STRUCTURED FINANCE ASSOCIATION

Treasury Housing Finance Reform Plan

Treasury Report:
Housing Finance Reform Plan

The Treasury Department issued a report laying out a series of potential legislative and administrative reforms to create competition and lay a path to end GSEs Conservatorship

Initial Thoughts from SFA Staff

What we learned from the Administration's Housing Finance Reform Plan

- Treasury's eagerly awaited housing finance reform plan, released on September 5th, is the first proposal that outlines a deterministic administrative end to conservatorship. Both the Bush and Obama Administrations repeatedly spoke of a Congressional process to "wind down and replace the GSEs" with a better system. For the Trump administration, that is now officially no longer the plan.
- The plan seeks Congressional action. While Treasury prefers Congressional action to effectuate many of the stated goals, such legislation will not occur in the next 18 months prior to a new Congress. Therefore, any meaningful action will require an administrative route.
- Many of the proposals will take years – perhaps a decade – to effectuate. As such, the likelihood of this plan becoming real depends on the reelection of the Trump Administration.
  - Recent court cases have thrown into question whether or not a new President could actually fire the FHFA Director, adding increased importance on the next Presidential election as it relates to these proposals.
- Whether global MBS investors will view a Treasury backstop for private companies as being equivalent to the GSEs' current backstop while in conservatorship is a question mark. It will take a good bit of explaining, and the administration has no incentive to disrupt this market prior to an election.
- The FHFA speaks at length of reducing the GSEs' footprint prior to a release from conservatorship, but this may be at odds with the idea of raising new capital. How this tension plays out will be very important to watch.

Congress Weighs in on Administration's Plan in Senate Banking Committee Hearing

- A few days after the release of the Housing Reform Plan, the Senate Banking Committee held a hearing with Secretary Mnuchin, Director Calabria, and Secretary Carson. Many questions were raised, particularly over the practicality of executing this plan as well as its impact on housing affordability programs.
- Committee members also repeatedly said they hope a law can pass with a framework similar to the Administration's. Many details remain unanswered, but the broad idea of moving forward on some elements of this reform proposal was largely supported.

Part 1: Summary of the Treasury Report

- Issued pursuant to March 2019 Presidential Memorandum to achieve **four main goals:**
  - End the conservatorships of the GSEs upon the completion of specified reforms;
  - Facilitate competition in the housing finance market;
  - Establish regulation of the GSEs that safeguards their safety and soundness; and
  - Provide that the Federal Government is properly compensated for any explicit or implicit support it provides to the GSEs or the secondary housing finance market.
- **Supports legislation that authorizes an explicit, paid-for government guarantee limited to the timely payment of principal and interest on qualifying MBS** – this would replace support provided via the PSPA.
  - Would be available to FHFA-approved guarantors with significant first-loss exposure
- **Pending legislation, supports FHFA's administrative actions to enhance the regulation of the GSEs, promote private sector competition, and satisfy recommended preconditions for ending the GSEs' conservatorships.**
  - Leave PSPA in place after end of conservatorships (government should be compensated via periodic commitment fee)
  - PSPA drawn upon only in exigent circumstances
  - To facilitate GSE recapitalization, Treasury and FHFA should consider adjusting the variable dividend ("net worth sweep") required by Treasury's senior preferred shares
  - PSPAs should be amended to enhance Treasury's ability to mitigate the risk of a draw on the commitment after the conservatorships
- **Recommends that FHFA and HUD develop defined roles for the GSEs and FHA so as to avoid duplication of Government support.**
- **To achieve a level playing field between the GSEs and private sector competition**, the regulatory frameworks governing the GSEs and other market participants should be harmonized, and in particular, the QM patch should be replaced with a bright line safe harbor that does not rely on the GSEs' practices.

Part II: Background

Taxpayer bailout

- **On September 6, 2008, FHFA placed the GSEs into conservatorship, and the next day Treasury exercised its temporary authority under HERA to enter into the PSPAs.** As of June 30, 2019, the remaining PSPA commitment to Fannie Mae and Freddie Mac was $113.9 billion and $140.2 billion, respectively.

