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

In this paper we review the historic changes in the role and functions of the government sponsored enterprises, Fannie Mae and Freddie Mac (GSEs) as secondary market guarantors of primary market lending. We then explore the manner in which government housing policies directed the GSEs to expand mortgage financing without regard to other important regulatory and social priorities and discuss how these innovations caused private mortgage originators to follow the GSEs down a path toward more -- but less sound -- mortgage products. We then demonstrate how these actors together, with private mortgage insurers (PMIs) and rating agencies, enticed consumers and investors into shouldering unacceptable levels of financial risk that led to the financial crisis.

In contrast to recent purported “GSE reform” proposals offered in Congress, which further empower the nation’s largest banks and lenders with a new government backstop, undoing much of the progress achieved by post-crisis legislation and regulation of those same financial institutions, **we offer a plan that places the GSEs back in their historic role as countercyclical providers of liquidity to the primary mortgage market. It does so in a manner that limits the GSEs’ political and market influence while allowing them to support affordable housing and, by leveling the playing field between large and small lenders, the growth and vibrancy of the smaller lenders and banks which are more closely tied to the communities they serve.**

**This GSE reform proposal is grounded in the current existing powers granted to the regulatory community through the Housing and Economic Recovery Act of 2008 law (HERA) and regulatory provisions of the Dodd-Frank Act, both of which were acts of Congress. If the current Director of FHFA recognized the previous failures to follow statutory requirements of HERA, and chose to correct these failings, he could place the secondary mortgage market on a viable path to meaningful reform.**

**As demonstrated by section 1367 of HERA, since the time of the decision to place the GSEs into conservatorship, the conservator’s powers have been abused. HERA clearly states that only the Director of the FHFA has the authority to determine the GSEs should be placed into conservatorship<sup>1</sup>. Also, while the Director of the FHFA had the authority to appoint the agency as conservator, it also had the discretion to appoint an independent conservator<sup>2</sup>. HERA clearly states: “When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency”<sup>3</sup>.**

Comments from former Secretary of the Treasury, Hank Paulson, strongly suggest that, at inception of the decision to place the GSEs in conservatorship, there were several violations of HERA. First, it seems clear that Treasury, rather than the Director of FHFA (as required by HERA), chose to place the entities into conservatorship<sup>4</sup>. Second, it appears that FHFA was subjected to direction and supervision of other agencies. Third, by appointing itself conservator, rather than an independent conservator, it left itself open to influence by the Treasury. Fourth, these decisions created conflicts between its role as a safety and soundness regulator. Each of these failings and violations of HERA caused the conservator to become unable to meet the most basic requirement HERA places on a conservator: to "... put the regulated entity in a sound and solvent condition... and preserve and conserve the assets and property of the regulated entity"<sup>5</sup>.

**While the previous Director of FHFA, who was also conservator, appears to have failed to meet his statutory obligations, there is an opportunity for the current Director to change course and become fully compliant with the statutory requirements of HERA. The reform proposals in this paper can largely be implemented without new legislation and through retained earnings and raising external capital from the markets, perhaps with an assist from current non-government shareholders through rights offerings.**

While the several steps outlined here will not entirely eliminate the need for legislation, they will increase market certainty, reduce the number of political issues to be addressed and minimize the difficulties of reaching a consensus over those issues that legislators will ultimately need to address.

### **Both Private Markets and the GSEs Caused the Financial Crisis**

*"But what drove those behaviours in the first place? It was a classic financial arms race, a case not so much of "keeping up with the Joneses" as "keeping up with the Goldmans". From the early 1990s onwards, league-leading firms began posting high returns on equity. Those firms with lower relative returns, who languished in the league, found themselves with sand kicked in their face. They felt obliged not just to keep pace but to leapfrog, to shake their tail feathers. The lower their rank, the greater these market pressures. Facing these competitive pressures, the best-response strategy for languishing banks was simple – gear-up...Leverage delivered an instant leapfrog in returns on equity, a conspicuous display of rich plumage... That spiral defined the pre-crisis arms race in financial returns. It generated equilibrium of synchronously high returns and pay, as banks unilaterally militarised as defence against their competitors. But as in military arms races, the resulting outcome was a sub-optimally risky one...With hindsight, it was easy to spot this market failure, the co-ordination problem. Banks and the financial system as a whole would have been better off had there been a benign, enlightened regulatory planner, able to co-ordinate banks on a lower return equilibrium. Unfortunately, there was not."*<sup>6</sup>

For the past eight years, in an effort to assign blame for the financial crisis, an ideological and politicized divide has polarized Washington. Regardless of where blame should be assigned there is little disagreement that the housing crisis disproportionately harmed those least capable of bearing losses and has consumed the political class with few meaningful responses other than to allow our largest banks to reassert their primacy in the financial system.

These attempts to assign blame prevent policy-makers from embracing the structural mortgage finance reforms necessary to address the weaknesses that brought the economy to the precipice of collapse. Having failed to materially address or reduce the economic, market, social and political risks presented by weakness in the regulation of the mortgage finance industry we have accepted an unsustainable stasis even while recognizing the need for systemic repair that has long been understood by former President Bush, former Federal Reserve Chairman Alan Greenspan and the then-Presidential-candidate Barack Obama<sup>7</sup> who said:

**“...We excused and even embraced an ethic of greed”; “we encouraged a winner-take-all, anything-goes environment” and “instead of establishing a 21st century regulatory framework, we simply dismantled the old one.” – Barack Obama<sup>8</sup>**

Today, as was the case prior to the crisis<sup>9</sup>, regulators remain unwilling to effectively utilize existing legal authorities and instead excuse their failure to do so by suggesting a need for new congressional authorities. As a result, a future crisis becomes ever more likely, especially as we have reached an end to the Federal Reserve’s purchases of mortgage backed securities (MBS) and can soon expect increases in interest rates. Without a change of course, it appears, once again, that feckless behaviors of our elected leaders and regulators will become an historical marker of this period in U.S. history. While Democratic ideologies assign blame to the weak regulation of private markets and unbridled greed, Republican ideologies assign the blame to government policies that attempted to deliver social subsidies through the off-balance sheet, quasi-public and quasi-private GSEs, Fannie Mae and Freddie Mac. Both sides of the political spectrum have failed to understand what many private citizens understand, these are not mutually exclusive explanations. In fact, there is little doubt that the crisis was the result of the interplay between poorly considered government policies, weak regulatory oversight, the lobbying power of key industry players, unrestrained profit-seeking behavior by issuers of private-label mortgage-backed securities, structural changes and a failure to properly regulate the activities and oversight of the GSEs in combination with a lack of prudent economic decision-making by borrowers.<sup>10</sup> **If, for the purposes of economic and financial stability, we hope to rebuild a truly sustainable secondary mortgage market that is able to provide adequate mortgage funding liquidity during the adverse economic periods during which private lenders or capital market participants will not, we must address these problems.**

Ironically, in the wake of the financial crisis, many conservative critics who had previously railed against the implied government guarantees that were conferred on the GSEs remain silent about the reality that, through the Dodd-Frank Act, we have conferred the same implied government guarantees on our largest banks. Many of these critics have also been among the strongest supporters of recent “reform” legislation efforts that were designed by and can be expected to primarily benefit our largest financial institutions. Specifically, rather than reducing these benefits, the Corker-Warner bill<sup>11</sup>, Crapo-Johnson bill<sup>12</sup>, the PATH Act<sup>13</sup> and also the language included in Title VII of the regulatory reform bill<sup>14</sup> recently introduced by Senate Banking Chairman Richard Shelby would further extend the government’s backstop of the largest banks.

### **Government Housing Policy - A Long-Term Partnership**

Prior to the Great Depression of the early 1930’s, short-term mortgage products with five to ten year terms dominated mortgage lending. When those loans matured, borrowers were expected to either pay off the remaining principal balance or to refinance the loan. When the Great Depression hit, a large number of lenders became unwilling or unable to refinance loans and, as a result, many borrowers were unable to pay the outstanding balances due on their mortgages. It is estimated that by 1934, half of all borrowers were delinquent on their homes<sup>15</sup>. Declining home prices only served to exacerbate these problems as borrowers found themselves owing more than the home would be worth in a sale. Mass foreclosures ravaged the national economy and, with borrowers typically<sup>16</sup> having made downpayments of 50% of the purchase price, many families found themselves not only unable to support their mortgage, but also penniless and homeless.

The damage quickly extended to those remaining banks, thrifts and lending associations who found themselves stuck with large volumes of unsalable or foreclosed properties, the liquidation of which only threatened to drive prices further downward. Even in cases in which lenders had obtained private mortgage insurance (PMI), to ensure them against loss of principal and interest, most of these insurers were inadequately capitalized and unable to pay claims. By 1930, for example, there were 50 mortgage insurance companies that had a combined capital and surplus of \$200,000,000 against \$2,867,000,000 of outstanding guarantees.<sup>17</sup> A large number of these PMIs failed, causing further damage to the solvency of those financial institutions that relied on the ability of those insurers to pay. By 1932 nearly 40% of banks that existed in 1929 had failed.

In response to the national housing crisis, President Roosevelt created a series of programs to restructure failed mortgages, to stabilize and restore liquidity and solvency to the banking system, to create mortgage loan standards<sup>18</sup> and, with an understanding that the government didn’t want to be in the business of holding mortgage loans, to sell those

mortgages to investors while providing those investors with an insurance regime they could be confident they would be repaid.

The creation, in 1933, of the Home Owners Loan Corporation, the 1936 creation of the Federal Housing Administration and other predecessor programs to the 1938 creation of the government-owned Federal National Mortgage Association (Fannie Mae) all sought to ensure that a utility-like program stood willing to buy and insure, at par, mortgage loans from banks. **The goal of creating a liquid secondary market to promote and ensure stability in mortgage lending was thus realized. Ensuring that mortgage risks were transferred into the hands of market participants rather than remaining on the government's balance sheet reduced the risks of the public.**

Fannie Mae's mission continued with few changes until 1954 when the Charter Act transformed Fannie Mae from an agency of the federal government into a mixed ownership, public-private, corporation. In 1968 Fannie Mae was transformed into a publicly traded and privately owned firm and then, in 1970, Freddie Mac was created to expand the secondary market.<sup>19</sup>

### **GSEs – No Controversy Until S&L Crisis**

**In 1989, as a result of the failure of the savings and loan industry and the near insolvency for Fannie Mae<sup>20</sup>, the federal government began to reconsider the regulation and oversight of the GSEs.** Amazingly, on April 18, 1989, the House of Representatives Ways and Means Committee held what was the first comprehensive oversight hearing of the GSEs in 30 years.<sup>21</sup>

As documented in Reckless Endangerment<sup>22</sup>, it was at this point that Fannie Mae's Chairman David Maxwell accepted the advice given to him by his then independent advisor (and future Fannie Mae Chairman) James Johnson -- that the largest risks confronting the GSEs were no longer operational, credit, interest rate risks but political risks. Recognizing the threat, Maxwell handed the company's reins to Johnson, who would transform the GSEs from sleepy secondary mortgage utilities with conservative growth rates into political actors that would bind themselves more closely to the U.S. political class while "Showing America a New Way Home" to "Expand(ing) Opportunities for Home Ownership"<sup>23</sup>.

**In a 1991 Report, to then President George H.W. Bush, regarding the GSEs, Treasury Secretary Nicolas Brady, pointed out<sup>24</sup>:**

*"Since there is no imminent financial threat from the activities of the GSEs, the temptation may exist not to create a more sensible and effective regulatory structure. However, such a course is inappropriate. The experience with the troubled thrift industry and the Farm Credit System vividly demonstrates that taking action once a financial disaster has already taken place is costly and difficult. The most prudent policy goal*

*should be to establish a regulatory framework that will reduce the likelihood of another financially painful Government rescue. As is discussed... the regulatory structure for GSEs has lapses of varying degrees to the point that the current structures are not adequate to provide sufficient assurance that the GSEs will be operated in a financially safe and sound manner over the longer term...that GSEs can get into financial difficulty is more than a hypothetical possibility. Both the Farm Credit System and Fannie Mae experienced financial stress during the 1980s...The financial difficulties encountered by Fannie Mae in the early 1980s, for which direct Federal assistance was not required, is an example of the potential for a GSE's financial condition to deteriorate while its access to the credit markets remains unimpeded..."*

Secretary Brady then offered a sober assessment of the necessary shape of GSE reforms:

*"In times of economic stress, a regulator with unclear or dual statutory objectives (safety and soundness versus promotion of another public policy goal) may decide to subordinate its safety and soundness responsibility in favor of the achievement of other public policy goals. Therefore, unless a regulator has an explicit primary statutory mission to ensure safety and soundness, the Government may be exposed to excessive risk... Second, the regulator must have sufficient stature to avoid capture by the GSEs or special interests... Third, the private sector should play a role in helping the Federal Government to assess the safety and soundness of GSEs... Fourth, the basic statutory authorities for safety and soundness regulation must be consistent across all GSEs. Oversight can be tailored through regulations that recognize the unique nature of each GSE."*

**Unfortunately, by the time Congress legislated a new regulatory regime for the GSEs, the enterprises had, with the help of friends in Congress, neutered those recommendations** As in the case of the thrifts,<sup>25</sup> and more recently with the Dodd Frank Act<sup>26</sup> and HERA itself<sup>27</sup>, when Congress leaves implementation of complex issues to a weak regulator legislative intent is often lost.<sup>28</sup> Often-captured regulators then weaken oversight and controls of financial firms to levels that appear to reduce risk while actually engendering more risk<sup>29</sup>.

As a result of these hearings, and extensive lobbying by the GSEs, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. Failure to heed the prescient recommendations of Secretary Brady, **this statute neutered safety and soundness standards and created a weak primary regulator that lacked the authority to raise or lower capital requirements, as it deemed prudent. Instead the statute created congressionally defined capital standards that allowed the mortgage-backed securities of these poorly capitalized GSEs to receive lower capital risk weightings than private MBS. The Act also failed to provide the regulator with explicit authorities regarding the enterprises' leverage or their portfolio growth; established three different types of affordable housing goals but failed to prioritize**



**safety and soundness; failed to provide the regulator with “bright line language” that would allow it to limit the activities of the GSEs; tied the regulator to the budget appropriation process; and increased both the politicization of the GSEs and the appearance of a government backstop to the GSEs by allowing the President to select half the members of the enterprises’ boards of directors.**

It would be impossible to overstate the problems created by the split-regulatory structure embedded in the Act. By creating a “mission regulator” at the Department of Housing and Urban Development (HUD) and a “safety and soundness regulator” at the newly established Office of Federal Housing Enterprise Oversight (OFHEO), In reality, the legislation left OFHEO constrained by an overly prescriptive and materially inadequate regulatory capital regime that took six years to put into place and offered an inappropriate static snapshot of capital required for the enterprises. On the other hand, the 1992 Act placed new language in the GSEs’ charters, providing them a mandate to do more for “underserved”<sup>30</sup> markets. **What Congress accomplished was to legislate an environment diametrically opposed to Secretary Brady’s primary recommendation; one in which the GSEs’ delivery of affordable housing goals would always generate the necessary political support for pushing back against the safety and soundness authorities of OFHEO.**

With Congress empowered to use the GSEs as tools for politically-motivated social engineering and the enterprises able to use the law as political-cover for increasing their business activity, goals became a means for the GSEs to further weaken support for their soundness regulator<sup>31</sup> and to increase their returns to shareholders by increased leverage and other financial risks<sup>32</sup>. Further ensuring supervisory failures by OFHEO was statutory language that tied OFHEO to the annual budget appropriations process. As a result of the GSEs’ political power, major efforts by critics to rein them in on the basis of safety would even result in efforts by the GSEs and their political allies to starve OFHEO of funding necessary to effectively oversee the GSEs<sup>33</sup>.

### **Problems with GSEs Didn’t Develop Overnight**

The GSEs, originally intended to provide liquidity to the secondary mortgage market, were then repurposed by the Clinton administration to direct social policy and public subsidies through the housing and mortgage markets. Such use of the agencies was not a Clinton-only affair; President George W. Bush would later expand on the social engineering policies<sup>34</sup> that placed the expansion of homeownership ahead of the safety and soundness of the GSEs - and the broader economy.

A combination of the GSEs being used as “tools”<sup>35</sup> of social policy and falling interest rates built the foundation of a housing bubble by fostering borrower, lender and investor acceptance of low- and no-down payment loans, lower FICO scores, higher debt-to-income and loan-to-value ratios. These “benefits” are exemplified by the 1999 comments

of Fannie Mae's then Chairman Franklin Raines: "A record of prompt utility bill and rent payments can be substituted for the traditional credit report to verify a potential borrower's willingness to pay a mortgage loan".<sup>36</sup> Amazingly and almost without being noticed the entire mortgage underwriting system began to shift its lending standards toward a focus on a borrower's willingness, rather than ability, to pay. This change had been more than just the result of "animal spirits"<sup>37</sup>.

