GSE Reform: Something Old, Something New, And Something Borrowed

Executive Summary

"Don't build a new assembly plant to fix a fender when the chassis is in good shape"

- **SIFI designation** with bank-style capital standards and enhanced regulatory oversight
- **Utility-like model** to regulate g-fees – provides investors a modest stable return and maintains Affordable Housing Trust Fund and Capital Magnet Fund goals
  - Explicit affordable housing goals included in rate-making process
  - Designated by charter in order to limit political mission creep
- Enterprises to **build taxpayer protecting capital** over a reasonable 5+ year timeframe by retaining capital and issuing primary equity until SIFI capital standards are met – no dividends (preferred or common) until Enterprises meet SIFI capitalization requirements
- **Monetizing Treasury's warrants** could provide in excess of $100 billion in funds for affordable housing and/or other public initiatives

A utility-like model could be implemented largely through powers already granted by HERA

Intended Purpose of GSEs and Secondary Market Role

Why were the GSEs created?

- Role of Fannie and Freddie as mortgage lender of last resort when primary sources of capital dry up
- Needed to address regional shortages of lending, short-term loans, balloon loans, refinancing risk, cyclical shortages of credit, underwater mortgages, etc.
- Need to keep primary market and secondary market participants separate to ensure liquidity during business cycles
- Prior to the Great Depression of the early 1930s, home purchases were primarily financed with short-term loans (e.g. 5-10 years). When those loans matured, borrowers were expected to either pay off the remaining principal balance or refinance the loan. Having made down payments of 50% of the purchase price, during the Great Depression, many families found themselves unable to support their mortgage or lost a majority of their wealth
- Support of TBA market creates hedging mechanisms that allow small community lenders (regional banks, credit unions, etc.) to forward-hedge their fixed rate pipeline. This results in mortgages being available to regional pockets that could be overlooked by large banks – this balances the playing field for smaller banks
- Maintains bedrock of American housing policy by making a 30-year fixed rate mortgage available to all credit-worthy borrowers

Fannie and Freddie have proven track record of supporting American housing during business-cycle downturns

Why this time would be different

- **Capped investment portfolio** mitigates mis-aligned incentives
- **SIFI designation** would ensure prudence and Safety & Soundness
- **Better quality mortgages** – Qualified Mortgage rule and new servicing oversight standards
- **FHFA regulation** – FHFA is an independent agency with substantial powers whereas OFHED was largely ineffective
- **Enhanced state level regulations** helps to minimize bad actors and fraud
- **Consumer protection rules** softening the impact of "exotic" mortgage products
- **Utility-like rate-making board** incorporating effects of explicit affordable housing goals, reduces mission creep, political interference and lobbying capabilities.
- **Subordinated capital** built over a 5+ year time frame by suspending dividends and issuing primary equity until SIFI style capital goals are met
- **HERA** replaced the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 which was ineffective and contributed to oversight short comings

Substantial game-changing regulation has been already put in place by HERA, the CFPB, and state regulators; this greatly mitigates ongoing risk and a return to past bad-practices

Minimal Legislative Reform Requirements

- The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act of 1992) resulted in a 16 year deterioration in mortgage underwriting standards in the U.S. that culminated in the financial crisis
- HERA replaced the GSE Act of 1992 and granted FHFA substantial power to act as an independent regulator
- Turning off the Net Worth Sweep and **rebuilding capital does not require either Congressional or Treasury approval**. Senior Preferred dividends could simply be not declared by the BOD of each GSE. 'Duty to Serve' is part of the GSEs charters and already FHFA has the authority to implement capital standards without new legislation
- FHFA should direct the GSEs to submit a capital plan as required by HERA
- As explicitly stated in the PSPA agreement, the **Treasury line is not a replacement for Tier 1 Capital**
  - "***Disclaimer of Guarantee.*** *This Agreement and the Commitment are not intended to and shall not be deemed to constitute a guarantee by Purchaser or any other agency or instrumentality of the United States of the payment or performance of any debt security or any other obligation, indebtedness or liability of Seller of any kind or character whatsoever."* – PSPA agreement (September 26, 2008)

Substantial change can be achieved under the existing authority granted to the FHFA without new legislation

Proper Capital Levels and SIFI Designation

- Basel III is a framework for global bank regulation formulated by the BIS, which includes detailed and proscriptive requirements for capital adequacy, as well as requirements for liquidity risk, stress testing and enhanced supervision
- Basel III has been adopted in the U.S. with capital requirements currently in the process of being phased-in
- Basel III will also be applied to certain other institutions via the Federal Reserve Board's authority under the Dodd-Frank Act to establish enhanced prudential standards:
  - These include intermediate holding companies (under foreign banking organizations) which hold U.S. banking and non-banking subsidiaries as well as nonbank financial companies that are designated as systematically important by FSOC

