, racial covenants, block-busting, fraud, and other abuses by realtors, lenders, and other program participants that FHA failed to prevent have led to neighborhood deterioration. See Sean Zielenbach, *The Art of Revitalization: Improving Conditions in Distressed Inner-City Neighborhoods*, (New York: Garland Publishing, 2000), p. 57, pp. 136-38.
- 48 For example, one idea that has been proposed for the Market Access Fund has been to capitalize an equity pool that would purchase participations in local and state "shared equity" homeownership funds, providing scale to this affordability product that has been greatly successful in smaller settings, but which lacks access to the secondary capital markets and is thus otherwise limited in the funds it has access to. The two major barriers to scale for this product have been a large degree of heterogeneity in local products, and a lack of standard performance data. The leveraging of Market Access Fund capital would clearly address these hurdles and allow shared equity to achieve a larger scale, potentially accessing the secondary markets in time.
- 49 *Dodd-Frank Act*, Section 941.
- 50 *Dodd-Frank Act*, Section 1412.

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