In early 1993, the Clinton Administration realized that, among the "*available Federal resources*", "*capital investments for housing and community development*" could be driven "*through Fannie Mae, Freddie Mac, FHA, and HUD/USDA programs*"<sup>38</sup>. Clinton's Department of Housing and Urban Development quickly established dramatic performance goals for Fannie Mae and Freddie Mac.

**In an effort to restore the promises of the "American dream", the Administration embarked on a major initiative to increase homeownership.** In 1993, the Census Bureau recommended specific ways to do so. Lowering down payment requirements and increasing available down payment subsidies were suggested. In early 1994, HUD Secretary Henry Cisneros met with leaders of major national organizations from the housing industry to implement these suggestions.

**By early fall 1994, the Clinton Administration, along with over 50 public and private organizations<sup>39</sup> agreed on 'working groups', a basic framework and the core objectives of what they named the "National Homeownership Strategy".** The creators of the strategy of the National Partners in Homeownership ('NPH') include, among others: HUD, the Treasury Department, the Federal Deposit Insurance Corporation, Fannie Mae, Freddie Mac, the Mortgage Bankers Association, America's Community Bankers, the American Institute of Architects and the National Association of Realtors. **Their primary goal was "reaching all-time high national homeownership levels by the end of the century". This was to be achieved by "making homeownership more affordable, expanding creative financing, simplifying the home buying process, reducing transaction costs, changing conventional methods of design and building less expensive houses, among other means".** It was almost unprecedented for government regulators to partner this closely with private-sector parties that they had been charged with regulating.

**In 1994, the Administration set out to "raise the ownership rate by 0.5% - 1.0% per year for the seven years, from 65% to 70% by the year 2000" and recognized this "can be done almost entirely off-budget - through creative leadership and partnerships with HUD, FHA, Fannie Mae, Freddie Mac, FHLBs, CDFIs, the private mortgage and insurance companies, and the banks and thrifts".<sup>40</sup>** In 1994 the Administration created and, in 1995, rolled out their "National Homeownership Strategy"<sup>41</sup> with the goal of using the GSEs to "provide low- and no-down payment loans to eligible low- and moderate-income purchasers" even to borrowers "the private



mortgage market has deemed to be un-credit-worthy”.<sup>42</sup> By the peak of the market, these goals, combined with the GSEs’ desires to increase their market share, drove “more of the borrowers who met affordable housing criteria” to “increasingly mov[e] into bad [mortgage] products (e.g., option ARMs and low or no down payment loans), that led to risk layering”.<sup>43</sup>

Homeownership began to rise in 1995 and continued to rise through the late 1990s. Existing home sales grew from 27.5 million units in the 1970s to 29.8 million units in the 1980s and ended the 1990s at 40 million units. By 1998, in an internal memorandum from then Secretary of the Treasury Robert Rubin to Clinton’s National Economic Advisor Gene Sperling<sup>44</sup> recognized the many risks associated with increasing lending to the most ‘at risk’ borrowers and noted:

- *“Lowering the down payment requirement is likely to reduce saving among low-income people who would like to be home owners”;*
- *“We may not want to encourage poor people especially those who cannot save, to purchase their homes. In an economic downturn, these home owners may be more vulnerable and more likely to lose their homes”; and*
- *“It is not clear that home ownership causes the desired positive effects attributed to homeowners”.*

Still, the Clinton Administration’s plans continued.<sup>45</sup>

“In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent”<sup>46</sup>. This trend continued unabated throughout the 1990s and by 1999, over 50 % of mortgages had down payments of less than 10%. In 1976 the average down payment by first time homebuyers was 18% and by 1999 that down payment had fallen to 12.6%. In 1999, more than 5% of all residential mortgages had no equity or had negative home equity. Eliminating down payment barriers had created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues.<sup>47</sup> While the GSEs were certainly a key driver of these results other government actions,<sup>48</sup> fraud,<sup>49</sup> and the impact of falling interest rates also fueled the expansion. **By 2000, U.S. homeownership exceeded 67%.**



Source: U.S. Census Bureau

### **GSEs Seasoned the Market but Were not the Only Culprits**

In July 2001 I authored a paper titled “*Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt*”.<sup>50</sup> That paper, written in the aftermath of the “dot-com” crash, sought to answer questions about the relationship between the broader economy and the housing market and asked whether housing faltered as a result of the weakening economy.

The executive summary noted: “*there are elements in place for the housing sector to continue to experience growth well above GDP. However, we believe there are risks that can materially distort the growth prospects of the sector*”. Specifically, “*it appears that a large portion of the housing sector’s growth in the 1990’s came from the easing of the credit underwriting process*”. That easing included:

- “The drastic reduction of minimum down payment levels from 20% to 0%”;
- “A focused effort to target the “low income” borrower”;
- “The reduction in private mortgage insurance requirements on high loan to value mortgages”;
- “The increasing use of software to streamline the origination process and modify/recast delinquent loans in order to keep them classified as ‘current’”; and
- “Changes in the appraisal process that have led to widespread over-appraisal/over-valuation problems.”

The analysis concluded: “*If these trends remain in place, it is likely that the home purchase boom of the past decade will continue unabated. Despite the increasingly more difficult economic environment, it may be possible for lenders to further ease credit standards and more fully exploit less penetrated markets. Recently targeted populations*

*that have historically been denied homeownership opportunities have offered the mortgage industry novel hurdles to overcome. ...The virtuous circle of increasing homeownership due to greater leverage has the potential to become a vicious cycle of lower home prices due to an accelerating rate of foreclosures.”*

Still, at that time, there was little private market competition to the GSEs MBS machines. Banks had, to that point, either sold production to the enterprises or the FHA or they held loans on their books. In other words, even if they were originating loans to the weakening standards of the GSEs and selling them to the GSEs, the loans they were not selling to the GSEs or government programs remained more soundly underwritten. This was about to change.

### **Banks and Investment Banks Join the Fray**

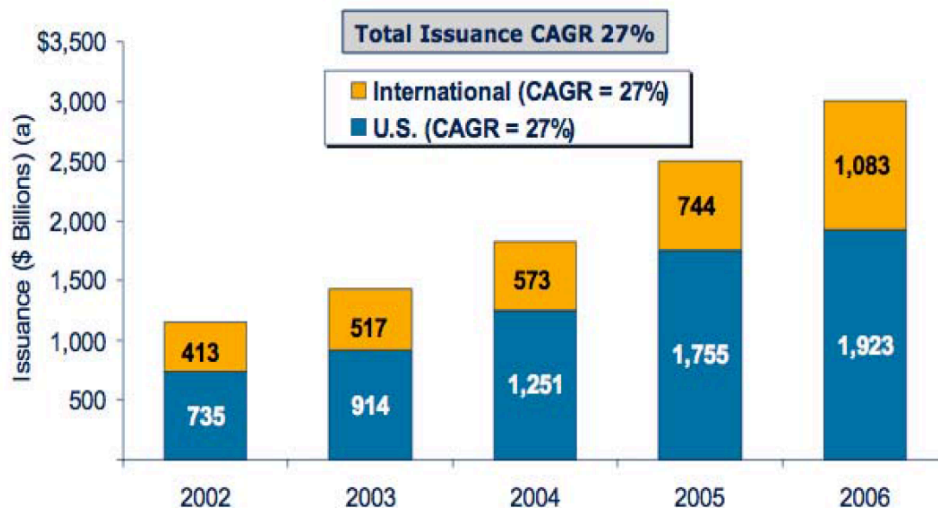
**By late 2002, as a result of lobbying by the Federal Reserve and the large commercial and investment banks, the Basel Committee of the Bank for International Settlements (BIS) lowered the capital risk-weightings for all “AAA” and “AA” rated private label securities (PLS). As a result, from a capital requirement perspective, tranches of highly-rated PLS securitizations were to be treated the same as similarly rated tranches of sovereign, agency and corporate bonds.<sup>51</sup> Through this action, the BIS created massive new income opportunities for the rating agencies, larger banks and investment banks. Having leveled the playing field between PLS, Ginnie Mae and the enterprises’ MBS products, the international banking regulatory body opened the floodgates for new capital to rush into the private label securitization market. The rating agencies had long acknowledged that different types of bonds, even with similar ratings – such as sovereign, corporate, agency and asset-backed – had different probabilities of default or losses given default. Still, now that regulators adopted this new view regarding agency and PLS securities, which allowed similar treatment of highly rated securities of these different classes by banks, insurance companies and other investment-charter-constrained investors, the PLS market took off.**

In 2002 the private label securitization (PLS) market was now at ease with changes made by the GSEs in 2000 “which expanded their purchases to include “Alt-A,” A-minus, and subprime mortgages, in addition to private-label mortgage securities”.<sup>52</sup> Private issuers began to aggressively target borrowers with lower down payments, lower FICO scores, lower documentation and higher debt-to-income and higher loan-to-value ratios. PLS activity exploded. Conforming securitization rates increased from 60 percent in 2000 to 82 percent in 2005 and non-conforming securitization rates from 35 to 60 percent over that same period.

Banks that had only a few years before sought to reduce their exposures to consumer lending used their branch network to originate mortgage loans to distribute through

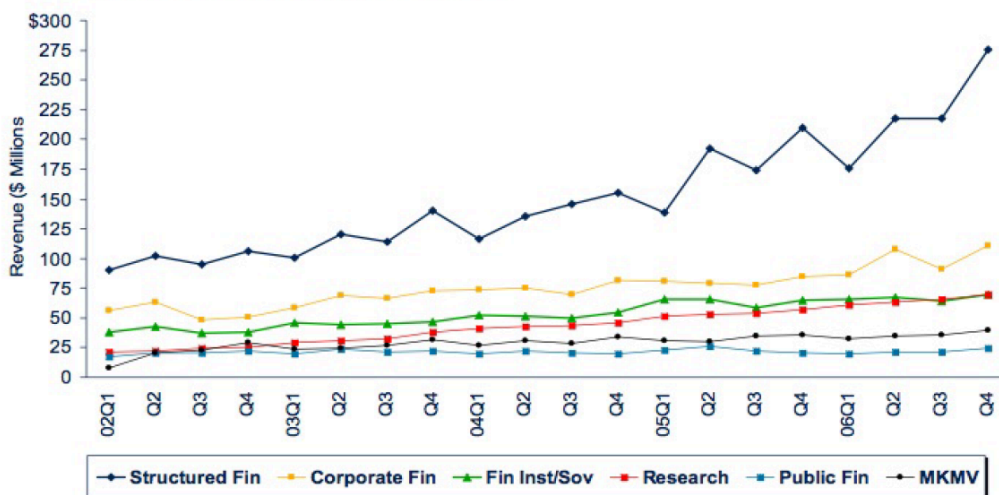
securitization markets. Investment banks, which had no branch networks, began to expand their provisioning of warehouse lines of credit to third party mortgage originators.

FIGURE 7: GLOBAL STRUCTURED FINANCE ISSUANCE IS GROWING RAPIDLY



Source: Moody's Corporation, Investor Presentation (March 2007), available at <http://library.corporate-ir.net/library/12/123/123831/items/236937/MCO%20March%20Long%20FINAL.pdf>

FIGURE 8: QUARTERLY REVENUE BY SEGMENT: Q1 2002 TO Q4 2006



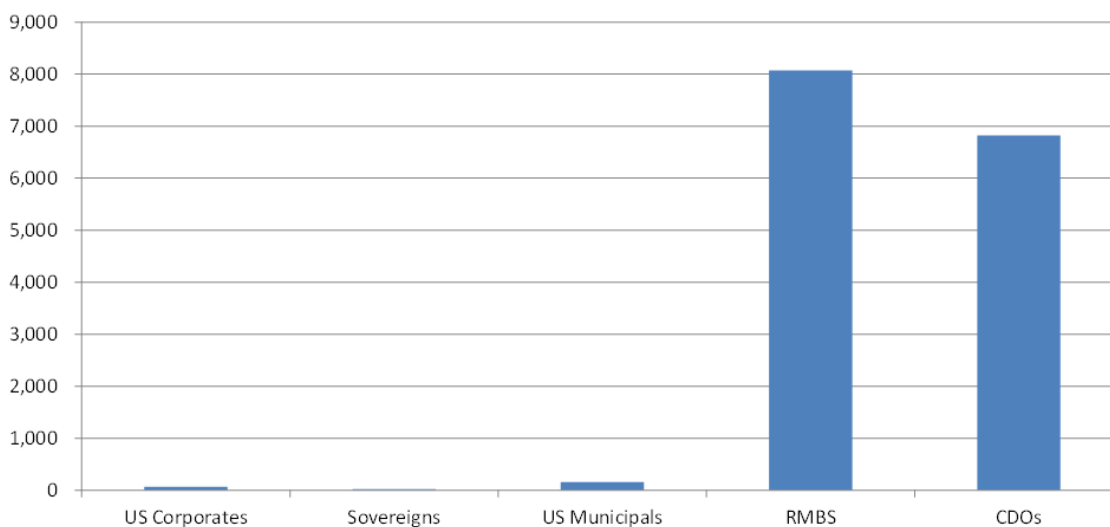
Source: Moody's Corporation, Investor Presentation (March 2007), available at <http://library.corporate-ir.net/library/12/123/123831/items/236937/MCO%20March%20Long%20FINAL.pdf>

Source: Mason & Rosner: Where did the Risk Go?<sup>53</sup>

There are very few corporations and even fewer sovereigns that could garner AAA ratings. Because the rating agencies were allowed to design their models without needing

to assume an AAA mortgage backed security would perform similarly to an AAA rated U.S. Treasury bond, the opportunities to provide yield-hungry investors with higher yielding bonds seemed limitless. As a result, *Investment banks and their third-party mortgage origination partners created more and more risky products, including many negative amortization products.*

### Number of AAA-Rated Securities, by Type



Source: Rosner, 2007<sup>54</sup>

By late 2004 it became clear that the Federal Reserve, which had begun to increase rates at the end of June, would continue to raise rates. On November 16, 2005, I warned “we continue to expect consumer mortgage credit quality to show deterioration in the third quarter (largely from energy prices and Hurricane Katrina) and expect that it will continue to rise from there”.

Borrowers rushed to lock in low but rising interest rates. The strong investor demand for these relatively higher yielding PLS debt securities led to issuers taking significant market share from the GSEs. Refinancing’s and the 40%<sup>55</sup> of all sales that were investment or vacation homes continued to stoke the bubble, and the informational asymmetry – between issuers and investors –that was built into PLS hid the risks to investors and supported uneconomic activity.

For the first few years, the GSEs avoided direct and aggressive competition with the looser standards of these lenders and instead, increasingly used their portfolios to become the largest purchasers of private label securities. By 2004, Freddie Mac decided to expand its direct exposure to Alt-A lending.

As I noted in a 2007 report: “As early as 2004, 16% of Fannie Mae’s portfolio had FICO scores below 660 (S&P 12/06) and Fannie Mae’s 2004 exposure to second homes and vacation properties was already about 8%. It also appears that prior to the Joint Guidance on non-traditional mortgages, one or both of the GSEs were offering negative-amortization products that would not begin to fully amortize until after the reset period.

***As OFHEO noted in their April 2007 Annual Report to Congress, “higher-risk products such as interest-only, sub-prime, Alt-A and negative amortization loans are growing, but are currently about 20 percent of the book of business”. At that time I noted “recently, 7 private mortgage insurers insured about 17% of the GSE’s book (roughly \$400BB) and it is unclear how the PMI industry’s capital base (roughly \$40BB) would have the ability to absorb the possibly sizeable impact to their first loss exposures to the GSE’s book”.***

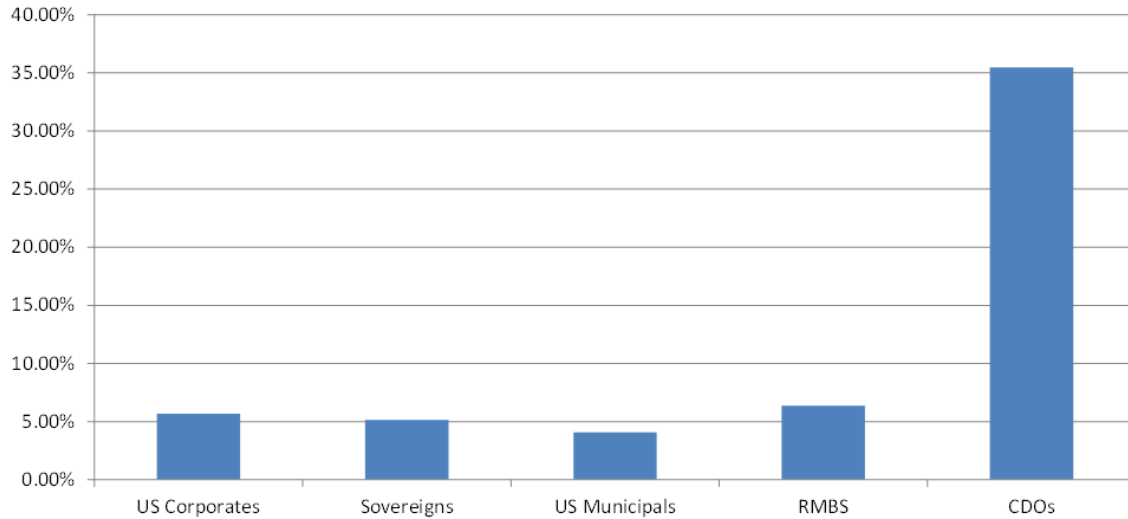
As the volume of creditworthy homebuyers started to slow the banking industry, with support of the rating agencies, increasingly turned to offering negative amortization and hybrid products as a way to take advantage of falling interest rates and generate new volumes of mortgage securities. As investors became increasingly uncomfortable with the credit quality of the mezzanine and equity tranches of these securities, which are required to be purchased before the issuance of the investment-grade tranches, the issuers increasingly turned to the sale of those mortgage securities in the form of Collateralized Debt Obligations (CDOs).