BANK SIFI's

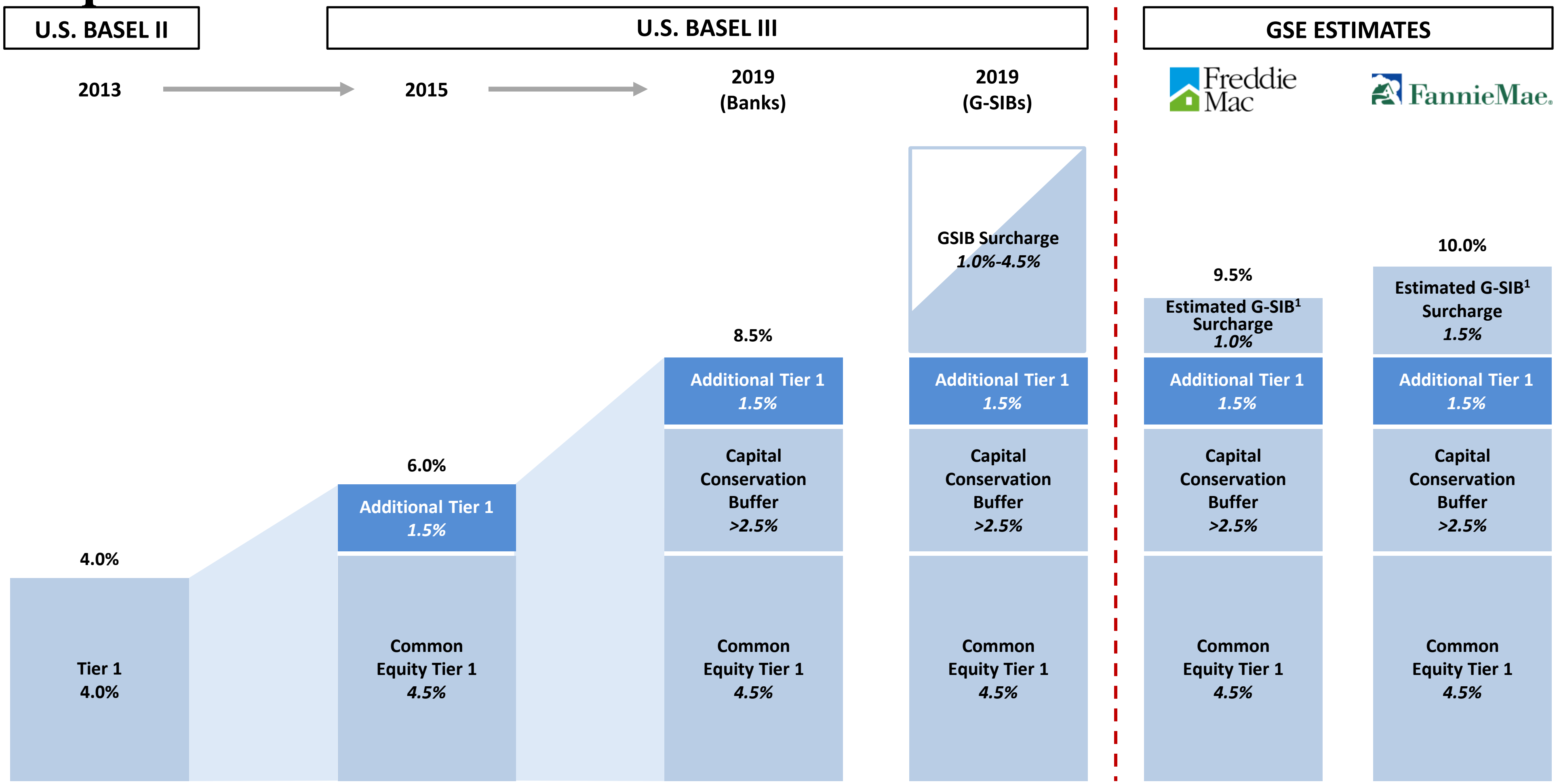
RBS
STATE STREET
中国农业银行 AGRICULTURAL BANK OF CHINA
ING
Santander
HSBC
citi
Nordea
GROUPE BPCE
BNP PARIBAS
Deutsche Bank
CRÉDIT AGRICOLE
BARCLAYS
JPMORGAN CHASE & CO.
ICBC
Morgan Stanley
中国建设银行 China Construction Bank
Standard Chartered
MIZUHO
WELLS FARGO
UBS
Bank of America
SOCIETE GENERALE
Mitsubishi UFJ Financial Group
SMBC SUMITOMO MITSUI BANKING CORPORATION
UniCredit Group
BNY MELLON

