Housing Finance 101

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Overview

- Abbreviations and acronyms
- History and evolution of the housing finance system model
- The housing market bubble and Great Recession
- The current situation and the need for housing finance reform
- Implications

Abbreviations and Nicknames

- Government Sponsored Enterprise (GSE)
  - Federal National Mortgage Association (FNMA or Fannie Mae)
  - Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)
- Federal Housing Finance Agency (FHFA)
- Federal Housing Administration (FHA)
- Government National Mortgage Association (GNMA or Ginnie Mae)

Before the Great Depression

- All mortgage finance was private
  - 50% down payments
  - terms of 10 years or less
  - balloon payments at end of term
- Lack of government support contributed to scale of Great Depression
- Homeownership rate
  - 45.6 percent in 1920
  - 47.8 percent in 1930

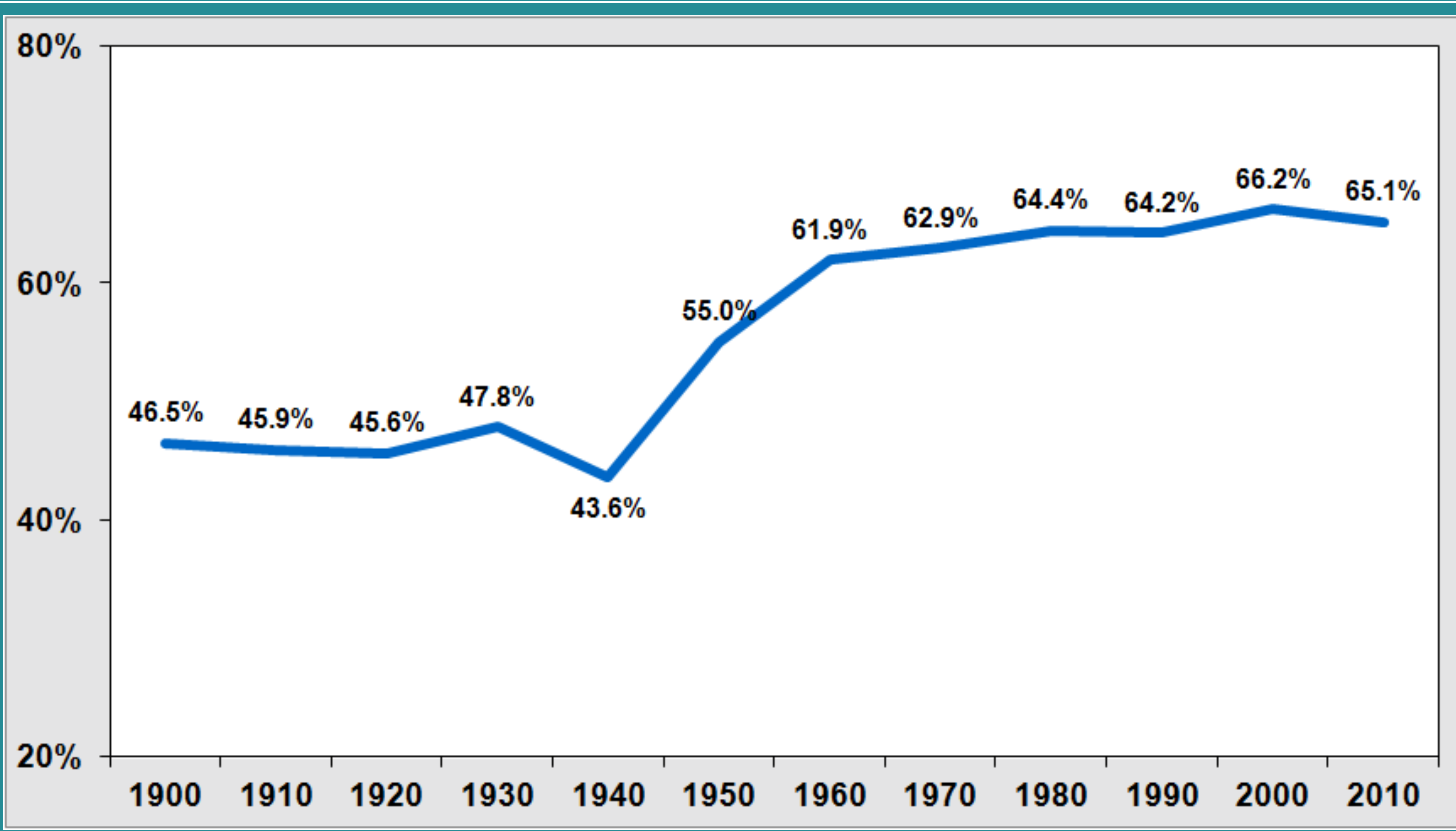
Creation of the GSEs

- 1938 — Fannie Mae created as part of the New Deal
- 1954 — Fannie Mae reorganized from federal agency to public-private corporation
- 1968 — Fannie Mae reorganized into for-profit corporation
- 1970 — Freddie Mac created to help thrifts manage interest rate risk
- 1989 — Freddie Mac reorganized into for-profit corporation
- 1992 — Affordable Housing Goals created