The game should have stopped before this point, but those institutional investors that are required to invest only in investment grade securities were still hungry for the higher yields on PLS, and the banks, investment banks and rating agencies were more than happy to feed them.

***“Taking unsecured borrowings that the government inadvertently supported, so they were really cheap, buying assets, not the mortgage guarantees, was the largest source of earnings in both these companies. Not the actual core business that they were set up to do.”<sup>56</sup>***



## Yield of AAA-Rated Securities, by Type



Source: Rosner, 2007<sup>57</sup>

As a result of these changes, the GSEs no longer stood by to support liquidity in the secondary market as they had been created to do. Combining their public mission with government demands they serve as a private mechanism to deliver potentially uneconomic housing subsidies, a desire of the enterprises managements' to maximize returns to shareholders and a regulator who had no real ability to limit their growth into riskier parts of the market or to raise their regulatory capital requirements all resulted in an inevitable and foreseeable disaster. Inadequate oversight, weak capital requirements, an implied government guarantee and the GSEs' low cost of capital relative that of other private market players, encouraged them to use of their portfolios to generate highly leveraged returns through investment in each other's securities and the eventual purchase of almost 25% of all investment grade-rated PLS.

By the beginning of the last decade both Fannie and Freddie had begun to foster uneconomic and distortive excessive market liquidity led the private markets in a race to zero. The GSEs underpriced the insurance fees they charged lenders (guarantee fees or G-Fees) for the purpose of increasing the volume of business they attracted, in an effort to compete with these private label issuers. As the PLS market became a real threat to their market share, the GSEs again increased use of their portfolios, this time to purchase AAA-rated tranches of riskier private label mortgage backed securities. Through these portfolio activities, the GSEs replaced their intended public function of counter-cyclicality with purely profit-seeking pro-cyclicality and encouraged private market players to continue to issue those PLS.

Even as the crisis was coming into view there was little that OFHEO, the safety and soundness regulator could do to require the GSEs to increase their capital. In 2004, Treasury Secretary John Snow wrote a letter to Senate Banking Chairman Richard Shelby<sup>58</sup> in which he highlighted: “*New activities undertaken by the GSEs should be subject to clear, plenary review and disapproval, if appropriate*” and “*Changes in minimum capital requirements should be unencumbered by a lengthy regulatory process*”. As Federal Reserve Chairman Alan Greenspan testified, in 2005, without adequate capital, the portfolio growth of the GSEs became a potentially destabilizing force:

*“The ability of the GSEs to borrow essentially without limit has been exploited only in recent years. At the end of 1990, for example, Fannie’s and Freddie’s combined portfolios amounted to \$132 billion, or 5.6 percent of the single-family home-mortgage market. By 2003, the GSEs’ portfolios had grown tenfold, to \$1.38 trillion or 23 percent of the home-mortgage market. The almost unlimited low-credit-risk profit potential from exploiting subsidized debt has been available to the GSEs for decades. The management of Fannie and Freddie, however, chose to abstain from making profit-centers out of their portfolios in earlier years, and only during the mid-1990s did they begin rapidly enlarging their portfolios... The creation of mortgage-backed securities for public markets is the appropriate and effective domain of the GSEs. Deep and liquid markets for mortgages are made using mortgage-backed securities that are held solely by investors rather than the GSEs... Almost all the concerns associated with systemic risks flow from the size of the balance sheets of the GSEs, not from their purchase of loans from home-mortgage originators and the subsequent securitization of these mortgages.”*<sup>59</sup>

By the time the crisis was upon us, private lenders and banks had retained excessive credit exposure to those toxic mortgages and the mortgage securities that were packaged. The GSEs, having loosened their underwriting standards in an effort to compete with the private markets also held and guaranteed unmanageable levels of risk that were not supported by adequate amounts of capital with which to absorb losses. As a result, even before the losses extended into the books of the GSEs and their higher quality assets, we witnessed the failure of AIG, Bear Stearns, Lehman Brothers and the potential failure of several other inadequately capitalized firms.

*In late 2006 it was clear that “dramatic shrinkage in the RMBS sector [was] likely to arise from decreased funding by the CDO markets as defaults accumulated. Of course, mortgage markets are socially and economically more important than manufactured housing, aircraft leases, franchise business loans, and 12-b1 mutual fund fees. Decreased funding for RMBS could set off a downward spiral in credit availability that can deprive individuals of home ownership and substantially hurt the U.S. economy”.*<sup>60</sup>

### **For Two Decades We Knew What to Do**

There is nothing specifically wrong with the existence of entities whose purpose is to support liquidity in the secondary mortgage market. In fact, we believe that for macro-stability, there is a substantial need for such a function to exist. The problem was the use of quasi-private institutions as tools of social policy for the purpose of delivering off-balance-sheet government subsidies to the public in a manner to be arbitrated by private market participants.

If one considers the period between 1994 and 2008 to be anomalous and recognizes the prior history of the GSEs, it becomes clear there is still much to be lauded in the intended purpose and function of the GSEs. Some of those features are still in place and provide value to both the housing and mortgage markets. **The GSEs' originally intended purpose, as lenders of last resort to banks and other private lenders seeking to fund conforming and conventional home mortgages, is now distorted but could be readily repaired.** Still, the GSEs continue to offer industry standards, many of which have been improved since the crisis, that remain absent from private mortgage markets. **The GSEs have spent the last 6 years standardizing mortgage underwriting and have moved toward a rational model for properly pricing their guarantee-fees (G-fees). With the GSEs under conservatorship and the control of the government and its political process, public pressure from both lenders and housing advocates threatens to undermine those more prudent standards.** As importantly, while there is little disagreement that private markets need to take on a larger function in the mortgage market, while the GSEs continue to offer standardized representations and warranties and pooling and servicing agreements, private market players have resisted, or failed, to fully create their own meaningful standards<sup>61</sup>.

### **Washington knew how to fix the GSEs, They Failed to do it**

As noted previously, regulators and legislators have long understood the key risks posed by the GSEs and how to effectively address those through regulation or, where inadequate regulatory authorities exist, through legislation. The 1992 Act failed to meaningfully achieve any of the prudent objectives laid out by then Secretary of the Treasury, Nicholas Brady. As a result, less than a decade later, there were calls from within the White House<sup>62</sup>, Congress,<sup>63</sup> and Senate<sup>64</sup> to again seek meaningful GSE reform.

Key elements of those efforts to reign in the GSEs and reduce the risks they posed focused primarily on (a) stringent capital standards to be imposed by a regulator that could raise or lower requirements as prudent, (b) "bright line" language which sought to prevent "mission creep", (c) receivership language that would allow the enterprises to be resolved if they failed, (d) elimination of the conflicting oversight by a mission regulator and safety-and-soundness regulator so safety and soundness would have primacy and (e) efforts to reduce or eliminate the GSEs investment portfolios. The portfolios, especially with inadequate capital, amplified the risks that the GSEs could fail. In fact, the portfolios were central contributors to the only other episodes of instability at the GSEs.<sup>65</sup>

Another key item then President George W. Bush and reform-minded senators demanded to be included in any legislation they would consider was a credible regime to resolve a failed GSE. Both Senate Banking Chairman Shelby in his bill and Senators Hagel, Sununu and Dole in their legislative proposals included such language. So too did the Republican leadership of the House Financial Services Committee. The arguments for such powers were strong, as highlighted in 2005 by former Assistant Secretary of the Treasury for Financial Institutions Richard S. Carnell.

*“Fannie Mae and Freddie Mac are huge, fast-growing, highly-leveraged, lightly - regulated, and susceptible to failure. Prudence calls for having a legal mechanism adequate for handling their failure. Yet no adequate insolvency mechanism currently exists for Fannie Mae and Freddie Mac. Unlike ordinary business firms, these government-sponsored enterprises (GSEs) cannot liquidate or reorganize under the Bankruptcy Code. If Fannie Mae or Freddie Mac became sufficiently troubled, its regulator could appoint a conservator to take control of the firm and attempt to restore its financial health. But by then the firm’s problems could well have become too severe for the conservator to resolve. The conservatorship statute provides no means for effectuating reorganization and does not expressly authorize liquidation. Uncertainty about the priority and process for handling creditors’ claims could worsen the firm’s problems and increase the risk of disrupting financial markets and eliciting a costly congressional rescue. By enacting a workable insolvency mechanism, Congress could avoid using public money or credit to rescue a troubled GSE’s creditors.”<sup>66</sup>*

Once again, the GSEs and their supporters successfully fought back against the inclusion of a resolution regime and argued that it would be destabilizing to the market and used other areas of contention, such as the inclusion of affordable housing goals as a way to undermine legislative efforts<sup>67</sup>. Sadly, in 1991, UST warned that receivership and conservatorship authority, for the GSEs needed to exist.<sup>68</sup> As they had in 1992, Congress failed to legislate the powers necessary to prevent the failure of the GSEs or the mechanisms to resolve them in the face of a future financial crisis, a crisis that was already unfolding in the face of rising interest rates.

### **HERA, the GSE Reform Act of 2008: Necessary and Appropriate But Too Late**

**In July 2007, as the first flames of the mortgage crisis were already visible<sup>69</sup>, a legislative draft of a bill, introduced to address the shortcomings of GSE oversight was introduced. The House passed its initial version of the bill by early August 2007 but it was not until February of 2008, when then Assistant Secretary of the Treasury, David G. Nason, laid out the Bush Administration’s views on the powers necessary to address the shortcomings of oversight and its recommendations.<sup>70</sup> More than fifteen-years since Secretary Brady laid out his recommendations for GSE reform and these were essentially identical. The Senate passed its version of the Housing and Economic Recovery Act of 2008 (HERA) in April 2008, and President**

**Bush finally signed the legislation into law in July. It took an entire year to pass this legislation, during which a kitchen-fire in the housing market had grown into a full-fledged forest-fire. By the time it was passed into law there was no time to implement any of the authorities intended to safeguard the GSEs. In fact, while the new statute provided the GSEs' new regulator FHFA with essentially all of the powers that had been recommended for so long<sup>71</sup> there was little that could be done to save the enterprises. It was only two months later that the government used the conservatorship statute to take control of the teetering GSEs.**

The process for regulators to implement rulemaking and operationalize new authorities is a multi-year one. HERA passed only after the GSEs' distress was clear, there was no chance that new capital requirements could be designed, let alone implemented, no way to reduce the size of the GSEs' investment portfolios, and little time for a new regulator to even consider how a conservatorship would be effected in a prudent manner. In the two months between the introduction of the new law and the decision to place the GSEs in conservatorship, there was not enough time to design a conservatorship that was consistent with congressional intent or the rule of law.

**While few in the political world of Washington would ever utter an admission out-loud, had these powers been passed into law in the early 1990's it is unlikely the mortgage market crisis would have occurred at all. Had, instead, the law been passed in 2002 or 2003, it is unlikely that even, in the face of a broader crisis, the GSEs would have failed.**

### **Why did Fannie & Freddie Fail?**

As shown in the earlier portions of this paper, in the 1980s the GSEs had been poorly and improperly regulated. Those problems were only made worse by the passage of the 1992 Act. Although there were efforts prior to the 2008 crisis to craft a prudent oversight regime with a properly empowered prudential safety and soundness regulator, no meaningful reform legislation was enacted until after the crisis had begun.

Nonetheless, it is important to consider the reasons the GSEs failed and whether, if they had existed at the beginning of the last decade, the reforms and authorities granted in HERA would have sufficiently empowered their new regulator to ensure they operate in a safe and sound manner to prevent their failures.

### **The failures of Fannie Mae and Freddie Mac was the result of several factors:**

- **Mission creep.** The GSEs used their portfolios to **invest in assets outside of their core activities, to provide liquidity to parts of the market that was outside their mission**, and to create highly leveraged bets for little purpose beyond generating shareholder returns and larger bonus pools to benefit senior executives of the enterprises. Even as early as 2001, the total leverage of the GSEs approached 80:1.

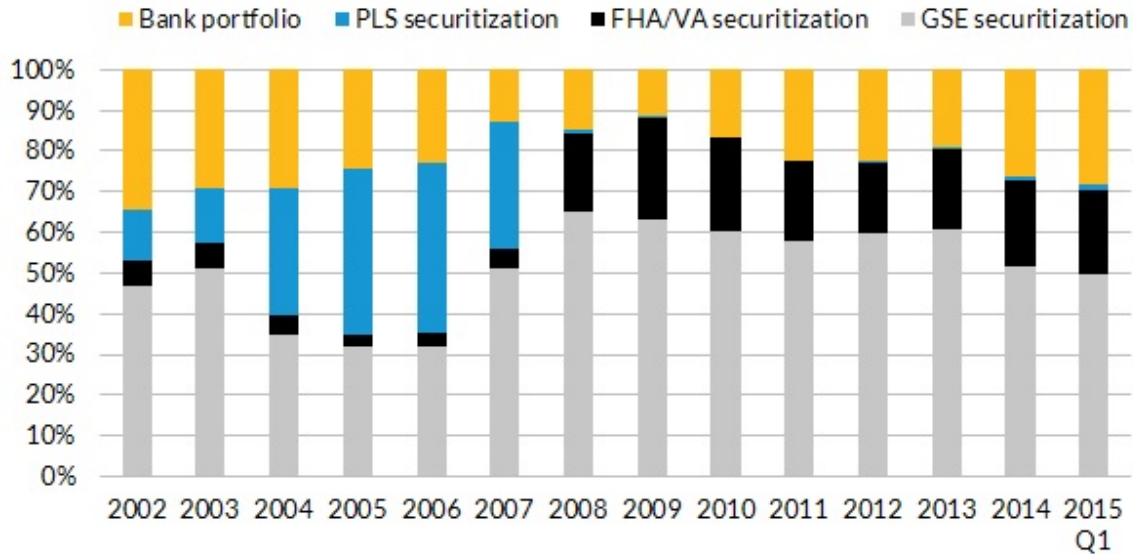
- Mispricing of credit risk. Beginning in the mid-1990's, in competition for market share, **the GSEs offered significant discounts on guarantee fees for large volume customers.**<sup>72</sup> As a result those guarantee fees didn't reflect the underlying, loan-level, mortgage credit risk that the GSEs were taking on. Regulators allowed this underpricing to persist without the capital cushions necessary to absorb the excessive risk taken on - as a result of the underpricing.
- Failure of private mortgage insurance. By 2007, seven private mortgage insurers (PMIs) with combined capital base of \$40 billion insured about 17% (roughly \$400BB) of the GSEs' book of business. **Nobody questioned the ability of these parties to absorb the first loss exposures as the GSEs were relying on them to do.** The failure of PMIs to properly assess the risks they insured on those portions of mortgage loans above an 80% loan-to-value ratio left them with inadequate capital to meet their obligations, further imperiling the GSEs.<sup>73</sup>
- Inadequate regulation. **The GSEs' regulator did not have the authority to adjust their required capital to recognize the GSEs' increases in their on-balance-sheet operational, credit and interest-rate risk profiles.** Moreover, the regulator was not able to require they maintain appropriate levels of capital in support of their off balance sheet liabilities.
- Improper regulation. By the year 2000, the GSEs had employed the use of novel automated underwriting and automated appraisal systems that were not sufficiently stress-tested by their regulator, OFHEO. Even if they had been stress-tested, OFHEO was too politically compromised to limit their activities. As a result, Fannie Mae and Freddie Mac expanded their credit underwriting standards without proper oversight.<sup>74</sup>

### **Post Crisis GSE Legislative Efforts**

Over the past several years there have been a multitude of proposals to reform or eliminate the GSEs.<sup>75</sup> **Nearly all of these proposals have sought to replace the \$5 trillion agency market with new and untested systems in which the largest banks would have outsized influence on the operation of the secondary mortgage markets. Ironically, the effort to award the market to these too-big-to-fail banks is being supported<sup>76</sup> by, among others, conflicted economists<sup>77</sup> that have publicly argued that blame for the crisis belongs to those very same financial institutions that were central to it.**<sup>78</sup>



## First Lien Origination Share



Sources: Inside Mortgage Finance and Urban Institute.