NON-BANK SIFI's

AIG
GE Capital
Prudential
MetLife

Designating GSEs as SIFIs creates an acceptable way for regulators to determine the minimum capital levels to protect both taxpayers and the mortgage market. It also demonstrates that the problem is manageable and is not too large or un-estimable to tackle as some commentators have implied

Proper Capital Levels and SIFI Designation Minimum Risk-Based Capital (RBC) Requirements



SIFI designation would create a well understood standard for risk-based capital retention for both Fannie and Freddie

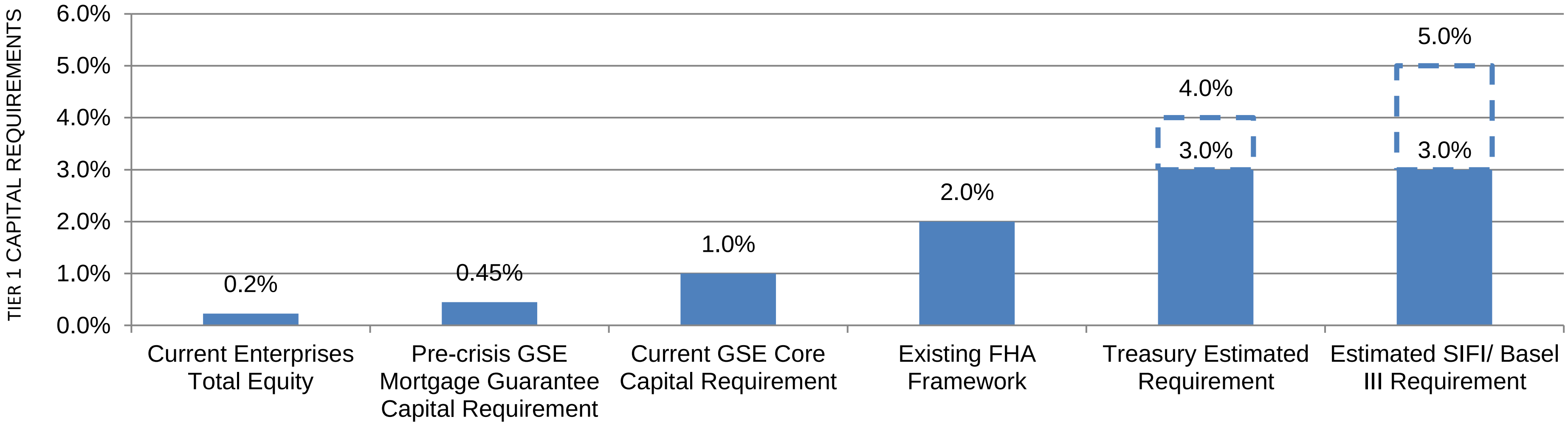
Source: Davis Polk

Note: U.S. Basel II excludes Tier 2 capital requirement. U S. Basel III excludes Tier 2 capital requirement as well as the countercyclical buffer requirements for advanced approaches banking organizations. Estimated Freddie Mac G-SIB surcharge of 1.5% and estimated Fannie Mae G-SIB surcharge of 1.5%

1. Global systemically important banks

Proper Capital Levels and SIFI Designation Estimated GSE Capital Requirements

	Designation	RWA Approach	Tier 1 Requirement	Average Risk Weighting	Tier 1 Capital % of Total Assets
Risk-Based Capital Requirement	Basel III Bank	Standardized[1]	8.5%	50%	**4.25%**
		Advanced[2]	8.5%	35%	**<3.0%**
	G-SIB	Standardized[1]	10.0%	50%	**5.0%**
		Advanced[2]	10.0%	35%	**3.5%**
Leverage Ratio Requirement	SLR				**3.0%**
	eSLR				**5.0%**



Tier 1 capital of 3% to 5% as a percent of total assets is consistent with the Treasury's own estimate of 300 – 400 bps as discussed in Jeffrey Goldstein's January 2011 Memorandum to Secretary Geithner

Source: BIS, Federal Reserve Bank, Company Filings, FHFA, FHA, Rosner
Note: Company Filings, FHFA, FHA, BIS, Treasury memorandum
1. Standardized Approach: In this approach, Banks are given risk weights by regulators to apply for the various assets to which they are exposed
2. Advanced Internal Ratings Based Approach: Rather than relying on regulator-mandated inputs, under the this approach banks are allowed to use their own estimates of creditworthiness to calculate capital requirements through a supervisory formula