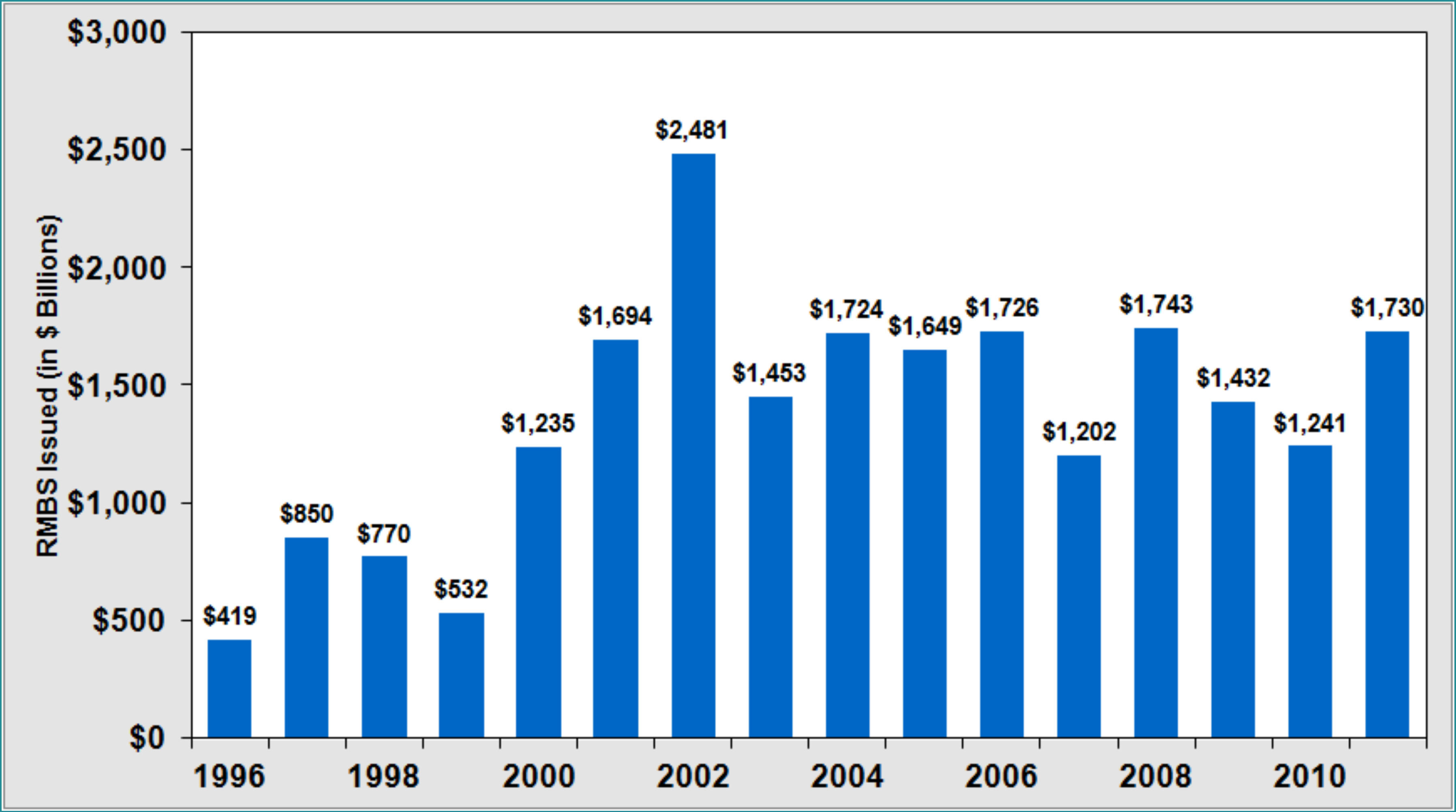
Housing Market Finance Model

- Lender originates 30-year, fixed-rate mortgage with no prepayment penalty
  - sells loan for cash that funds another loan
- Loan purchaser buys many loans
  - bundles them into securities
  - sells securities for cash to buy more loans
- Investor buys RMBS
  - clips coupons for income to buy more securities

Impact on Homeownership



Residential Mortgage-backed Securities (RMBS)