URBAN INSTITUTE

In or out of conservatorship, the GSEs remain the largest financial companies in the world with assets of \$5.19 trillion and liabilities of \$5.18 trillion. **As HERA recognizes, the balance sheet integrity of the GSEs must be respected as these institutions are hugely important to the financial markets. They cannot be modified willy-nilly, with their assets given away and liabilities moved to the government or over to new entities, without serious collateral financial damage to both investors and U.S. home borrowers.**

**Ignoring this reality and that the GSEs finally have a regulator empowered to address all of their pre-crisis failings, leading legislation has been proposed to create a brand-new mortgage finance system with many of the features of the old, pre-HERA, GSE model:**

- Regulatory powers and responsibilities split between the current primary financial regulator of those banks and the new regulator of the new mortgage system. The new federal regulator would have responsibilities far greater than those at which OFHEO failed. **It would be the most complex financial regulator of any regulator and would oversee mission, consumer protection and safety-and-soundness of mortgage aggregators, insurers and the securitization platform;**
- New implied or explicit guarantees conferred on banks that have already been overly interconnected and are already systemically risky;
- Public subsidies delivered through off-balance-sheet, shareholder owned private companies without appropriate regulation and safeguards; and

- Replicating the co-mingling of activities by primary market and secondary market players that contributed to the last crisis. This feature promises exactly the same pro-cyclicality that caused the failure of the GSEs and prevented the secondary market from operating without government support. **In fact, the leading proposals offer to replace a limited implied government guarantee with an unlimited and explicit government guarantee that is supposed to stand behind private capital. That capital would disappear in crisis at exactly the time that it is most needed, leaving the government at the hook for maximum losses.**

**In considering the various reform legislative proposals it is imperative to ask:**

- *Is it an improvement from what we have now?*
- *Does it serve and protect the public?*
- *Does it improve market discipline by private actors?*
- *Does it reduce systemic financial risk?*
- *Does it create a strong divide between the utility-like function of the secondary mortgage market and the primary (private) mortgage origination market?*

With respect to all the legislative proposals to date, the answer is clear: **“NO!”**

It appears that the same mortgage industrial complex that captured Washington before is attempting to do so again. **Unfortunately, this approach is dangerous, creates new systemic risks and supports several false myths.**

Thus far, the bill that received the most support in Congress was the Johnson-Crapo bill, which was modeled on an earlier bill composed by Sens. Corker and Warner. Johnson-Crapo would have replaced Fannie and Freddie with an untold number of new government-sponsored enterprises by handing a massive explicit taxpayer backstop to the nation's largest banks. These banks would profit handsomely from new and large mortgage volumes that would be generated a result of the bill.<sup>79</sup> As was the case with the Clinton National Partners in Homeownership Strategy, there is little focus on the safety and soundness implications of these efforts. **It is important to understand that both Johnson-Crapo and the PATH Act introduced in the House by Financial Services Committee Chairman Hensarling, would recreate – in a new and less tested form – many of the prior key failings of both regulators and the GSEs – particularly, by comingling roles of primary and secondary market players in the mortgage market. Both Johnson-Crapo and the PATH Act recreate a dangerous system<sup>80</sup> in which legislators seek to deliver public subsidies through shareholder - owned and private companies without proper regulation.**

Rather than fix the problems that caused private mortgage markets and the GSEs to fail, legislators have so far sought to demolish the current mortgage market and build from scratch a new system that actually *reduces* certainty and stability. If these legislative proposals became law, our largest financial firms will, like the GSEs after the 1992 Act,

use their public homeownership mission to push for eased lending standards. In good times lenders and their shareholders will enjoy the profits generated by higher mortgage volumes, and in bad times the public will again be exposed to losses.

**To avoid public outcry, Sens. Johnson and Crapo claim their bill requires that private capital accept the first 10% of losses ahead of the government. But like the authors of the PATH Act, they fail to demonstrate from where that capital will come.** Recognizing the likelihood that sufficient capital would not appear and that even that capital that was committed would likely disappear in periods of economic uncertainty, Johnson-Crapo allows regulators to waive the "first loss" requirement and to commit the "full faith and credit of the United States" when necessary to support the mortgage finance market. Such a waiver would no doubt come when lending becomes scarcer -- i.e. during times of financial stress. Unlike the unpopular Troubled Asset Relief Program, which forced lawmakers to justify using billions of taxpayer dollars to support failing financial firms, Johnson-Crapo requires no congressional authorization for choosing to place the government on the hook and allowing easily captured, and panicked, regulators to justify such a commitment of taxpayer resources only after the fact.

If one were to offer a proper analogy for the proposals offered, whether Corker-Warner, Johnson-Crapo, the PATH Act, or the Partnership to Strengthen Homeownership Act (by Reps. Delaney, Carney and Himes), it would punctuate the absurdity of the approaches being proffered.

**Imagine a car getting rear-ended by another car as it is stopped at a red light. The damage is significant but repairable. In considering the options available to the owner, there are three obvious choices: First, the owner can choose to bring the car to an auto repair shop and have it fixed. This seems to be the most rational economic choice as it retains most of the value of the vehicle and provides real benefits given the limited downtime. Second, the owner can leave the car unrepaired with an understanding that its resale value will suffer because of not only the damage but also the resulting future rust and other degeneration. Third, even though the car is mechanically sound and the damage is just cosmetic, the owner could nonetheless opt to junk the car. This would obviously be an uneconomic choice. Not only would it be a total loss of value, but also the necessary downtime of raising funds to purchase a new car would be costly. Sadly, the leading legislative proposals, and administrative proposals being recommended have found a fourth choice – Build a new auto assembly plant to produce a new car. This is so monumentally unsupportable from an economic perspective that it could only have been thought up either by bureaucrats that don't live in the real world or by parties that would financially benefit from such an approach.**

**False Myth #1 – “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 banking system.”<sup>81</sup>*

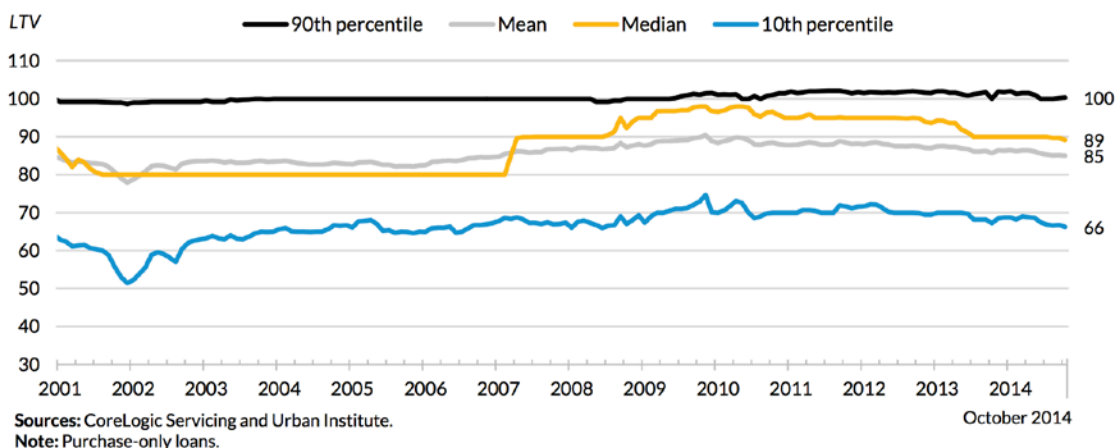
Many in Washington appear to believe that the amount of private capital that will be necessary to replace the GSEs will just appear - like magic. This notion is both unproven and, given the recent history of private capital entering the mortgage market, wholly unsupportable. Currently, the average FICO scores on mortgages that the GSEs insure are close to 750, while the average FICO score for all Americans is only about 694. Given that private firms have historically high levels of capital it seems reasonable to ask why those firms have not satisfied the loan demands of non-conventional borrowers. With only 2.5% of all securitizations being private-label securitizations one must question the validity of this claim.

It is also important to consider that, given the Treasury’s seizure of the privately owned GSEs without regard for preferred or equity holders<sup>82</sup> and the apparent violations of both the standards of conservatorship under the Federal Deposit Insurance Act<sup>83</sup> and HERA<sup>84</sup>, **this capital formation is unlikely.** After all, markets function on clarity of contract and law and the ability to enforce legal rights. Even more demonstrative is that the PMI industry, which was used to reduce losses to the GSEs by insuring any portion of an agency mortgage above 80 LTV, remains thinly capitalized.

If one considers, as we have previously discussed, the GSE charters -- which require that they have insurance against any portion of a loan that is above an 80% loan-to-value (LTV)—and the still-incredibly-thin capital base of the PMI industry, it is even more clear that the lack of private capital has only served to increase demand for both loan origination and insurance on direct government programs (i.e. FHA).

The persistence of some parties arguing that private mortgage insurance should take over from the GSEs suggests that ideology, and perhaps lobbying, are the drivers of this notion. Certainly, there is nothing in PMIs’ recent history or longer-term history supports the notion that they are central to fixing the mortgage market or that the model of private mortgage insurance is viable. In fact, the losses resulting from weak credit underwriting in 2005-07 continues to weigh on many of the legacy PMI providers even seven years after the financial crisis.<sup>85</sup>

## Combined LTV at Origination

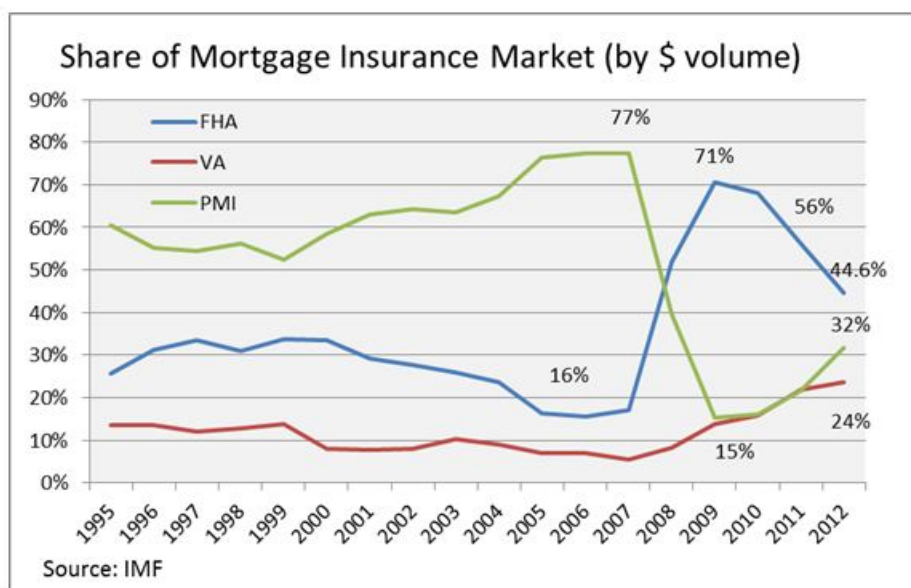


## MIIs Incapable & the Fallacy of Risk Sharing

PMI is a method by which non-federally-guaranteed (FHA or VA) homebuyers can, with monthly insurance premium payments, forgo the 20% down payment requirement. Just as the government insures the FHA or VA lender on FHA or VA loans in the event of default, PMI protects the lender - or a GSE - if a conventional borrower defaults. Generally, to be considered for PMI, a homebuyer must make a down payment of 3-5% of a home's *value*. Fannie and Freddie, recognizing the "near certainty of losses on most foreclosures"<sup>86</sup>, were required by the 1992 legislation to require credit enhancements on mortgages with loan to value (LTV) ratios higher than 80%. To meet these requirements, they relied on the PMI industry. The insurance has generally covered the top 20 to 30% of the potential claim amount of the loan or the portion of the loan that is greater than 70% of the value of the property. Unfortunately, the GSEs and their regulators did not look at the historical record that showed the PMI industry has repeatedly failed (1930s, 1950s, 1980s).

By 2001, seemingly in an effort to further reduce monthly borrower costs, the GSEs increasingly purchased bulk/wholesale PMI insurance. These wholesale insurance policy sales impaired the PMIs' margins and the resulting capital they needed to make good on claims. Between 2000 and 2006, the market share of the PMI industry expanded as private market and GSE loan growth reduced demand for FHA loans and the FHA's insurance products. The use of private mortgage insurance reduced costs to borrowers on GSE-backed loans and benefited issuers of private label mortgage-backed securities (PLS) by improving the credit ratings of those securities due to an expectation that state-regulated insurance companies protected investors. Unfortunately, given the failures of both state insurance regulators, and the GSEs, to require that these firms hold adequate capital, both GSEs and PLS investors were exposed to massive losses associated with private mortgage insurance.

**By 2007, as massive increase in default rates affected PMI-insured mortgage loans the PMIs found themselves unable to offer any meaningful support to the efforts of the GSEs.** With inadequate capital and weak reserving policies, the claims-paying ability of the PMIs was impaired. Not only did the PMIs require forbearance but also their ability to write meaningful amounts of new business, in support of markets, was impaired.



Source: National Association of Realtors<sup>87</sup>

To manage their losses, to help the PMI industry recover, and to reduce the repurchase risk of mortgage originators, the GSEs went to extraordinary lengths to assist PMIs<sup>88</sup>, once again becoming tools employed for financial and social engineering. The risks to their solvency led several of the PMIs to require forbearance, including through the issuance of Deferred Payment Obligations (DPOs) to the GSEs<sup>89</sup>. In effect, the GSEs accepted potentially significant losses on loans that had been insured<sup>90</sup> in an effort to shield mortgage originators from - losses and to maintain the appearance of viability in the PMI industry.

As the MI industry had done repeatedly through history, it again failed in the 2008 financial crisis due to weak regulatory capital and poor state regulatory oversight. Although PMI capital standards were always intended to require “a ratio of capital funds to guaranties adequate to insure against another major depression,” this simply did not occur.<sup>91</sup> PMI companies, like most other insurance companies, are regulated under state and not federal laws. Those laws typically require PMI companies to have a risk-to-capital ratio no higher than 25 to 1, a 4% capital ratio.



On May 8<sup>th</sup> 2014, the Office of the Inspector General of the GSEs' regulator FHFA received a report<sup>92</sup> that pointed out that as a result "of their financial condition and inability to meet the state's minimum risk-to-capital ratio requirement of 25:1, five of the ten mortgage insurers eligible to conduct business with the Enterprises are considered financially weakened", and that "three of the five financially weakened mortgage insurers—PMI Mortgage Insurance Co. (PMI), Triad Guaranty Insurance Corporation (Triad), and Republic Mortgage Insurance Company (RMIC)— are in run-off and no longer able to issue new mortgage insurance policies". Moreover, these mortgage insurers have established deferred payment obligation (DPO) agreements that require a percentage of their claims obligations, to the Enterprises, to be deferred.<sup>93</sup>

More recently FHFA adjusted the Private Mortgage Insurer Eligibility Requirements (PMIERs) and Fannie<sup>94</sup> and Freddie<sup>95</sup> have implemented the requirements. These new guidelines attempt to introduce risk adjustments for the quality of the portfolio that is guaranteed by each PMI. These guidelines require designated assets to equal or exceed a risk-based required amount. These new guidelines translate to an approximately 18:1 **maximum** risk-to-capital (RTC) for new originations when they are put on the same footing as the traditional 25:1 measure. Legacy originations require more punitive capital amounts.

Even today, with the weakest players having gone out of business or unable to write new business, the total capital of the remaining insurers remains thin and doesn't support the belief that there is adequate private capital available to replace the GSEs. Still now, even outside of the legislative process, the PMIs are working with the Mortgage Bankers Association and rating agencies to push the GSEs to accept deeper levels of private insurance coverage as a way to reduce GSE guarantee fees. The benefits of these efforts would accrue to those parties while leaving borrowers, investors, the GSEs and the public exposed, once again, to the rent-seeking behavior of the industry.