Utility Model Rate-making and Oversight

A public utility model offers one possibility for incorporating private ownership. In such a model, the GSE remains a corporation with shareholders but is overseen by a public board. Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return to shareholders" – Ben Bernanke

To ensure the stability of the secondary market Congress should empower the regulator to determine an allowable rate of return necessary to ensure the enterprises maintain a stable capital base

With capped rates of return and rate cases determining cost-recoveries which include the cost of affordable housing programs, a utility model limits many of the problems of the past (lobbying, regulator capture, undue influence by shareholders, management, and Congress, etc.)

Regulated Utility

Rate Case

Regulated electric utilities typically need to adjust rates when costs have risen and the revenues no longer cover the costs of ongoing operations. This process is called a <u>**Rate Case**</u>

Public Utility Commission (Regulator)

Public Utility Commissions (PUCs) serves as an replacement for the competitive market. In exchange for granting the exclusive right to sell electricity in a given service territory, PUCs determine how much the utility is allowed to invest and in what, how much it can charge, and what its profit margin can be

Service

The utility provides service to customers. Customers pay for utility service at the cost determined by the utilities' rate

Financing

The utility goes to the financial markets to raise the necessary money to build power plants and make other capital investments

Customers (Ratepayers)

The rate paid by customers reflects the cost of production, capital expenditures, operating and maintenance costs and distribution

Investors

Investors are an important part of the business, especially when the utility needs to raise money to modernize the electric system

<u>Benefits of regulated utility model</u>

- ✓ **Attractive framework for third party investors due to low earnings volatility**
- ✓ **Ensures end-user affordability through strict regulation and oversight**
- ✓ **Effective model for maintaining end-user access to critical public services under private enterprises**
- ✓ **Low cost of capital benefits are directly passed on to end-users**

If we want to strike the proper balance in support of the secondary mortgage market, we have to recognize that Fannie and Freddie provide an essential public service (e.g., the ongoing availability of secondary mortgage credit, much like providing water, gas, electricity, or sewers)

Benefits of Utility Model, Regulated Capital, Affordable Housing, and Safety & Soundness

- By limiting the size of the investment portfolios, the role of insuring and securitizing mortgage-backed securities would transfer interest-rate risks to the financial markets and the retained credit risk would be backed by appropriate levels of capital

- The value of the Treasury's warrants will increase as capital is built and safety and soundness is achieved

- Warrants could be used to provide a significant amount of affordable mortgage funding while reducing Fannie and Freddie from mission creep and political pressures

- Through utility-like regulation, rate of return targets would soften the ability of politicians to lower their credit standards, without offsetting increases in necessary g-fees, in such a way as to jeopardize safety & soundness

A well regulated utility model with SIFI designated levels of capital would build upon a strong chassis already in place with the intellectual capital and mechanisms already in place at Fannie and Freddie

Support for the 30-year Mortgage and TBA Market

- Maintaining the 30-year mortgage for middle-class conforming investors is an important goal for policy makers, builders, realtors, and smaller lenders
- The 30-year mortgage is an important bedrock of American housing and provides, not only the ability for stable borrower cash flows over a long amortization period, but also provides an important hedging tool for credit and interest rate management purposes
- Supporting a 30-year mortgage and a successful TBA market requires that the secondary market be fully functioning during period of business cycle downturns. Fannie and Freddie support the secondary market when other forms of private capital are unavailable (e.g., bank support, credit risk transfer products, etc.)
- Some level of government commitment would be needed to support the Enterprises and, in turn, secondary mortgage market from catastrophic risk
- An explicit guarantee should be as small as possible and stand behind significant levels of capital determined by the FSOC as part of its SIFI designation. It should be a catastrophic guarantee "… not to fund a future bailout, but to fund the resolution of a failing firm in the face of another 100-year flood."
- The government should charge a fee for its catastrophic guarantee and this fee should be included in the rate-making process by the rate-making board. This fee could be set by FSOC by referencing market rates
- The existing Treasury lines of support outstanding could be transferred to backstop this explicit guarantee

The 30-year fixed rate mortgage and TBA market are the cornerstone of American housing finance

A False Myth: “Private Capital can replace the GSEs”

***“The entire banking system of the United States only has $13-15 trillion of assets. Mortgages are almost as big as the entire domestic economy.”* – Don Layton, CEO of Freddie Mac**