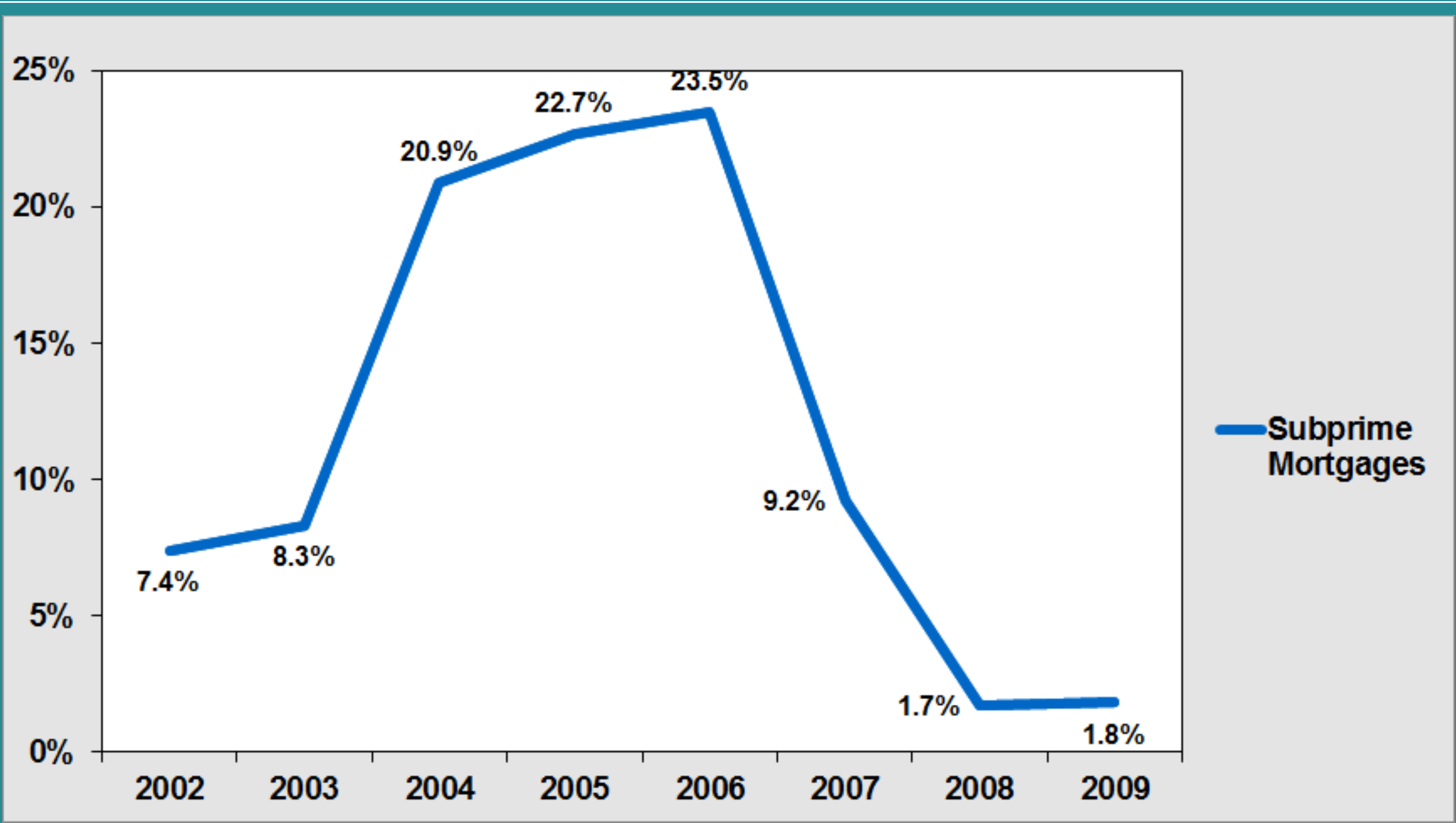
Role of the GSEs

- Establish a market for mortgages
  - – assume default, interest, and prepayment risk; provide liquidity for originators
- Guarantee timely payment on RMBS
  - – reduce risk for investors; keep interest rates low
- Achieve social goals
  - – affordable housing
  - – multi-family rental housing