\*2007 figure is combined  
\*\* As of 3Q14, 4Q14 not available yet

	Risk-to-Capital									2014 Market Share
	2014	2013	2012	2011	2010	2009	2008	2007	2006	
Macquarie	18.4:1**	17.9:1	N/A	N/A	N/A	N/A	N/A	N/A	N/A	24.6%
United Guaranty Corp.	17.9:1	19.5:1	20.8:1	21.5:1	16.8:1	15.4:1	16.4:1	14.9:1	10.4:1	22.3%
Radian Guaranty Inc.	14.6:1	15.8:1	44.7:1	20.3:1	19.8:1	19.4:1	12.9:1	10.3:1	6.4:1	20.5%
Mortgage Guaranty Insurance	14.3:1	19.3:1	36.9:1	32.9:1	23.8:1	< 25:1	< 25:1	< 25:1	< 25:1	14.8%
Genworth Financial*	16.2:1	16.5:1	15.8:1	5.2:1	0.3:1					13.1%
Essent Guaranty										95.3%

\* Genworth Financial did not start reporting risk-to-capital ratios until 2010.  
\*\* As of 3Q, 2014

	Total Capital (\$mn)									2014 Market Share
	2014	2013	2012	2011	2010	2009	2008	2007	2006	
United Guaranty Corp. (*)	\$1,819	\$1,630	\$1,428	\$1,433	\$1,341	\$1,045	\$1,106	\$1,261	\$1,563	24.6%
Radian Guaranty Inc.	\$1,715	\$1,341	\$926	\$843	\$1,315	\$1,100	\$1,607	\$2,507	\$3,212	22.3%
Mortgage Guaranty Insurance	\$1,903	\$1,603	\$755	\$1,661	\$1,698	\$1,860	\$3,700	\$4,818	\$6,443	20.5%
Genworth Financial	\$1,792	\$1,226	\$735	\$792	\$1,098	\$1,756	\$2,282	\$2,546	\$2,691	14.8%
Essent Guaranty	\$706	\$469	\$204	\$151	\$165	\$0	\$0	\$0	0	13.1%
Industry Total Capital	7,935	6,269	4,048	4,880	5,617	5,761	8,695	11,132	13,910	95.3%

\* As of 3Q, 2014

*Perhaps these efforts to arbitrage the GSEs, investors and the public interest is the result a desire to generate business in the face of our current reality in which there is*

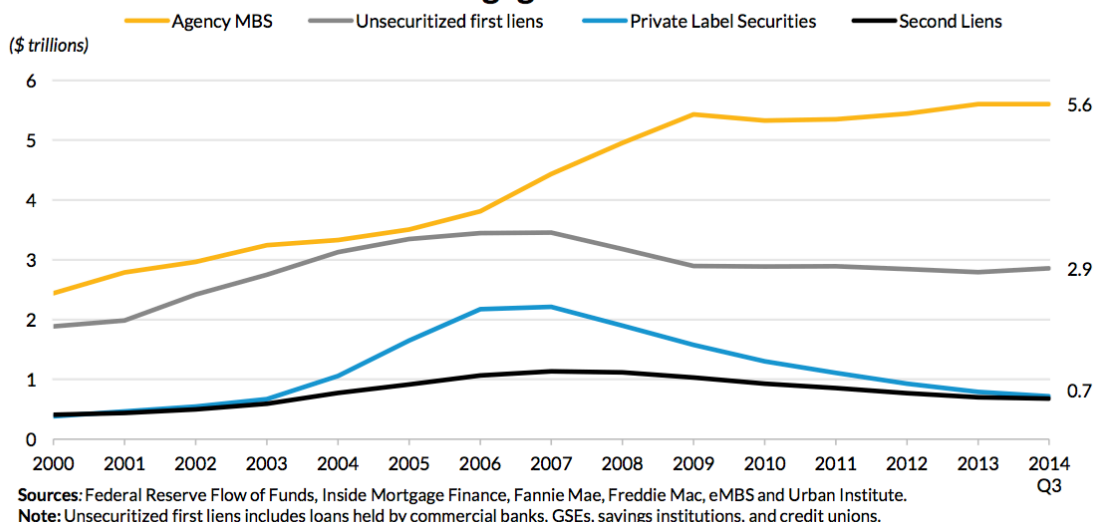
*currently no meaningful private securitization market - because neither regulators nor industry participants fixed it or created the standards necessary to revive it. If one looks at the share of GSE and private-label MBS issuance it is brutally clear that private capital has not sufficiently returned to the market.*

At the same time that some bankers argue GSE guarantee fees should to be increased to allow private capital to compete, many borrowers and mortgage bankers are pushing for the GSEs to lower those fees. The duplicity of these views is obvious. The mortgage bankers desire to be able to take over the business of the GSEs but, in absence of replacing them, they are happy to shift uncompensated risks to them. In truth, with the GSEs underwriting mortgages with an average FICO score close to 750, there should be plenty of opportunity for private lenders to step in more fully. For context, the “prime” label for mortgages allows FICO scores down to the 680 level.

Beyond the failure of the PMIs, as providers of first-loss private capital, one must consider how much private label securitization exists, and even how much private capital the GSEs have been able to attract to their newer first-loss, risk sharing deals. After all, 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. **From the start of 2014 through April 2015, the private capital investment in agency first-loss deals was only \$13.1 billion. It is important to note that, to date in 2015, this capital was in support of mortgage pools that had average FICO scores of 752.**<sup>96</sup> In other words, private capital is still only available for the crème de la crème of cherry-picked loans. Today, there simply isn’t enough private capital available to support the market in good times and certainly wouldn’t be enough to support the markets in any future-housing crisis.

Aside from private-capital invested in PMI industry and agency risk-sharing deals, there remains little other private capital. The private-label securitization market remains closed and without clear standards, clarity of contracts and meaningful protections for investors, it remains unlikely that market will restart anytime soon.

## Size of the US Residential Mortgage Market



Source: Urban Institute<sup>97</sup>

### **False Myth #2 – “We Need more Competition”:**

**One of the key arguments employed by advocates who favor replacing or breaking up the GSEs, or expanding the number of players supporting the secondary mortgage market, is that Fannie and Freddie have “duopoly power” over the market.**

**While it is true that they are the only private secondary market firms tasked exclusively with ensuring ongoing liquidity to the primary market, they are not the only source of long-term mortgage funding, and they do not set the price of mortgage credit artificially high – key prerequisites to support claims of monopoly, duopoly or other anti-competitive labels.** To the contrary, they have been encouraged by the regulator FHFA and other mortgage industry participants to keep guarantee fees low to support the housing market in the wake of the 2008 crisis.

Bank balance sheets, federal government programs and, before the crisis, private label securitizations all provide what is intended to be stable funding for the financing of mortgage loans. **The GSEs are supposed to support a secondary-market only for the purpose of ensuring liquidity when those primary systems fail.** As a result, it is critical to remember that inadequate provisioning of liquidity to the mortgage market did not drive the failures of the GSEs. **Instead, rather than failing to support that liquidity when it was not necessary, the GSEs failed because they overprovisioned liquidity.** That excess liquidity, in pursuit of extraordinary financial returns, supported an environment of deteriorating credit standards not only for the GSEs but the broader

market. **In other words, while appropriate levels of capital and liquidity support economic outcomes, excess liquidity without adequate capital – by definition - supports uneconomic outcomes.**

In fact, as witnessed in 2007 and 2008, the increasingly imbalanced origination volume that was sold to Fannie rather than Freddie supported<sup>98</sup> a negative feedback loop -- in which the more volume Fannie received and securitized the better its funding costs and, conversely, the less Freddie received, the more difficult it became for them to economically execute their securitizations. This became a self-sustaining negative feedback loop. Until the years preceding the crisis, during which they mispriced their guarantee fees by basing them - in part - on the volume of loans originators sold them rather than on underlying credit characteristics, the two GSEs never competed on price. One cannot levy anticompetitive (i.e. “duopoly”) claims against firms that do not compete on price.

**If we want to strike the proper balance in support of the secondary mortgage market, we have to recognize the GSEs provide an essential public service -- ongoing availability of secondary mortgage credit -- much like the provisioning of water, gas, electricity or sewers that other utilities offer.** As with these other utilities, increasing the number of competing firms doesn’t improve outcomes. In fact that would drive up excess liquidity and create disparate execution prices for all but the largest providers. This is not a new concept but can be demonstrated throughout history, including during the Latin American banking crisis of the 1970’s during which it “was not the oligopolistic structure per-se but excess liquidity, coupled with the lack of banking regulation that permitted uncontrolled entry and cutthroat competition on loan volume and pricing”<sup>99</sup>. Supposed proponents of more competition in the mortgage securitization market also fail to honestly discuss that while the GSEs remain the only private secondary market firms tasked exclusively with ensuring ongoing liquidity to the primary markets, they are not the only source of long-term mortgage funding. **When the crisis occurred, all of those primary-market private funding sources fled the mortgage space as markets became distressed. Had the GSEs been properly capitalized and overseen, they would have been able to function as intended - as countercyclical providers of liquidity in support of primary mortgage originations to the real economy.**

Given their exclusive position as lenders of last resort to the primary market, and the importance of this function for the stability of the real economy, it seems more appropriate to recognize that, held to their primary role as credit guarantors, the GSEs are not anti-competitive, rather they are and were properly created as ‘natural monopolies’:

*“...A conduit for mortgage funding is a natural monopoly since the fixed costs are high and the marginal costs are relatively constant. The fixed costs are the development of the infrastructure to underwrite mortgages and pass cash flows through to investors in mortgage-backed securities in a timely and accurate manner. Such a setup involves*

*heavy use of technology, and a staff of highly trained statistical and financial analysts. Fannie Mae and Freddie Mac both have hundreds of PhDs on their staffs, and their principal function is the development, calibration, and review of underwriting and capital allocation models. This is expensive. If the supply of capital for prime mortgage funding is elastic, the average cost-curve for mortgage funding will be downward sloping at all relevant points. This means the most efficient mortgage industry is one that has only one funding firm.”<sup>100</sup>*

The GSEs operations are limited to a narrow section of the broader market, one that is specifically intended to support a relatively homogenous and middle-class borrower. As a result, it seems that the acceptance of them as a natural and secondary market utility is appropriate. Regulating the GSEs in a manner to power utilities is a clearly supportable approach. Regulated utilities employ private capital and their regulators closely regulate the private returns necessary to support a stable equity base. This model supports a specific, narrow and focused use of public benefits in a narrow market. The authorities granted to the FHFA, in HERA, lend itself to such an approach. Those authorities allow the regulator to ensure that the firms employ their benefits of scale to minimize the costs to end-users while allowing them to earn acceptable, rather than excessive, rates of return.

### **False Myth #3 – Any Guarantee Must be on the Securities & not the Issuer**

Suggestions that a government guarantee needs to be provisioned against the risks of insured mortgage-backed securities appears to be driven by both issuers and a few of the largest investors in mortgage securities who seek to benefit from an unnecessarily broad government guarantee. Instead, proper capitalization of secondary market guarantors should take into account counterparty risk as well as the risks of the underlying insured mortgages. Such an approach would reduce the need for a broad government guarantee and would properly allocate risks onto the backs of private market actors. The scale and capital requirements for such an insurance regime would be difficult to achieve without either avoiding a broad government guarantee or the more socially and economically supportable approach of a well-regulated and utility-like secondary-market.

Given the ability to create such a private marker utility regime there is no reason that any guarantee should be broad. It should be very narrow, stand behind considerable capital and act only as a catastrophic line of credit to help the To Be Announced (TBA) market function in good times and to ensure the continued operation of the firms during an unlikely catastrophic crisis.

### **Housing & Economic Recovery Act (HERA) Solved Most of These Issues**

As noted previously, the Housing and Recovery Act of 2008, passed into law after the financial crisis was upon us. It was then too late to allow the appropriate exercise the authorities granted to the regulator of the GSEs until after they had already been placed into conservatorship. **Had these authorities been granted several years before the**

**crisis, the GSEs would likely have remained safe, sound and able to carry-out their primary function – to support liquidity to the primary mortgage markets at times that capital markets and lenders were unable or unwilling to support mortgage lending.** In reviewing these new safety and soundness authorities it becomes clear that, excepting an implied government guarantee (outside of conservatorship) those authorities should satisfy even the historically staunchest critics of the GSEs. The primary concerns of many of the critics of the GSEs, prior to the crisis, were the related risks of interest-rate risk<sup>101</sup> posed by their portfolios<sup>102</sup>. While credit, rather than interest rate risk, was the largest driver of the GSEs' failures<sup>103</sup>, in the wake of HERA, even those risks have been ameliorated.

Key safety and soundness elements included in HERA include<sup>104</sup>:

- 1 *“Requires the Director to establish: (1) assessments to collect from the regulated entities in order to provide for Agency expenses; (2) standards for management and operations of the regulated entities; (3) criteria to ensure that enterprise portfolio holdings are backed by sufficient capital and consistent with entity mission and safe and sound operations; and (4) risk-based capital and minimum capital requirements to support risks in entity operations and management”;*
- 2 *“Authorizes the Director, in order to ensure safe and sound operations, to: (1) set higher minimum capital levels for the FHLBs and the other regulated entities; (2) increase the minimum capital level for a regulated entity on a temporary basis, and rescind increases; and (3) establish capital or reserve requirements for any products or activities”;*
- 3 *“Amends the Securities Exchange Act of 1934 to subject the regulated entities to its registration and reporting requirements”;*
- 4 *“Amends the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 with respect to the prohibition against excessive executive compensation. Authorizes the Director to require an entity to withhold such compensation, or to place it in an escrow account, during the review of its reasonableness and comparability”;*
- 5 *“Requires the Director, before issuing any regulations about the exercise of additional authority regarding prudential management and operations standards, safe and sound operations of, and capital requirements and portfolio standards, to consider the views of the Chairman of the Board of Governors of the Federal Reserve System regarding risks posed to the financial system by the regulated entities”;*



As a result of these statutory changes, the weak regulatory oversight of the GSEs, which persisted for decades, has been replaced by a prudential regulator with all of the authorities of a world-class regulator. Having been placed into conservatorship on September 6, 2008, the GSEs have since been operating not only in a manner inconsistent with the intent of HERA but in a manner that may violate the legal obligations of a conservator and certainly one that is less sound and less safe than should be acceptable to the public or to legislators.

HERA requires the FHFA to ***“to take such action as may be necessary to put the regulated entity in a sound and solvent condition”***. But in 2012, FHFA and Treasury entered into an Amendment to the 2008 Preferred Stock Purchase Agreement. When this amendment was announced, **Michael Stegman, then an unconfirmed advisor to Treasury, stated they were “acting upon the commitment made in the Administration’s 2011 White Paper that the GSEs will be wound down and will not be allowed to retain profits, rebuild capital, and return to the market in their prior form”<sup>105</sup>**. The actions of the Treasury Department have effectively prevented FHFA from the execution of its legal mandate and also appear to violate the HERA requirement that FHFA is expected to act without any supervision or oversight by any other Federal Agency<sup>106</sup>.

**If the Director of the FHFA followed the conservatorship requirements in the HERA statute, he would place the restoration of capital ahead of its 2012 agreement with the Treasury, which transferred all profits to Treasury.** After all, as the sole party to that agreement statutorily charged with the restoration of the GSEs’ capital, it is in his power either (a) to stop dividends and inform the Treasury that now that they have received repayment of all monies provided in support of the GSEs and that he must enter into a new agreement which effectuates the statutorily required process of restoring the GSEs capital or, (b) if he deems that they could not become adequately capitalized<sup>107</sup> according to the capital requirements of HERA<sup>108</sup>, and intends to place them in receivership and begin liquidation of the GSEs - with value allocated according to the legal priority of claims.

**Six years after the GSEs were placed in conservatorship under HERA, the regulator has made no effort to take those actions required by the statute: “To put the regulated entity in a sound and solvent condition” and to “conserve the assets and property of the regulated entity”.** Instead, Treasury has ‘swept’ \$40 billion more, from the GSEs than the GSEs received in borrowings. By contract with the Treasury, and in seeming violation of HERA, the conservator has allowed the Treasury to enforce *“the administration’s commitment to ensure existing common equity holders will not have access to any positive earnings from the G.S.E.’s in the future”<sup>109</sup>*.

