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 into for-profit corporation
1968: Freddie Mac reorganized into for-profit corporation
1970: Fannie Mae reorganized from federal agency to public-private corporation
1989: Freddie Mac created to help thrifts manage interest rate risk
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
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
<table>
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<th>Plan</th>
<th>CAP Mortgage Finance Working Group</th>
<th>Corker-Warner (S.1217)</th>
<th>Urban/Moodys Analytics/Milken</th>
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<tr>
<td>Official title</td>
<td>A Responsible Market for Housing Finance</td>
<td>Housing Finance Reform and Taxpayer Protection Act of 2013</td>
<td>A Pragmatic Plan for Housing Finance Reform</td>
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<td>Summary</td>
<td>Privately funded, government-chartered entities guarantee timely payment of principal and interest on qualifying mortgage-backed securities, or MBS. These guarantees are then reinsured by an explicit government guarantee, with a catastrophic risk insurance fund standing before the taxpayers.</td>
<td>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 (FMC) to regulate the MBS market and provide catastrophic guarantees (for a fee) on MBS that meet product standards, including 25% down payment. Private capital must have 10% first loss position.</td>
<td>Gradually wind down Fannie and Freddie. Privately funded, government approved entities (MBS insurers) issue timely payment of principal and interest on qualifying mortgage-backed securities. Creates a new government-owned corporation (FMC) 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.</td>
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<td>Who insures qualifying mortgage-backed securities?</td>
<td>Privately funded, government-chartered entities.</td>
<td>Government-approved private entities for single-family, FMC for multifamily (private capital takes 10% first loss).</td>
<td>Government-approved and regulated private entities (5-10 total). Cannot be affiliated with depositories, unless a small-firm coop approved by the FMC.</td>
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<td>Nature of the government guarantee</td>
<td>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.</td>
<td>Private entities can purchase an explicit government guarantee against catastrophic risk on qualifying MBS (loans must meet &quot;Qualified Mortgage&quot; rule and have 5 percent down payment). Regulators can alter the restrictions on the guarantees in times of crisis.</td>
<td>Private entities may 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.</td>
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<td>Portfolio investments by covered entity</td>
<td>Generally permitted, as long as the investments are safe and serve some functional purpose (i.e., hard-to-securitize loans).</td>
<td>Issuers can hold loans or first loss position on balance sheets for 6 months to facilitate securitization.</td>
<td>Private MBS insurers cannot maintain an investment portfolio, except for a small portfolio for underwriting and loan modifications.</td>
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<td>Affordable housing provisions</td>
<td>Requirement to serve qualified borrowers throughout the United States, including underserved areas. Private firms pay into a special fund that helps to expand products that expand access and affordability (the Mortgage Accessibility Fund).</td>
<td>Sets aside 5-10 basis points on all FMC backed MBS to fund the Housing Trust Fund and Capital Magnet Fund. After the IHT fund research and testing of products that promote access and affordability.</td>
<td>Eliminates the affordable housing goals. Establishes a Market Access Fund, funded with a 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.</td>
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<td>Multifamily provisions</td>
<td>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 the rental units with a rent ceiling set at 90 percent of area median income.</td>
<td>Transfers existing multifamily business to the FMC. Authorizes FMC to guarantee any multifamily mortgage it purchases for a fee, backed by the U.S. government.</td>
<td>No specific recommendations.</td>
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<td>Oversight</td>
<td>Federal regulator puts covered entities through yearly planning, reporting, and performance evaluation processes.</td>
<td>FHA approves all loan originators, servicers, issuers and guarantors of MBS eligible for the government wrap. FHA also maintains a single securitization platform for FMC 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%.</td>
<td>FHA is wrapped into the new FMC, which manages a single securitization platform for all FMC 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.</td>
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<td>Transition</td>
<td>No specific recommendations.</td>
<td>Wind down Fannie and Freddie over a 5-year period, starting with an immediate decrease in conforming loan limits. Transfers 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 5 years, study the impact of full market privatization.</td>
<td>Finalize rules governing the primary and secondary mortgage markets. Speed up wind-down of Fannie’s and Freddie’s portfolio. Establish FMC and set capital, pricing, and other rules for the market. Gradually sell off Fannie and Freddie assets and reduce government’s risk as private capital returns, with a target of around 50% of the market backed by FMC.</td>
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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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