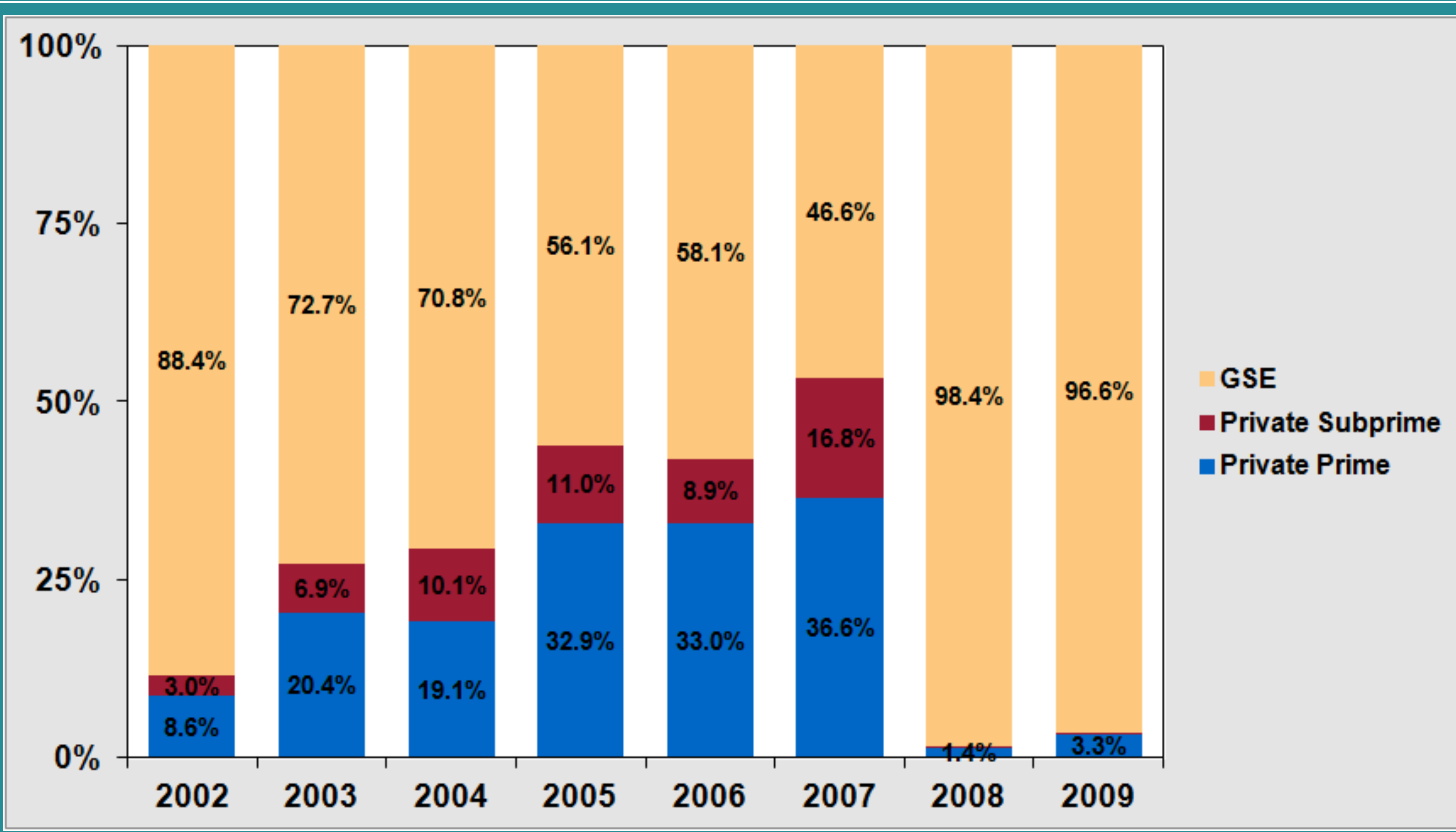
Housing Market Bubble

- Lenders start originating more subprime mortgages
- Private-sector loan purchasers
  - bundle them into investment-grade RMBS
  - without GSE guarantees
- Investors, including the GSEs, buy RMBS
  - relying on investment-grade ratings
  - chasing higher yields

The Rise of Subprime Lending



The Rise of Private Label Securities



The Great Recession

- Loans in RMBS default at high rate
  - interrupts cash flow, scares investors
- RMBS ratings downgraded
  - reduces value of RMBS
  - forces some investors to sell
- Credit constricts and housing prices decline
  - self-reinforcing cycle leads to collapse

Impact on the System

- GSEs bankrupt
  - put into receivership with FHFA
- Private capital flees the housing market
  - despite TARP injection
  - credit severely constricted
- GSEs, FHA only game in town
  - federal guarantees supporting the market
  - risk for taxpayers, federal deficit

Current Situation

- Housing finance system is not functioning on old model
  - politically unacceptable to both left and right, but for very different reasons
- Agreement on need for reform to get private capital back into market
- Lack of agreement on what should emerge as new model

Issues for Housing Finance Reform

- Who issues RMBS
- Who guarantees RMBS
- Nature of the guarantee
- Affordable housing provisions
- Multifamily housing provisions
- Oversight

Center for American Progress

The $5 Trillion Question: What Should We Do with Fannie Mae and Freddie Mac?