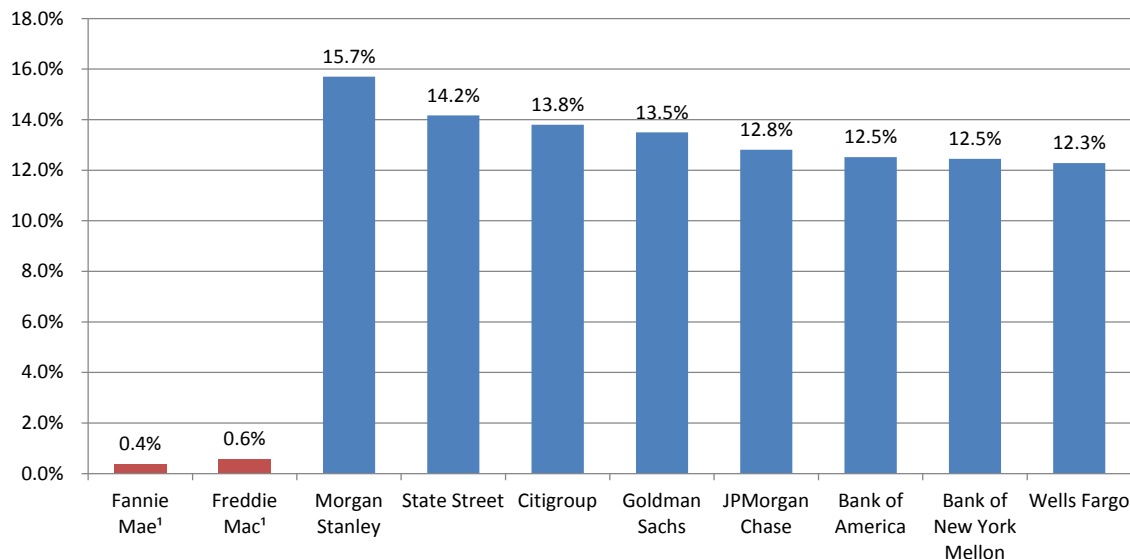
Further evidencing its violations of HERA, FHFA has ignored key provisions which require that it *“periodically review the amount of core capital maintained by the*

*enterprises... and the minimum capital levels established for such regulated entities”; and “determine the capital classification of the regulated entities for purposes of this subchapter on not less than a quarterly basis.” Instead of meeting these explicit requirements, in October 2008 the Director of FHFA unilaterally chose to ignore the legal directive and, instead, chose to “suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship”<sup>110</sup> and the current Director and conservator continues not to meet these statutory obligations. By failing to provide information about the capital classification and future plans of each enterprise, the GSEs regulator has supported the GSEs in offering less disclosure, under the Securities Exchange Act of 1934, than any other publicly held firm and less than they offered before the crisis. The requirement that each GSE submit “a feasible plan for restoring the core capital of the regulated entity subject to the plan to an amount not less than the minimum capital level for the regulated entity and for restoring the total capital of the regulated entity to an amount not less than the risk-based capital level for the regulated entity” has also been ignored and no such plan has ever been submitted, approved or carried out. **As a result, and contrary to the requirements of the statute, the GSEs currently have less capital than they did prior to the financial crisis.***

**Though the GSEs remain critically undercapitalized, the FHFA has begun to fund the affordable housing funds created by HERA also in violation of HERA requirements that clearly state an enterprise “shall make no capital distribution if, after making the distribution, the regulated entity would be undercapitalized”<sup>111</sup>.**

Instead of recognizing the primacy of the statute as requiring the restoration of capital, the Director of the Federal Housing Finance Agency, as conservator, has chosen to rely on the Treasury’s outstanding commitment, under the 2012 amendment to the Preferred Stock Purchase Agreement”, to provide funds to the GSEs on an ‘as needed’ basis. It has treated those Treasury commitments as the basis to deem the GSEs as adequately capitalized. **While many suggest that the GSEs do not need capital, as a result of their Treasury backstop, even with the Government’s Senior Preferred Stock included the GSEs are significantly undercapitalized relative to other large financial firms.** The chart below compares an estimate of the GSE’s “Total Equity” (inclusive of Government Preferred Stock) / RWA ratio, to Tier 1/RWA ratios of the largest US banks. It should be noted that the Government’s Senior Preferred Stock (or related commitment) does not qualify as Tier 1 capital due to its cumulative nature. It should be further noted that, while the Government’s Senior Preferred Stock provides a level of capital protection (albeit Tier 2 capital) to the GSEs, this capital does not protect taxpayers, it is in fact provided by taxpayers.

## Tier 1 Capital Ratios



**Source:** Company Filings

**Note:** Figures as of Q2 2015

(1) For Enterprises, Tier 1 Capital ratio based on estimated Total Equity / Risk-Weighted Assets assuming 50% standardized risk weighting

When asked, in congressional testimony, how his actions regarding the affordable housing funds and the undercapitalization of the GSEs, FHFA Director Watt stated that the 2012 agreement between the GSEs, the FHFA and Treasury “trump the law”<sup>112</sup>.

The assertion, that an agreement between two Federal Agencies can supersede a federal statute passed by Congress and signed by the President, is staggering. Especially when proffered by the Director of an agency who practiced law for 22 years and then served as a member of Congress for another 22 years (including during the time when HERA was passed by the House Financial Services Committee on which he served). The basis of these claims becomes more peculiar in the context of Director Watt’s claims that he is “not part of the Administration. The Federal Housing Finance Agency is an independent regulatory agency. We don’t play out the administration’s policy. We follow the statute”.

With all of the income generated by the GSEs swept directly to the Treasury, and into general Treasury accounts rather than a capital account earmarked for the GSEs, it seems impossible for Director Watt to credibly argue that either GSE “maintains an amount of total capital that is equal to or exceeds the risk-based capital level established for the enterprise under section 4611 of this title; and maintains an amount of core capital that is equal to or exceeds the minimum capital level established for the enterprise under section 4612 of this title”<sup>113</sup>.

To some observers this discussion may seem abstract and esoteric, but such a view is shortsighted. After all, some day – perhaps soon – one or both of the GSEs could swing from profit to loss. Even under FHFA’s incorrect interpretation of HERA that confuses profits for capital, affordable housing funds they have begun to fund should not be funded until such time the GSEs are adequately capitalized. A further draw especially would reignite calls for that funding to be suspended. **Moreover, if the GSEs were unable to become adequately capitalized, they would be at risk of mandatory receivership in 2018 when the Treasury agreement sweeps not only the profits but also all of the GSEs’ capital reserve accounts.** As a result, the entire mortgage system could fail and the ensuing systemic risk would be impossible for financial markets, the government and the country to ignore.

**Instead of accepting these realities, it appears the FHFA has become the biggest opponent of plans to restore the capital of the GSEs<sup>114</sup>. This can be demonstrated by the fact that the GSE ‘profit sweep’ is calculated on a quarterly rather than annual basis. As a result, even if the GSEs had a single quarter of losses, with the other three quarters being profitable, the GSEs would require a draw from Treasury. This approach appears designed to force the GSEs to draw against the Treasury commitment again, in hopes that such action reignites a legislative push to replace the GSEs with the “bank-centric” approach contemplated<sup>115</sup> by Treasury.**

So, the conservator has failed to periodically classify the capital position of the enterprises, has failed to require a capital restoration plan, has allowed the GSEs to provide insufficient disclosures to the Securities and Exchange Commission and has allowed undercapitalized GSEs to make capital distributions that do not improve their capital position.

### **The Way Forward**

Even before the crisis it was clear the GSEs were inadequately capitalized. Privatization advocates recognized that, for safety and soundness sake, and to ensure they were seen as strong on a standalone basis, they should build a level of capitalization that their regulator “considers equivalent to the level of capitalization a company would have to maintain for its debt to be rated AA by a recognized debt rating agency”.<sup>116</sup> Nonetheless, to expect that private markets can provide enough capital to support the mortgage finance system in good times, or that private market participants will not withdraw liquidity in bad times is unrealistic.

In 1968, when Fannie Mae was converted from a government-owned corporation to a shareholder-owned corporation that no longer insured government-issued loans<sup>117</sup>, it functionally acted as a utility. Like other utilities, Fannie Mae retained its natural monopoly control over its market, until the creation of Freddie Mac in 1970<sup>118</sup>. **Given the legacy competencies, the capital needs, the infrastructure costs, the required efficiencies, their market reach and the need to be able to deliver services on a**

countercyclical basis (regardless of macro-economic conditions) the GSEs should be looked at in the same manner as other utilities.

**Lewis Ranieri**, a pioneer of mortgage securitization who is often referred to as the “Godfather of mortgage finance” recognized the needed functions of the GSEs, as being utility-like when he wrote: **“before re-chartering, reforming, eliminating or restructuring Fannie Mae and Freddie Mac, policy makers must recognize and come to terms with the massive amount of current obligations (debt and MBS) outstanding. Fannie Mae and Freddie Mac currently finance some \$6 trillion of today's market”** and that **“as policy makers assess the housing finance system, they should keep at least three principles in mind: (1) Federal government support of housing is essential, but the current level is out of balance and inappropriate; (2) Restoration of private capital is essential for a sustained economic and housing recovery; and, (3) Securitization – built on assets originated in a system of sound and prudent underwriting – is a critical part of the long term viability of our system”**.<sup>119</sup>

While some might argue these goals can be achieved with an alternative, purely private model, former **Treasury Secretary Paulson** noted his disagreement when he stated: *“I am skeptical that the ‘break it up and privatize it’ option 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 on capital.”*<sup>120</sup> In a 2005 analysis for one of the GSEs, regarding the future of their business model, **Citigroup** offered a similar view: *“The business cannot exist without the benefits provided by the charter...these factors drive our view that the two “extreme” outcomes – stay the course and full privatization – are, in fact, not options”*<sup>121</sup>.

It is important to remember that it is of great importance that, in order to diversify risks and provide a countercyclical buffer for mortgage financing, we **keep the secondary market (GSEs) separate from the primary market in which banks and other lenders operate**. As the crisis was building it became clear that concentration, interconnectedness and contagion can occur because when primary market risks and secondary market risks are combined, through the blurring of the lines between the players, these risks are able bring down the entire financial system – and, with it, key sectors of the real economy. If the GSEs were properly capitalized, had essentially no portfolios (and thus no interest rate risk), were properly reserved for each MBS deal, and properly regulated the **secondary market would have functioned even during the collapse and contagion of interconnected banks**. This would have relieved many of the economic pressures caused by the withdrawal of primary market consumer lending.

Rather than introducing an entirely new system in which the commingling of the duties of primary and secondary market players recreate systemic risks<sup>122</sup>, **we should repair the existing system and ensure the GSEs have meaningful levels of capital, real constraints on their ability to leverage their balance sheets, and should ensure that mortgages are priced commensurately with both underlying credit risks and counterparty risks.** The GSEs should be allowed to earn utility-like rates of return, so in good times these firms build capital sufficient to ensure a continued ability to support lending in bad times.

This is not a theoretical or academic issue. The reality remains that banks that hold mortgages in their portfolios retain both credit and interest rate risk. If, as rates rise, these banks end up in trouble, and the GSEs have no capital, the obligations for support of the primary mortgage market will fall not on the GSEs, as intended by their charters, but directly on the government. As we saw in the 1960's, as rates rose and bank deposits were withdrawn and placed in Treasuries, there was a reduction in bank willingness to support mortgage lending.

### **How do We Fix the GSEs? Anything but Rocket Science:**

Currently, there is little risk of GSEs taking new and risky bets. In fact, the average FICO score for the GSEs is close to 750<sup>123</sup>, which compares to 720 in 2009. Prior to 2009, the lower levels of GSE FICO credit scores were close to 600, since 2009 that has moved up to about 680<sup>124</sup>. Given that the average FICO score for all borrowers in the U.S. is about 694 the GSEs remain conservative in their underwriting. Still, it is fair to consider that the longer they are in conservatorship the more likely it becomes that political pressures will rise for them to, once again, be used as tools of social policy.<sup>125</sup>

The FHFA<sup>126</sup> as well as current<sup>127</sup> and former<sup>128</sup> administration officials repeatedly claim that the only way to move forward on GSE reform is through congressional action. Given the authorities provided for in HERA this is a falsehood and ignores that the intention of HERA is to require the regulator to either place them in a sound and solvent condition or, if that is not possible, to put them in receivership. **So, what should FHFA and the conservator do to satisfy its legal mandates?**

### **Capital**

**Firstly, the FHFA should place the restoration of capital ahead of the PSPA. As the sole party to an agreement with Treasury who is statutorily charged with the restoration of the GSEs' capital, it is in the FHFA Director's power to either suspend the payment of dividends to the Treasury and to enter into a new agreement which effectuates the statutorily required process of restoring the GSEs capital or, if the conservator deems the GSEs could not become adequately capitalized, according to the capital classifications in HERA, reorganize the enterprises through receivership by creating a limited life regulated entity (LLRE)**



**and then selling the capital stock of the LLRE.** Given that there is little doubt that the Government Accounting Office would require the consolidation of all of the GSEs' outstanding debt if the GSEs were placed in receivership, we believe that recapitalization is the best path forward.

**To date, the enterprises have borrowed \$187.5 billion from Treasury and have repaid over \$239 billion. That amounts to a 27.5% return on the government's investment.** The GSEs have been far and away the most successful of the credit-crisis related bailout programs, accounting for a combined 80% (\$51.5bn of \$64.6bn) of total program profits to date. This excludes the large additional potential profits, associated with Treasury's warrants. As a result, it seems reasonable and politically feasible to consider the government paid back while retaining value of exercising the government's warrants for 79.9% of the GSEs common stock.

## ProPublica Bailout Tracker

Rank	Company	Programs	Funds Received by Company	Funds Received by Government	Net Government Profit (Loss)	% Total	Government Exit?
1	Fannie Mae <sup>(1)</sup>	HERA	\$116.1	\$142.5	\$26.4	41%	✗
2	Freddie Mac <sup>(1)</sup>	HERA	71.3	96.5	25.1	39%	✗
3	AIG	SSFI	67.8	72.9	5.0	8%	✓
4	General Motors	AIFP	50.7	39.3	(11.4)	(18%)	✓
5	Bank of America	CPP/TIP/AGP	45.0	49.6	4.6	7%	✓
6	Citigroup	CPP/TIP/AGP	45.0	58.4	13.4	21%	✓
7	JPMorgan	CPP	25.0	26.7	1.7	3%	✓
8	Wells Fargo	CPP	25.0	27.3	2.3	4%	✓
9	GMAC (Ally)	AIFP	16.3	19.3	3.1	5%	✓
10	Chrysler	AIFP	10.7	9.5	(1.2)	(2%)	✓
<b>TOTAL PROGRAM RECIPIENTS</b>			<b>\$616.6</b>	<b>\$681.2</b>	<b>\$64.6</b>	<b>100%</b>	
<b>GSEs</b>			<b>\$187.5</b>	<b>\$239.0</b>	<b>\$51.5</b>		
<i>GSE % of Total</i>			<i>30%</i>	<i>35%</i>	<i>80%</i>		

**Source:** ProPublica

**Note:** Excludes impact or participation in any of the following programs: FDIC insurance limit increase, Asset-Backed Commercial Paper Money-Market Mutual Fund Liquidity Facility, Commercial Paper Funding Facility, Money-Market Investor Funding Facility, Primarily Dealer Credit Facility, Term Auction Facility, Term Securities Lending Facility, TALF credit market program, Treasury money market fund guarantee program, FDIC bank debt insurance program (TLGP), PPIP mortgage securities program, HAMP, HARP, Hardest Hit Fund, Neighborhood Stabilization Program, or Treasury mortgage backed securities purchase program

(1) Includes dividends declared but not yet paid through September 2015

**The conservator should, recognize its statutory requirements under HERA supersedes the 2012 amendment to the PSPA. As such it is in its power to suspend and defer the payment of any and all dividends to the Treasury. Such actions would**

**be in furtherance of its mandate to ensure the safe and sound operations of the enterprises and “restore” the companies to an adequately capitalized position.** FHFA has the authority to define the appropriate levels of capital for the GSEs and, in determining the appropriate level of capital, which we determine to be between 3% and 5% if they were designated as nonbank SIFIs (see below); they should ensure that beyond merely considering statutory capital requirements that the proper levels of capital consider the actual issuance of agency securities. Prior to the 1992 Act the capital requirement on unsecured GSE debt to total capital was 15-to-1<sup>129</sup> but there was no requirement for capital to be held against the agencies’ MBS. If they were required to maintain appropriate levels of equity capital against MBS outstanding and also the institutions, in case of operational or other risks, they would have been able to withstand crisis. Unfortunately, not only did the 1992 Safety and Soundness Act water down the GSEs’ capital requirements through a poorly designed stress-test that it took a decade to implement and left the GSEs thinly capitalized but even on the eve of the crisis the Paulson Treasury failed to force the GSEs to issue new equity<sup>130</sup>.

Such an approach would ensure that the companies are able to attract private capital while ensuring that the risk to the government is eliminated.<sup>131</sup> As the Congressional Budget Office pointed out, in 1991, “capital is the deductible on the government's implicit guarantee of the enterprise's obligations”<sup>132</sup>.

**We estimate that without raising any private capital, and with no value placed on the government’s preferred securities or undrawn PSPA commitment, the GSEs can build to \$150 to \$200 billion capital over 10 years. If the President, together with the FHFA, announced a plan to recapitalize the GSEs and reform them as privately capitalized utilities, the GSEs could easily raise private capital to accelerate the recapitalization.**

### **Portfolios**

As we have demonstrated, the largest risks to the GSEs has long emanated from their investment portfolios. These risks have been meaningfully diminished and will continue to become less significant. HERA authorizes the regulator to define these portfolio limits either in or out of conservatorship and the portfolios should continue to be reduced to a level that provided only for the short-term liquidity needs of the enterprises. Such a view is in-line with the recommendations made by Wallison in his paper recommending the privatization of Fannie Mae and Freddie Mac.<sup>133</sup>

In the 2008 Preferred Stock Purchase Agreement the FHFA and Treasury agreed “To promote stability in the secondary mortgage market and lower the cost of funding, the GSEs will modestly increase their MBS portfolios through the end of 2009. Then, to address systemic risk, in 2010 their portfolios will begin to be gradually reduced at the rate of 10 percent per year, largely through natural run off, eventually stabilizing at a

lower, less risky size”.<sup>134</sup>As a result of the 2012 amendment to the PSPA, “Those portfolios will now be wound down at an annual rate of 15 percent – an increase from the 10 percent annual reduction required in the previous agreements. As a result of this change, the GSEs’ investment portfolios must be reduced to the \$250 billion target set in the previous agreements four years earlier than previously scheduled”.<sup>135</sup>

### **SIFI Designation**

With the passage of the Dodd-Frank Act, Congress established the Financial Stability Oversight Council (FSOC)<sup>136</sup> under the Department of the Treasury to bring together federal and state financial regulators to look across the financial system to identify risks to financial stability, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system”<sup>137</sup>. The FSOC has 10 voting members, including the Secretary of the Treasury (who chairs the Council), the Chairman of the Federal Reserve, the Comptroller of the Currency, the Directors of the CFPB and FHFA, the Chairpersons of the SEC, FDIC, CFTC and NCUA Board, and one independent member (with insurance expertise), as well as 5 non-voting members (including a state insurance commissioner, state banking supervisor, state securities commissioner, and Directors of the Office of Financial Research and Federal Insurance Office (both of which reside within Treasury).