- To replace the GSEs and attract enough private capital to insure only the top 10% of their $5 trillion mortgage credit book of business, the industry would need to attract close to $500 billion of capital before considering the capital risk weighting of assets
- Back-end risk transfer (BERT) vehicles (STACRS and CAS) provide an important supplement to private risk capital; however they would most likely not be available during business cycle downturns
- Private capital investment in BERT has only been $25.2 Billion to date
- Private-label securitization market remains closed and unlikely to restart anytime soon
- The entire PMI industry has only ~$4 billion in Surplus available to support its guarantees; with a 15:1 risk-to-capital ratio as determined by the FHFA’s PMIERS, deep MI can provide some capital relief, but it will only be a dent in what is required during benign business cycles

It is important to separate from the primary market in which banks and other lenders operate the secondary market in order to provide a counter-cyclical buffer for mortgage finance

Second False Myth: “We Need More Competition”

- A key argument from those who are in favor of breaking up the GSEs is that they have ‘duopoly’ power over the market
- But this argument ignores:
  - Fannie and Freddie are not the only source of long-term mortgage funding and they do not set the price of mortgage credit artificially high. They support the secondary market and do not compete with lenders for primary business
  - They have been encouraged by the FHFA and other stakeholders (Congress, the Administration, and affordable housing advocates) to keep guarantee fees low to support the housing recovery
  - The GSEs are supposed to support a secondary-market only for the purpose of ensuring liquidity when those primary systems fail
  - Under a Utility Model, pricing would largely be determined by a rate-making board similar to that of other public utilities. The minimum capital that would be required to protect from credit risk would be determined by the FSOC through its SIFI designation; and capital to protect from interest rate risk would not be necessary due to the elimination of the investment portfolios
  - With the level playing field established through a Utility Model, and the implementation of the Common Securitization Platform (CSP), Fannie and Freddie would essentially be able to compete with each other through high quality service, product innovation and other intangibles. As such they would have duopsony power and not duopoly power
    - A Duopsony is an economic condition, similar to a duopoly, in which there are only two large buyers for a specific product or service. Members of a duopsony have great influence over sellers and can effectively lower market prices for their supplies
  - The CSP will create incentives for each firm to drive down marginal costs in the secondary market while it will also help to eliminate the underpricing of risk that can result from the creation of excess liquidity and uneconomic behaviors

Fannie and Freddie would compete through quality of service and innovations, not price, under a utility model

Massive Transition Risks and Costs of Alternative Models

PATH Act

- Jeb Hensarlings's Path Act eliminates Fannie and Freddie in 5-years and relies solely on the development of private capital to support a publicly based securitization platform
- Rates would undoubtedly need to increase to support mortgages that don't fit an ideal standard
- Private capital would be unlikely to be available during market declines at reasonable returns
- With no mechanisms to support the market during downswings; business cycles could be amplified

Johnson-Crapo

- Johnson-Crapo's Act also eliminates Fannie and Freddie in 5-years: but they replace Fannie and Freddie with Big Bank sponsored clearinghouses that depend upon a catastrophic guarantee to support the secondary market
- Rates are likely to be higher as a result of multiple layers of execution that would included guarantors as well as the common securitization platform
- Runs the risk of blurring the lines between primary and secondary market participants
- Gives an incentive for private capital to dry-up during cyclical downturns; hereby rivaling governments role as a potential backstop without the mechanics in place

Taking these massive risks with the financial and real estate sectors of the U.S. economy as a whole is morally and politically unacceptable when post-HERA we already have most if not all of the straightforward tools to fix the problems that hit the GSEs during the financial crisis (i.e. more capital and proper regulation)

Conclusion

- Given the legacy competencies, the capital needs, the infrastructure costs, the required efficiencies of scale, their market reach, and the need to be able to deliver services on a counter-cyclical basis, the GSEs should be viewed as public utilities

  - ***"I am skeptical that the 'break it up and privatize it' option [e.g., Corker-Warner or the PATH Act] will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection. It is difficult to envision a sound, practical, private sector mortgage insurance business of any significant size that does not require large amounts of capital, and consequently generates only a modest return of capital …" - Hank Paulson***

- A Utility model keeps the secondary market separate from the primary market in which banks and other lenders operation in order to diversify risks and provide a counter-cyclical buffer for mortgage finance

- Rather than introducing an entirely new system in which the commingling of the duties of primary and secondary market players recreate systemic risks, we should repair the existing system and ensure that the GSEs have meaningful levels of capital

A utility model that emphasizes safety & soundness, a mission to serve, and stability in the secondary markets can be largely achieved through the powers granted to the FHFA by HERA