- **In return for the PSPA commitment, Treasury received from each GSE nonvoting senior preferred shares with a liquidation preference of initially $1.0 billion, warrants to purchase 79.9% of the GSE's outstanding common stock for a nominal price, and a right to a periodic commitment fee to be determined at a later date.** After $191.5 billion in combined draws and a $3.0 billion non-cash increase for each GSE in 2017, the GSEs' combined senior preferred liquidation preference now stands at $199.5 billion.
- **Treasury and FHFA amended the senior preferred shares in August 2012** to replace the fixed 10% dividend with a variable dividend that requires each GSE to pay a quarterly dividend to Treasury equal to the GSE's positive net worth above a specified capital reserve amount.27 Through June 30, 2019, the GSEs have paid a total of $301.0 billion in dividends to Treasury.

Conservatorship

- **The continued conservatorships have given the Federal Government far-reaching influence over a large portion of the economy, while providing only limited transparency or accountability to taxpayers.** For example, FHFA, through its management of the GSEs as conservator, has control or other influence over:
  - The underwriting of single-family mortgage loans through the GSEs' underwriting criteria, now the industry standard even for non-GSE mortgage loans in part as a result of the QM patch;
  - The pricing for single-family mortgage loans through approval of the GSEs' loan-level price adjustments and their capital framework;
  - Which mortgage lenders, servicers, mortgage insurers, and CRT counterparties may participate in the secondary market and how they are monitored (e.g., through FHFA's role in approving the GSEs' capital requirements for mortgage insurers); and
  - The GSEs' pilot programs and entry into new lines of businesses, which are all ultimately supported by taxpayers through the PSPAs.

Part III: Defining a Limited Role for the Federal Government

Clarifying Existing Government Support

Maintain longstanding support of the 30-year fixed-rate mortgage loan

- **The PSPA commitment should be replaced with an explicit, paid-for guarantee backed by the full faith and credit of the Federal Government limited to the timely payment of principal and interest on qualifying MBS.** Should be available not only to the GSEs but also to any other potential guarantors that would be chartered by FHFA.

- **Congress should authorize Ginnie Mae to extend this explicit guarantee on MBS backed by conventional mortgage loans.**
- Pending legislation, **Treasury should continue to maintain its ongoing commitment to support each GSE's single-family MBS through the PSPAs**, as amended as contemplated by this plan.

Underserved Renters

- Policy rationale for the GSEs' multifamily businesses **focuses on promoting the availability of affordable rental units.**
- **Congress should authorize an explicit, paid-for guarantee by Ginnie Mae of qualifying MBS that are collateralized by eligible multifamily mortgage loans.**
- **Pending legislation, to preserve support for low- and moderate-income and other historically underserved renters**, Treasury should continue to maintain its ongoing commitment to support each GSE's multifamily MBS through the PSPAs, as amended as contemplated by this plan.

Catastrophic Backstop

- **Congress should condition the availability of the Government guarantee of qualifying MBS** on a GSE or other FHFA-approved guarantor taking the first-loss position on the Government-guaranteed MBS through specified credit enhancement on the mortgage collateral securing the MBS.
- Pending legislation, **each GSE should be recapitalized so that private capital takes the first-loss position on the GSE's exposure to risk and loss.** *Note: GSEs' CRT already provides some private capital standing in front of taxpayer losses.*
- **FHFA and Ginnie Mae should assess the operational and other issues posed by authorizing Ginnie Mae to guarantee the timely payment of principal and interest on qualifying MBS**, including any necessary enhancements to existing securitization and bond administration infrastructure.

Taxpayer Compensation

- **Congress should authorize FHFA to set and adjust fees for Government guarantees of qualifying MBS** so that the compensation paid to the Federal Government is consistent with the pricing of similar risk by private sector market participants (accounting for Government support in other market segments).
  - The fees collected by the government should be deposited in a mortgage insurance fund. The reserve target for the fund should be set each year to ensure taxpayers are protected against losses, should be based on the amounts expected to be paid from or credited to the fund in that year and future years, and also should consider the conditions affecting the housing finance system.
  - In the event that the fund fails to satisfy its reserve target, FHFA should have the authority to recapitalize it through industry assessments on guarantors.
- Pending legislation, **each PSPA should be amended to compensate the Federal Government for the continued support of the GSEs through an appropriately priced periodic commitment fee.**