One of the FSOC’s responsibilities is to identify firms, with over \$50 billion in assets, that could pose a systemic risk, to designate them as “systemically Important Financial Institutions” (SIFIs) and to then implement processes to reduce the systemic risks posed by those institutions. Over five years after the passage of Dodd-Frank, there has been no effort to designate two of the largest financial institutions in the world, the GSEs, as SIFIs. Designating the GSEs as SIFIs would allow regulators, in addition to the FHFA, to oversee the interplay between the GSEs and other market participants. Specifically, designation subjects all SIFI institutions (banks, insurance companies, and other non-bank SIFI’s) to supervision by the Board of Governors of the Federal Reserve System.

In addition to the enhanced supervision of these firms by a consistent national regulatory authority, SIFI’s are subject to enhanced prudential standards, which include risk-based capital requirements, caps on leverage, stress testing, liquidity and risk management oversight. Furthermore, designated non-bank SIFI’s are required to file “living wills” with the Fed and the FDIC, and are subject to a resolution process administered by the FDIC.

The powers of the FSOC, to reduce systemic risks could also be used to ensure the consideration of private assessments of the government's exposure to the risks of each GSE. Once each GSE is adequately capitalized the FSOC could require it to issue subordinated debt that does not carry any explicit or implicit federal guarantee. Variations in the market value of that debt could aid regulators in calculating investor perceptions of a GSE's risks.<sup>138</sup> This market information would reduce the possibility that

either the FHFA or the FSOC allows an enterprise to take excessive risks, neglects to report losses or is noncompliant with capital requirements.

Given the broad authorities of the FHFA and the FSOC's purpose of reducing systemic risks it seems appropriate for the FSOC and the Fed to act as backup regulatory bodies to ensure that the credit-risk pricing functions of the GSEs are overseen in a manner that ensures they are determined through proper supervision, and based upon both the underlying credit risks and market assessments of private credit risks. The benefits of such an approach would be significant. Besides reducing the tendency for regulatory capture and the risks of political interference, this approach would ensure that primary market lenders would not be able to arbitrage the GSEs' insurance wrap. Instead the cost of privately securitizing, for the largest firms, would be competitive with selling loans to the GSEs and receiving an insurance wrap. This would reduce the amount of mortgage-backed securities backed by the agencies while still providing a vehicle for smaller lenders, who do not have direct access to private securitization markets, to access the market at execution prices competitive with their larger peers. Furthermore, in bad economic times, as lenders became unwilling to supply necessary liquidity to the mortgage markets, the well capitalized GSEs would provide both large and small lenders with the capacity to support the real economy. Such an approach would support the mission of the GSEs, as originally intended, to act as liquidity tools for the funding of new mortgages rather than as risk transfer mechanisms.

Alex Pollack stated in April 2014, "If you are a super-big and super-leveraged financial firm, the Financial Stability Oversight Council can designate you as a SIFI. But it has not so designated Fannie Mae and Freddie Mac ... to all impartial observers, this makes FSOC look incompetent. If anybody at all is a SIFI, then Fannie and Freddie are SIFIs. If Fannie and Freddie are not SIFIs, then nobody is a SIFI ..." <sup>139</sup>

### **SIFI Designation Capital Requirements**

**What amount, and what forms, of capital would likely be required of post-conservatorship GSEs if they were designated as nonbank SIFIs?**

Basel III is a framework for global bank regulation formulated by the Bank of International Settlements in Basel, Switzerland. The framework includes detailed requirements for capital adequacy, as well as requirements for liquidity risk, stress testing and enhanced supervision.

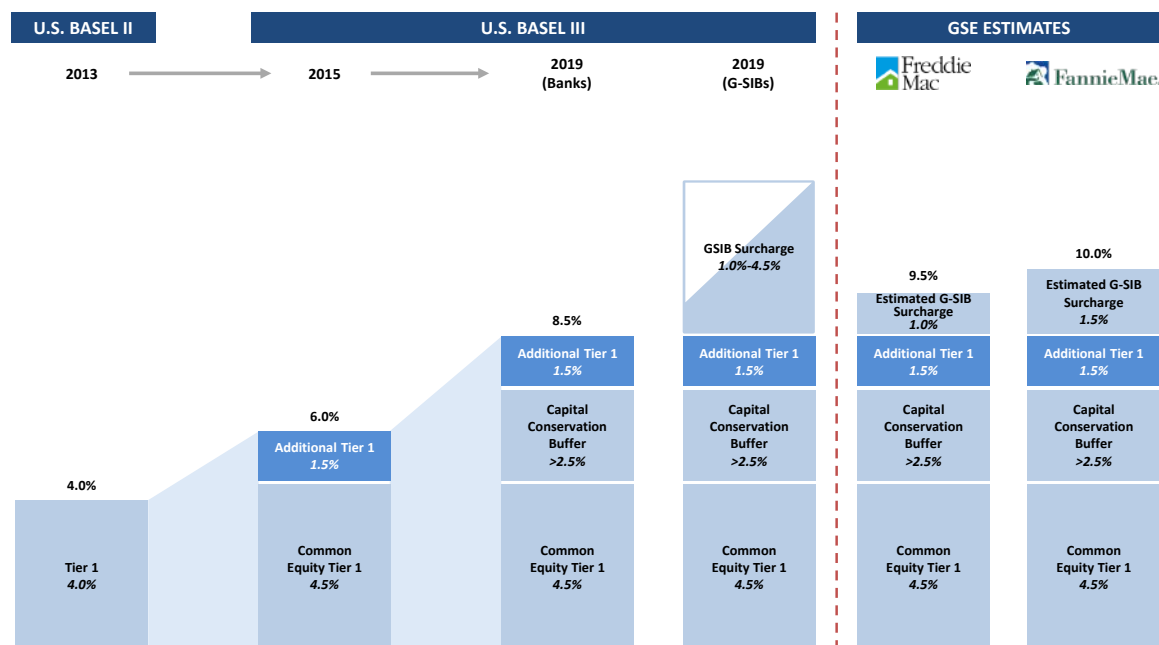
The Federal Reserve Board, OCC, and FDIC issued a final rule in July of 2013 to revise the regulatory framework for US Banks with implementation scheduled for March 2019. This final rule incorporates many aspects of the Basel III framework as well as changes to the bank regulatory environment required under Dodd-Frank.

**1 US Basel III applies to national banks, state member banks, state non-member banks, savings associations, and other bank entities (e.g., subsidiaries of foreign banks).** Elements of Basel III will also be applied to certain non-bank financial companies that are designated as a SIFI by the FSOC. Non-bank SIFIs currently include AIG, GE Capital, Prudential, and MetLife. Capital standards for the insurers designated as SIFI's (AIG, Prudential, and Met Life) have not yet been established, but are expected to be tailored to the nature of their businesses, and consistent with international insurance guidelines.

**2 US Basel III banks are required to hold a minimum of 8.5% in Tier 1 Capital, as a percentage of their Risk Weighted Assets (RWA), by 2019** (of which 7% must be "Common Equity Tier 1"). Tier 1 Capital includes common stock, certain reserves and retained earnings, and non-redeemable non-cumulative preferred stock (such as the GSE's current junior preferred shares). This is an increase from the 4% that was required before implementation in 2013 and the 6% that is required today.

**Globally systemically important banks (G-SIBs), which are designated by the Financial Stability Board (FSB) internationally or by the FSOC in the US, are subject to an additional capital surcharge ranging from 1% to 2.5% (1% to 4.5% under proposed US rules).** The application of G-SIB surcharges, while under consideration, does not currently apply to non-bank SIFIs. **The G-SIB surcharge, if applied to the GSE's – based on the public framework documents, is estimated at 1.0% to 1.5%.**

## Minimum Risk-Based Capital (RBC) Requirements



Source: BIS, Davis Polk, Federal Reserve Board

**Note:** U.S. Basel II figures exclude Tier 2 capital requirement for illustrative purposes. U.S. Basel III figures also exclude Tier 2 capital requirement, as well as the countercyclical buffer requirements (for advanced approaches banking organizations). Estimated Freddie Mac G-SIB surcharge of 1.0% and estimated Fannie Mae G-SIB surcharge of 1.5%, based upon published FRB frameworks.

**3 U.S. Basel III generally applies a 50% risk weighting to first-lien residential mortgages under the “Standardized” approach to determine RWA. Most large banks, however, will use an alternative “Advanced Internal-Ratings Based” (AIRB) or “Advanced” approach that often produces lower risk weightings than the Standardized approach.**

**4 When you include weightings for their full portfolio of balance sheet and guarantee assets the Standardized (e.g. 50%) approach for residential mortgages should yield an average risk weighting of just over 50% for the GSEs’ current portfolio. Application of the Internal-Ratings Based approach would reduce the average Risk Weighting to approximately 35%. This AIRB calculation relies upon estimates of probability of default (“PD”) and loss-given default (“LGD”), based on historical performance, and factoring in loan-to-value estimates, FICO scores, vintage, and other loan-specific data.**

**In addition to “risk-based” capital requirements, Basel III also introduces a new global minimum 3% Tier 1 Leverage ratio. A key difference between this new leverage ratio and the previous bank leverage assessments is that the denominator takes into-account both on-balance sheet assets and off-balance sheet exposures. This is very important when comparing the GSEs to bank designated SIFIs, some of whom have large notional derivative exposures.**

**U.S. Basel III also requires a supplementary “enhanced” leverage ratio (eSLR) for U.S. G-SIBs, requiring a 2% buffer above the 3% supplementary leverage ratio (SLR) for a total of 5%. The numerator of the SLR consists of a bank’s Tier 1 Capital (defined as CET1 or Common Equity Tier 1, and AT1 or Additional Tier 1). The denominator is Total Leverage Exposure that consists of average on-balance sheet assets, derivatives potential future exposure, notional amount of off-balance sheet commitments, etc.**

**Bringing it all together, the minimum Tier 1 Capital requirements for SIFI-designated GSEs could range from ~3% to ~5%, as a percentage of total assets and guarantee notional (equivalent to 8.5% to 10.0% of Risk Weighted Assets). The range of potential requirements is dependent upon three major factors:**

- First, would Fannie and Freddie be subject to traditional Basel III bank capital requirements if designated as SIFIs, or would they also be designated as a G-SIB? At this point no non-banks have been designated G-SIBs. That said, were Fannie and Freddie designated as G-SIBs, and subject to the surcharge, this would increase their Tier 1 Capital



requirement from 8.5% (the SIFI requirement) to an estimated 10.0% (based upon a 1.5% estimated surcharge)..

- Second, would a Standardized or Advanced approach be used to determine the amount of risk-weighted assets (RWAs)? The assumption is that, given the sophistication of the GSEs' infrastructure, and the wealth of historical performance data, the GSEs would ultimately be granted permission to use the advanced approach (or a more nuanced version of the Standardized approach, which differentiates risk-weightings based upon loan characteristics).
- Third, would special rules be written for the GSEs as non-bank SIFIs? The expectation is that, similar to the implementation anticipated in relation to SIFI designated insurers, the application of capital standards to the GSEs would be tailored to the specific nature of their business.

## Estimated GSE Capital Requirements Summary

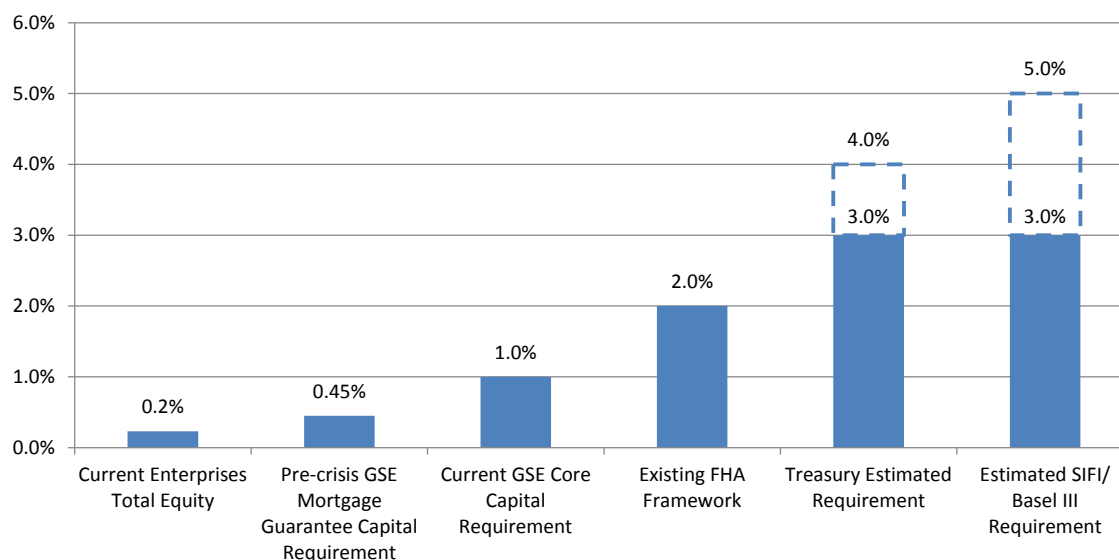
	Designation	RWA Approach	Tier 1 Requirement		Average Risk Weighting		Tier 1 Capital % of Total Assets
Risk-Based Capital Requirement	Basel III Bank	Standardized	8.5%	x	50%	=	4.25%
		Advanced	8.5%	x	35%	=	<3.0%
	G-SIB	Standardized	10.0%	x	50%	=	5.0%
		Advanced	10.0%	x	35%	=	3.5%
Leverage Ratio Requirement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

Source: BIS, Federal Reserve Bank, Rosner

As can be seen in the table above, minimum risk-based capital estimates range from just under 3% to approximately 5%. This range reflects the two alternative risk weighted asset approaches (i.e. IRB at ~35% versus Standardized at ~50%), and the two potential Tier 1 Capital Ratios (i.e. SIFI at 8.5% versus G-SIB at an estimated 10.0%). The leverage ratio requirements (SLR of 3.0% or eSLR 5.0%) serve as an additional constraint, but keep the expected total Tier 1 Capital Requirements in the 3% to 5% range.

**This 3% to 5% required capital estimate is consistent with the Treasury’s own estimates.** As stated in an Information Memorandum for Secretary Geithner prepared in January 2011 and approved by many of his then relevant key lieutenants for housing policy, “[T]he Administration will work with the FHFA and the Fed to establish improved capital requirements that reflect differential risk-weightings across LTV and risk profiles, consistent with Basel III. Based on current estimates, this would increase required capital to 300 – 400 bps. The pre-crisis GSEs were required to hold only 45 bps of capital against guaranteed mortgages.”<sup>140</sup>

## Estimated GSE Capital Requirements



**Source:** Company Filings, FHFA, FHA, BIS, [internal Treasury memorandum]  
**Note:** Figures as of Q2 2015

Based upon (1) the continued required reduction in the Investment portfolios, (2) moderate growth in the demand for mortgages, and (3) the run-off of the legacy vintages at estimated rates, the combined GSEs should have less than \$5 trillion in assets by 2020 (the year after the full implementation of US Basel III).

Based on the foregoing analysis of required capital levels, this \$5 trillion level of assets (which includes guarantee notional) would require less than \$200 billion of projected Tier 1 Capital. This is based upon an assumed 4% Tier 1 requirement (the mid-point of the SIFI/G-SIB range described above, and the high-end of Treasury’s own preliminary range). **Using all the tools available to FHFA to raise this capital – lock-boxing and retaining nearly \$20 billion of combined annual GSE earnings, writing off or converting into common equity any remaining preferred shares and raising fresh capital from the private markets, this could be realistically achieved in as few as 5 years.** (Other observers forecasting 10 or more years for the GSEs to reach required

*capital levels curiously only look at retained earnings. They neglect to consider fresh capital rises like those that brought the large banks back from the financial crisis. If the large banks were told in 2008 that they had to recapitalize solely through retained earnings they would still be in poor shape today.)*

**This analysis clearly demonstrates that designating the GSEs as SIFIs (or even the more punitive classification of a G-SIB) creates an acceptable way for regulators to determine the minimum capital requirements necessary to protect both taxpayers and the mortgage market. It also demonstrates that the size of the problem is manageable and is not too large or un-estimable to tackle as some commentators have implied.**

We would note that this analysis assumes a prescriptive application of Basel III bank capital requirements, which would likely be tailored to reflect the benefits of the GSEs' more stable business model (they are, at their core, insurance companies).