Comparison of 27 Plans to Reform Fannie Mae and Freddie Mac

John Griffith and the CAP Housing Team | February 2014

Plan	CAP Mortgage Finance Working Group	Corker-Warner (S.1217)	Urban / Moody's Analytics / Milken
Official title	A Responsible Market for Housing Finance	Housing Finance Reform and Taxpayer Protection Act of 2013	A Pragmatic Plan for Housing Finance Reform
Summary	Privately funded, government-chartered entities guarantee timely payment of principal and interest on qualifying mortgage-backed securities, or MBSs. These guarantees are then reinsured by an explicit government guarantee, with a catastrophic risk insurance fund standing before the taxpayer.	Wind down Fannie and Freddie over 5 years. Privately funded, government-approved entities guarantee timely payment of principal and interest on qualifying mortgage-backed securities. Creates a new government corporation (FMIC) to regulate the MBS market and provide catastrophic guarantee (for a fee) on MBS that meet product standards, including 5% down payment. Private capital must have 10% first loss position.	Gradually wind down Fannie and Freddie. Privately funded, government-approved entities (MBS insurers) insure timely payment of principal and interest on qualifying mortgage-backed securities. Creates a new government-owned corporation (FMIC) that offers a limited and priced government guarantee on qualifying MBS, with private insurance from an MBS insurer and a Mortgage Insurance Fund standing before the taxpayer.
Who issues qualifying mortgage-backed securities?	Private entities.	Government-approved private entities for single family, FMIC for multifamily. Limit on issuer share of FMIC-guaranteed market.	Private entities (may include loan originators).
Who insures qualifying mortgage-backed securities?	Privately funded, government-chartered entities.	Government-approved private entities for single-family, FMIC for multifamily (private capital takes 10% first loss)	Government-approved and regulated private entities (5-10 total). Cannot be affiliated with depositories, unless a small-firm coop approved by the FMIC.
Nature of the government guarantee	Explicit guarantee on qualifying mortgage-backed securities, which pays out when the covered entity fails. Neither the debt nor equity of the entity is backed by the government during normal economic times, but government-backed debt may be issued during deep economic downturns.	Private entities can purchase an explicit government guarantee against catastrophic risk on qualifying MBS (loans must meet "Qualified Mortgage" rule and have 5 percent down payment). Regulators can alter the restrictions on the guarantee in times of crisis.	Private entities can purchase a limited, explicit catastrophic government guarantee on qualifying MBS, with a requirement that private insurance capital take the first loss position. Only the securities are eligible for the guarantee. Treasury and Fed can grant authority to adjust requirements during crises.
Portfolio investments by covered entity	Generally permitted, as long as the investments are safe and serve some functional purpose (i.e., hard-to-securitize loans).	Issuers can hold loans or first loss position on balance sheets for 6 months to facilitate securitization.	Private MBS insurers cannot maintain an investment portfolio, except for a small portfolio for warehousing and loan modifications.