Support of Single-Family Mortgage Lending

- While the GSEs' charters permit acquisitions of higher balance mortgage loans and do not limit the range of acquired loan products and loan purposes, **these charters were granted when the Federal Government expressly denied any implicit or other support of the GSEs.**
- **Guarantors' activities should be restricted by statute in order to facilitate FHFA's regulation of the guarantors and to limit the exposure of the mortgage insurance fund**.
  - Specifically, guarantors should be monoline businesses limited to the business of securitizing Government-guaranteed MBS
- **Pending legislation, FHFA should assess whether each of the current products, services, and other single-family activities of each GSE is consistent with its statutory mission and should continue to benefit from support under Treasury's PSPA commitment.**
  - FHFA should solicit information on whether to tailor support for cash-out refinancings, investor loans, vacation home loans, higher principal balance loans, or other subsets of GSE-acquired mortgage loans.
- **FHFA should implement a policy and process for approval of the GSEs' new pilot programs and other new activities or products, with that process soliciting public input.**
  - Ensure that each new program, activity, or product is clearly authorized by the GSE's charter and would not compete with products or services already provided by the private sector.

Support of Multi-Family Mortgage Lending

- **In December 2015, FHFA announced that it would impose caps on each GSE's annual multifamily loan acquisitions** – and has adjusted these caps each year, with the 2019 caps limiting each GSE to $35 billion in multifamily acquisitions.
  - The caps are subject to broad exemptions, for example, for certain affordable housing loans and for loans to finance energy and water efficiency improvements.
- In part because of these broad exemptions, the GSEs have grown from owning or guaranteeing 25% of outstanding multifamily debt in early 2008 to almost 40% today. That share could climb, as the GSEs have acquired approximately 50% of recent multifamily originations.
  - Need to ensure that private capital is not crowded out.
- **Congress should implement a framework to limit the aggregate footprint of multifamily guarantors.** Congress should limit the multifamily mortgage loans that are eligible to secure Government-guaranteed multifamily MBS to ensure a close nexus to a specified affordability mission.

- Pending legislation, **Treasury and FHFA should consider amending** each PSPA to limit support of each GSE's multifamily business to its underlying affordability mission, including potentially through a revised framework for capping each GSE's multifamily footprint.

Additional Support for Affordable Housing

- On June 25, 2019, President Trump signed an Executive Order Establishing a White House Council on Eliminating Regulatory Barriers to Affordable Housing.
- **FHFA should revisit the GSEs' underwriting criteria** for acquisitions of multifamily loans secured by properties in jurisdictions that adopt rent-control laws or other undue impediments to housing development, e.g. prescribing lower LTV limits or other underwriting restrictions on these acquisitions.
- Congress should replace the GSEs' statutory affordable housing goals with a more efficient, transparent, and accountable mechanism for delivering tailored support to first-time homebuyers and low- and moderate-income, rural, and other historically underserved borrowers, with a portion of the associated funding potentially transferred to HUD to expand its affordable housing activities.
  - Report states that current goals contributed to the GSEs' risk taking and losses in lead up to the financial crisis.
- Pending legislation, **FHFA should consider more efficient mechanisms for the GSEs to achieve the statutory affordable housing goals.**
- FHFA and HUD should implement a specific understanding as to the appropriate roles and overlap between the GSEs and FHA, for example, with respect to the GSEs' acquisitions of high LTV and high DTI loans and FHA's underwriting of cash-out, conventional-to-FHA, and other refinancing loans and loans to repeat FHA borrowers.
  - Report states that duplication of support for affordable housing has unnecessarily increased with the conservatorships, particularly in the last several years.

Ending the Conservatorships

- **The specific preconditions for FHFA considering a particular GSE's exit from conservatorship should include, at a minimum, that:**
  - FHFA has prescribed regulatory capital requirements for both GSEs;
  - FHFA has approved the GSE's capital restoration plan, and the GSE has retained or raised sufficient capital and other loss-absorbing capacity to operate in a safe and sound manner (**see recapitalization bullets below**);
  - The PSPA between Treasury and the GSE has been amended to:

        - require the GSE to fully compensate the Federal Government in the form of an ongoing payment for the ongoing support provided to the GSE under the PSPA;
        - focus the GSE's activities on its core statutory mission and otherwise tailor Government support to the underlying rationale for that support;
        - further limit the size of the retained mortgage portfolio of the GSE;
        - subject the GSE to heightened prudential requirements and safety and soundness standards, including increased capital requirements; and
        - ensure that the risk posed by the GSE's activities is calibrated to the amount of the remaining commitment under the PSPA;
    - Appropriate provision has been made to ensure there is no disruption to the market for the GSE's MBS, including its previously issued MBS;
    - FHFA, after consulting with the FSOC, has determined that the heightened prudential requirements incorporated into the amended PSPAs are, together with the requirements and restrictions imposed by FHFA in its capacity as regulator, appropriate to minimize risks to financial stability

- Pending legislation, **FHFA should exercise its authority as conservator to begin the process to end each GSE's conservatorship** in a manner consistent with the preconditions set forth in this plan.
- Potential approaches to **recapitalization** include:
    - Eliminating all or a portion of the liquidation preference of Treasury's senior preferred shares or exchanging all or a portion of that interest for common stock or other interests in the GSE;
    - Adjusting the variable dividend on Treasury's senior preferred shares so as to allow the GSE to retain earnings in excess of the $3 billion capital reserve currently permitted;
    - Issuing shares of common or preferred stock, and perhaps also convertible debt or other loss-absorbing instruments, through private or public offerings, perhaps in connection with the exercise of Treasury's warrants for 79.9% of the GSE's common stock;
    - Negotiating exchange offers for one or more classes of the GSE's existing junior preferred stock; and
    - Placing the GSE in receivership, to the extent permitted by law, to facilitate a restructuring of the capital structure
- **Pending a recapitalization plan, and as an interim step toward the eventual PSPA amendment contemplated by this plan, Treasury and FHFA should consider permitting each GSE to retain earnings in excess of the $3 billion capital reserve currently permitte**d, with appropriate compensation to Treasury for any deferred or forgone dividends.

Part IV. Protecting Taxpayers Against Bailouts

Capital and Liquidity

Capital Requirements

- The report notes that deficiencies in the GSEs' regulatory capital framework were at the root of the GSEs' growth leading up to the financial crisis.
- **Treasury recommends each GSE/ guarantor should have regulatory capital requirements that allow for viability as a going concern after a severe economic downturn.** Losses should be borne by shareholders, not taxpayers. The regulatory capital framework also should contemplate a simple, transparent, non-risk-based leverage restriction to supplement risk-based capital requirements.
- FHFA should disclose additional detail with respect to the calibration of regulatory capital requirements, including the underlying models, data, and assumptions.

Credit Risk Transfers

- Report notes that GSEs began CRT programs in 2013, beginning with issuance of CAS and STACR products, but also encompassing insurance, reinsurance, lender risk-sharing and other front-end transactions.
- In prescribing regulatory capital requirements, **FHFA should provide for capital relief to GSEs and other guarantors through a diverse mix of approved forms of CRT.**

Liquidity Requirements

- GSEs have reduced reliance on debt funding as they have wound down their retained portfolio. However, they still have liquidity risk, especially around maintaining a cash window and purchases of non-performing loans out of securitization pools.
- **FHFA should continue to enhance GSEs/Guarantor liquidity requirements with high quality liquid assets to operate in safe and sound manner.**

Resolution Framework

- A credible resolution framework is a necessary component of ensuring taxpayers are protected against future bailouts.
- **Congress should authorize FHFA to require each large guarantor to maintain convertible debt or other similar loss-absorbing instruments sufficient to ensure there is adequate total loss-absorbing capacity to facilitate resolution**. (legislative)

- Pending legislation, Treasury and FHFA should consider amending each PSPA to require each GSE to maintain convertible debt or other similar loss-absorbing instruments sufficient to ensure there is adequate total loss-absorbing capacity to facilitate resolution.