Affordable housing provisions	Requirement to serve qualified borrowers throughout the United States, including underserved areas. Private firms pay into a special fund that helps test new products that expand access and affordability (the Mortgage Access Fund).	Sets aside 5-10 basis points on all FMIC-backed MBS to fund the Housing Trust Fund and Capital Magnet Fund. Alters the HTF to fund research and testing of products that promote access and affordability.	Eliminates the affordable housing goals. Establishes a Market Access Fund, funded with a fee of 6 basis points on all MBS (a strip), to fund the Housing Trust Fund, the Capital Magnet Fund, and grants and credit support to test new products that expand access and affordability.
Multifamily provisions	Government guarantee applies to certain multifamily loans. Covered entities must show they are providing rental housing for working households and offering at least 50 percent of rental units with a securitized loan at 80 percent of area median income.	Transfers existing multifamily business to the FMIC. Authorizes FMIC to guarantee any multifamily mortgage it purchases for a fee, backed by the U.S. government.	No specific recommendations.
Oversight	Federal regulator puts covered entities through yearly planning, reporting, and performance evaluation processes.	FMIC approves all loan originators, servicers, issuers and guarantors of MBS eligible for the government wrap. FMIC also maintains a single securitization platform for FMIC-backed MBS, including common pooling and servicing agreements and data standards. The Mortgage Insurance Fund must build up to a minimum capital reserve of 2.5%.	FHFA is wrapped into the new FMIC, which manages a single securitization platform for all FMIC-guaranteed MBS and regulates the entire secondary mortgage market in coordination with other agencies. The Mortgage Insurance Fund must maintain a capital reserve sufficient to withstand a severe housing and economic crisis. Regular stress testing required.
Transition	No specific recommendations.	Wind down Fannie and Freddie over a 5-year period, starting with an immediate decrease in conforming loan limits. Transfer all single-family assets to a Trust Fund to be sold off in a way that maximizes return to taxpayers, minimizes market disruptions and returns money to equity investors when possible. Within 8 years, study the impact of full market privatization.	Finalize rules governing the primary and secondary mortgage markets. Speed up wind-down of Fannie's and Freddie's portfolio. Establish FMIC and set capital, pricing, and other rules for the market. Gradually sell off Fannie and Freddie assets and reduce government's role as private capital returns, with a target of around 50% of the market backed by FMIC.

The Spectrum of Options

- Major government role
  - issuing and guaranteeing RMBS
  - strong affordable and multifamily goals
  - strong oversight
- Totally private-sector
  - no guarantee
  - no affordable or multifamily goals
  - strictly limited oversight

Some Implications

- Access to affordable long-term finance
  – 30-year, fixed-rate, pre-payable mortgages
- Allocation of risk in a downturn
  – private investor losses vs. taxpayer bailout
- Availability of affordable housing
  – single-family ownership units
  – multifamily rental units

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