Retained portfolios

- **Congress should prohibit each guarantor from investing in mortgage-related asset**s or other investments except to the limited extent necessary to engage in the business of securitizing Government-guaranteed MBS.
- Pending legislation, **Treasury and FHFA should amend each PSPA to further reduce the cap on the GSE's investments in mortgage-related assets**, setting a different cap for each GSE, and also to restrict the GSE's retained mortgage portfolio to solely supporting its business of securitizing MBS.

Credit Underwriting

- As background, report notes the improvements in underwriting at GSEs while in conservatorship, including the exclusion of certain product (negative amortization loans, balloon loans, interest only loans).
- Report recommends that **Congress restrict mortgage loans eligible for government guarantee on MBS to loans originated in compliance with sound underwriting restrictions**, taking into account DTI, insurance, LTV and down payments. FHFA should conduct an assessment of risks posed by GSE underwriting criteria.

Part V. Promoting Competition in Housing Finance

Level Playing Field

Harmonizing Regulatory Frameworks

- **The report notes that unwarranted differences in regulatory requirements between the GSEs and their private sector competitors should not create opportunities for regulatory arbitrage.** It states that similar credit risks generally should be subject to similar credit risk capital charges across market participants.
- **Treasury recommends that FHFA consult with the other federal financial regulators to ensure that differences in the regulatory frameworks between the GSEs and other market participants are tailored to differences in these regulated entities, and do not create opportunities for regulatory arbitrage.**

Qualified Mortgage and QM Patch

- Treasury supports expiration of the Patch. It also states that lenders should have a bright line safe harbor after expiration of the Patch. It states that Appendix Q should be modernized on an ongoing basis, possibly by referencing related sections of GSEs' selling guides. However, it also notes the shortcomings of this approach, as it risks cementing GSEs in a quasi-regulatory role post-conservatorship.

- **Report recommends exploring alternative approaches that provide bright-line requirements not relying on overly-prescriptive underwriting requirements**, and cites the example of pricing as proxy for risk, as well as presumption of compliance based on borrower payments over a specified seasoning period.
- Moreover, GSEs should be constrained by QM, but FHFA may set policies that limit GSE/guarantor purchases more restrictively
- **Report recommends Congress amend TILA to establish bright-line safe harbor**. Pending that, CFPB should amend ATR to establish bright-line replacement for Patch, working to avoid market disruption in connection with the expiration of the Patch. Finally, FHFA should revisit determination of which QMs should be eligible for government guarantee in MBS.

Private-Label Securities

- Report discusses current lack of PLS market, referring to Dodd-Frank capital treatment of PLS, risk retention rules for PLS, and assignee liability as factors that may limit investor demand. It also discusses regulatory burdens, noting the GSEs are not subject to Reg AB II compliance, which some have cited as an obstacle to PLS issuance. Treasury recommends that the Federal regulatory agencies review the above factors.
- **It also recommends FHFA consider requiring GSEs to comply with Reg AB II**, and disclosing more of GSEs historical loan-level data and property valuation to public.

Competitive Secondary Market

- Report notes history of GSEs, and the duopoly of Fannie and Freddie, and the role they have played in securitizing mortgage loans and providing a cash window for smaller lenders. It also notes some of the structural impediments for new entrants into the system, including the cash window and nationwide servicing requirements, which could allow FHFA to create national underwriting policy or pricing terms.
- It notes that volume-based discounts created an uneven playing field, and by eliminating them in conservatorship, FHFA helped level playing field.
- **Report recommends that each single-family guarantor be required to operate a cash window, should be prohibited from volume-based pricing, and should be required to maintain nation-wide presence.** Also recommends changes to PSPAs to ensure the GSEs meet the same requirements.

Competitive Primary Market

- Report notes the historical role of FHLBanks in providing mortgage credit, and that as the mortgage market has evolved, FHLBank membership access has been expanded as well. However, some lenders are excluded from FHLBank membership.
- The report notes that there are safety and soundness and counterparty risk considerations for limiting FHLBank membership, but recommends that Congress consider permitting additional classes of mortgage lenders.
- Pending legislation, **FHFA should revisit its rule excluding captive insurance companies from FHLBank membership** in light of the continued evolution of the housing finance system.