Finally, it should also be pointed out that the quality of mortgages being produced today in the post Dodd-Frank world (e.g., the Qualified Mortgage, etc.) is far superior to the mortgages that were being produced during the run-up to the financial crisis. This fact combined with the enhanced capital standards provided by a SIFI designation, enhanced regulatory scrutiny required of SIFIs, etc., will provide a much stronger framework for the GSEs going forward.

### **First Loss Transfer**

While legislators, regulators and the Administration all recognize the importance of transferring the first-loss risks borne by the agencies **the appropriate mechanisms for first-loss risk transfer been ineffective (PMI)**. Recognition of the needs to transfer first-losses is not new and, again, they were considered and largely ignored as part of the creation of the 1992 Act.

Currently, the leading political approach, offered by Senators Crapo, Johnson, Corker & Warner only offer illusory protections for the public. The first-loss approach provided in their legislative language allows this private first-loss to be waived in "adverse economic environments".<sup>141</sup> Simply, the approach offered through the leading approach is complex, convoluted and would, in fact, mean that as economic conditions deteriorated, market participants would pull liquidity from the market specifically to be relieved of their first loss requirements and transfer risks onto the public.

**Were the GSEs activities limited to the role of insuring and securitizing mortgage-backed securities they would effectively transfer interest-rate risks and the retained credit risk would be backed by appropriate levels of private capital.** The rightful purpose of capital at financial institutions is to absorb losses in regular and adverse

environments. Risk transfer techniques are used by banks and other financial institutions to raise capital and manage risk, but ultimately these companies have a stable base of permanent capital before resorting to these tools. Still, the GSEs have increasingly innovated new credit-risk-transfer securities to further reduce their exposures. As **Don Layton, CEO of Freddie Mac**, has stated:

*“It was assumed that private capital as first loss required legislation and that would be part of a future state and they discovered, “well, maybe we can do it while they’re still in conservatorship”... This is probably going to be a stair-step of five to seven years of developing tools that will evolve to put more and more risk, more thoroughly out into the private sector while we are in conservatorship. If there is no legislation for the next two or three years we will be substantively, my prediction, there i.e. the vast majority of risk will be going to the private sector through us. That will reduce taxpayer exposure while we are in conservatorship, which everyone thinks is a good thing.”<sup>142</sup>*

### **Affordable Housing Funding**

While we continue to have concerns about the longstanding use of private companies as a mechanism for the government to deliver off-balance-sheet subsidies we also recognize the political importance of this to a large number of legislators and to the President. We believe that any such subsidy should be crafted in a manner that prevents political influence from forcing the GSEs to increase their mortgage volumes by lowering of standards and taking on risks for which they are not adequately reserved. We recommend two mechanism exists that can provide such funding. Given that HERA prohibits the funding of the affordable housing funds, until such time that the GSEs are adequately capitalized, the conservator can suspend those payments to the affordable housing funds and enter into negotiations with the Administration to place the government’s warrants into the affordable housing fund. **As the companies build capital and thus improve the conditions of safety & soundness, the value of the warrants will increase. This approach would provide a significant amount of affordable mortgage funding in a manner that would reduce the future risks of GSEs while helping to insulate them from political pressures. This should not only be acceptable to the public but is consistent with a 2004 proposal by Peter Wallison of AEI.<sup>143</sup> Second, if the GSEs were regulated as utilities, with rate of return caps limiting their growth, there would be no ability for politicians to push them to lower their credit standards. Thus, the GSEs housing goals will allow them to serve as a direct support for affordable housing without the risks that they use the promise of further affordable housing as a means to generate support for lowering their lending standards.**

### **If FHFA Does its Job, Legislation Becomes Easier**

The steps we have outlined provide a clear path toward the restoration of the GSEs to their historical and intended role, increasing their ability to attract private capital and,

thus, reducing the amount of GSE-insured mortgages and the systemic risks they pose. They provide for the creation of a well-capitalized, well-functioning and countercyclical secondary mortgage market. HERA provides the FHFA with broad authorities to regulate the capital of the firms, recapitalize them, define their credit underwriting standards, regulate their retained portfolios, approve or prohibit new activities or products and, if the pricing of their g-fees would result in an unsafe or unsound condition require adjustments. As a result, fundamental reform, including regulating the enterprises as an effective natural monopoly, can be achieved through regulatory authorities - they do not require legislation.

As a result, in good times, borrowers would be able to access mortgage markets and large and small lenders would be able to compete on a level playing field. In bad times, both large and small lenders would be able to support the conforming-conventional consumer mortgage market.

Were the Administration to embrace these proposals it would provide both clarity and an important signal to borrowers, investors and interested public-policy groups throughout the government, the agency, the private mortgage markets and on 'Main Street'. It would also reduce the number of politically charged issues for Congress to address through legislation. Still, Congress could and should then act to ensure the ongoing and important functions of the "To Be Announced" (TBA) market, in which MBS are sold forward prior to the actual designation of the underlying securities.

#### **A Narrow Government Guarantee and the TBA Market**

It is generally believed that this market cannot be assured to function without some type of government guarantee.<sup>144</sup> While, prior to the crisis, the guarantee was implied, this approach supported excessive risk taking, reduced market discipline of both primary lenders and the GSEs and allowed the GSEs to operate without the levels of capital that private market investors would otherwise require. As a result, there should be some level of explicit government guarantee behind the GSEs. That explicit guarantee should be as small as possible and stand behind significant levels of capital appropriate to the risks of the securities they issue and the firms. It should only act as a catastrophic insurance policy behind these institutions, not to fund a future bailout, but to fund the resolution of a failing firm in the face of another 100-year flood.

That catastrophic government insurance guarantee should not be bestowed on the GSEs without the government being properly compensated. As a result we would suggest that legislators consider transforming the current Treasury lines of support to the GSEs to an explicit guarantee in support of the TBA market. Each GSE should pay an annual commitment fee for the explicit and narrow government insurance policy. To properly price the fee, Congress should direct the Financial Stability Oversight Council with determining that fee by reference to market rates for comparable financing and the risks

of drawing on that support. This approach would provide for a significantly narrowed guarantee than that suggested in Crapo Johnson or other legislative proposals.

Stringent capital standards, that incorporate security level requirements, real transfer of first loss and stringent capital standards for PMIs or other first loss holders, should give the public comfort that this government guarantee is unlikely to ever be employed. With capital determined on both the institutions and their guaranteed securities, this would be a backstop guarantee of the institutions so that, in crisis, they would still be able to access markets due to their strong equity capital positions. To further prevent either political interference or the failure of a primary regulator to prudently oversee the enterprises Congress should Direct FHFA and the FSOC to each provide quarterly reports to Congress detailing an assessment of the government's exposure to the risk of each GSE. Even without risky portfolios, with pricing of guarantee fees at rates comparable to private market execution, stringent capital standards and a limited and funded explicit government guarantee we continue to believe that, as private corporations, the GSEs must be regulated in a manner that aligns their public mission with an appropriate and stable equity investor base. As the GSEs leveraged their balance sheets to hypercharge their growth rates and, as a result executive compensation, their investor bases transitioned from those of stable, utility-like investors who were focused on dividends into those of earnings growth investors.

The political demands for the enterprises to meet increasingly large affordable housing goals supported a loosening of their underwriting standards and the neutering of their already weak safety and soundness regulator. To prevent a repeat of this capture and align the GSEs mission with an appropriate and stable investor base we would suggest that Congress re-regulate them as privately-owned public-utilities much like the state regulated electric, gas, sewer and water utilities.

#### **A Public Utility Model**

As we have previously highlighted, the GSEs are, through their core activities, natural monopolies, like other utilities. Nearly all of the distortions that emerged in their core guarantee business, prior to the crisis, did not result from competition with the primary market but rather from competition with each other in a manner that led to the mispricing of credit guarantees and the retention of excessive interest rate risk. **The creation of a common securitization platform (CSP)<sup>145</sup>, as is currently underway, will create incentives for each firm to drive down marginal costs in the secondary market while ensuring that the delivery of mortgage-backed securities, to markets, is effectuated in a manner that standardizes those products while eliminating the underpricing of risk that can occur in fully private firms who employ leverage and the creation of excess-liquidity, from capital markets, to support uneconomic behaviors.** Moreover, the costs and scale of this platform only further demonstrate the need for the GSEs to be treated as, and regulated as, utilities.



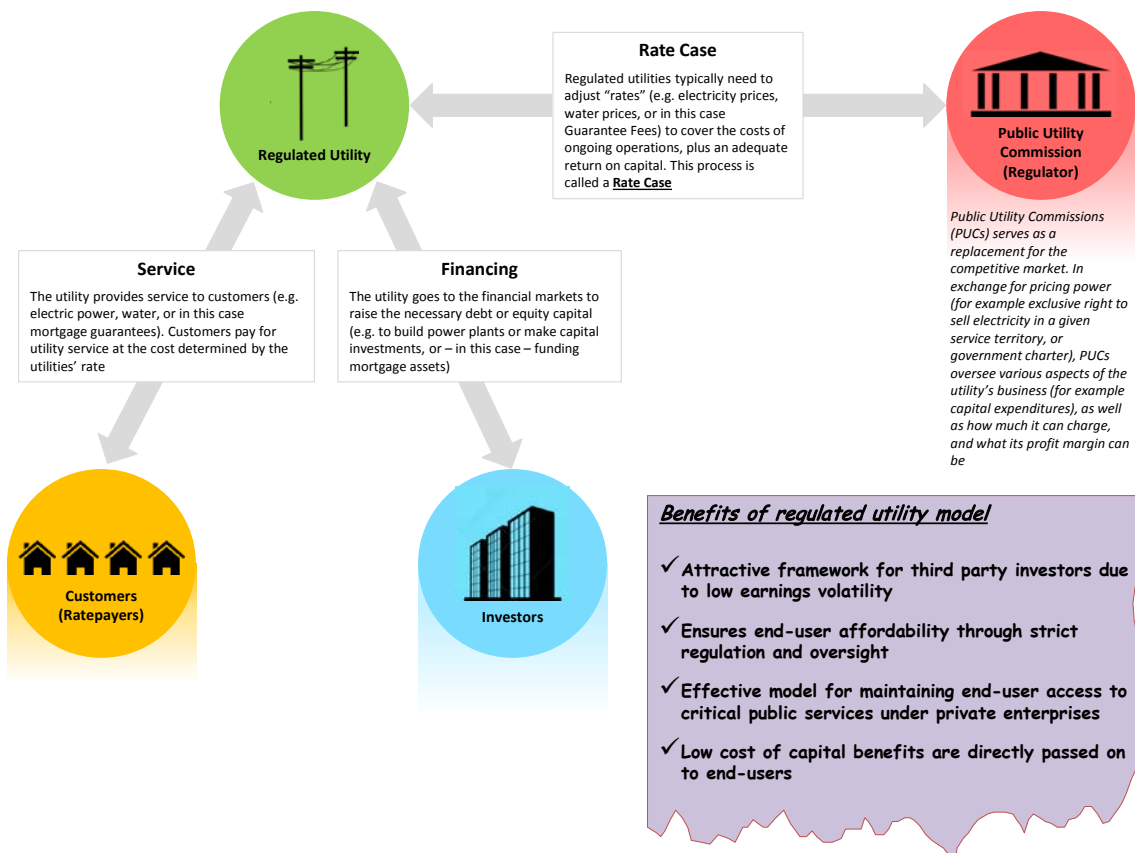
***“A public utility model offers one possibility for incorporating private ownership. In such a model, the GSE remains a corporation with shareholders but is overseen by a public board. Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return to shareholders”*** – Federal Reserve Chairman Ben Bernanke (October 31, 2008)

While private market competitors tend to focus strictly on revenue and income opportunities, utilities tend to think in terms of regulatory cost recovery and return on investment. *“The foundational premise underlying regulation is the need to limit earnings, usually by mandating a fair rate of return on invested capital. However, regulators are also in a position to enforce energy policy and shape the industry consistent with federal and state legislative goals. In many cases, concerns about the environment, reliability, national security, or other energy policies are more important than earnings or least-cost energy choices.”*<sup>146</sup> Clearly, the governmental goals of ensuring a stable and functional secondary mortgage market are more clearly aligned with this approach than with the approaches of primary mortgage market activities. After FHFA exercised its authorities to create such a de facto utility, it would be prudent for Congress to enshrine such a regulatory approach in legislation by transferring the current regulatory framework and oversight of the GSEs to a Public Utility Commission that would be responsible for determining the activities, cost recoveries, guarantee pricing and allowable rates of return of the enterprises.

**To ensure the stability of the secondary market Congress should empower the Commission to determine the allowable rate of return necessary to ensure the enterprises maintain a stable capital base.** Once an appropriate and allowable return on investment, for investors is met, the Utility Commission could direct the enterprises to build excess capital and, if the enterprises are capitalized above their highest historic loss experience, to fund a, affordable housing trust fund to be used only in adverse economic environments.

Legislation should require consultation and coordination between the FSOC and the PUC in overseeing the pricing of g-fees to consider the specific mortgage risks insured and the counterparty risks of the institutions whose loans are insured. Counterparty risk pricing should be based on a pass-fail, minimum threshold assessment that assumes that credit-losses due to violations of pooling and servicing agreements are fully recourse to originator. Firms’ that fail to meet this minimum threshold could be directed to offload first-loss risk to reduce the mortgage risks and access the GSEs.

## Illustrative Overview of Regulated Utilities



Source: Energy.gov, Duke Energy, Value Line

**With capped rates of return and rate cases determining cost-recoveries, the GSEs, like other utilities, would ensure the enterprises do not have deep pockets with which to lobby legislators. Preventing most of the chance of regulatory or legislative capture while ensuring the GSEs are able to provide their critical function in a counter-cyclical environment like other essential public services. Furthermore, it would reduce the systemic risks posed by primary market players as well as the GSEs.**

### Conclusion

As we have shown, there are several false memes that policy-makers should reject in considering the creation of a stable secondary market that works for borrowers as well as large and small mortgage lenders. It appears, in an effort to increase the rent-seeking behavior through a broad government guarantee and to secure the implied government guarantee of a newer generation of “too big to fail” banks and asset-managers, they have sought to replace a system that can be repaired with an overly complex and uncertain system that will disadvantage smaller competitors and increase costs to borrowers.

It is our belief that, just as occurred during the process of crafting the 1992 Act, and during the lead-up to the crisis, lobbying efforts have improperly captured, influenced and directed the approaches of legislators, regulators and executive branch policy makers. Moreover, it appears policymakers (with support of industry trade-groups and think tanks) have drained the GSEs of capital, and have gone as far as calculating the sweep of their profits on a quarterly rather than annual basis, to force them to again draw against Treasury. It is clear that the hope is that such an outcome would jumpstart their desired legislative and policy outcomes.

There is no economic model that supports the building of a new assembly plant to replace a car that has suffered body damage that is precisely the direction of secondary market reform and clearly the goal of the most influential primary market firms and the largest mortgage asset investors. We shouldn't reinvent a wheel that has driven the secondary market successfully for generations.

**Importantly, if the Obama Administration fails to act, using these existing authorities, it will likely lead to a future administration restructuring the secondary mortgage market in a manner that abandons any federal support of affordable housing or rental programs, dismantles a key tool of financial, household and economic stability that was crafted by President Roosevelt over 75-years ago. Furthermore, if recent legislative approaches become law it is clear that smaller community banks and lenders, who are necessarily closer to their customers, will see equal access to the secondary market diminish – and competition with it. Such capture of the secondary market will almost certainly lead the largest firms, over the next decade, to enter and capture the real-estate sales market claiming that, rather than reducing competition, vertical integration of that sector will reduce the costs to borrowers.**

Notes:

<sup>1</sup> Housing and Economic Recovery Act of 2008, Public Law 110–289—July 30, 2008, (See: ““(1) IN GENERAL.—Notwithstanding any other provision of Federal or State law, the Director may appoint the Agency as conservator or receiver for a regulated entity in the manner provided under paragraph (2) or (4). All references to the conservator or receiver under this section are references to the Agency acting as conservator or receiver. “(2) DISCRETIONARY APPOINTMENT.—The Agency may, at the discretion of the Director, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.”

<http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf>

<sup>2</sup> IBID (See: The Agency *may, at the discretion of the Director*, be appointed conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a regulated entity.”

<sup>3</sup> IBID

<sup>4</sup> Henry Paulson, *On the Brink*, iBook edition p54 (“The cooperation among federal agencies had generally been superb, but although Treasury, the Fed, and the Office of the Comptroller of the Currency (OCC) agreed, FHFA had been balky all along. That was a big problem because only FHFA had the statutory power to put Fannie and Freddie into conservatorship. We had to convince its people that this was the right thing to do, while making to let them feel they were still in charge”) and p38, (See: Foreword by Barney Frank: “In mid-2008, acting on a bill passed in the House in 2007, Congress gave the Treasury secretary the power to provide unlimited federal backstop funding and capital injections for Fannie Mae and Freddie Mac, and, if he felt it necessary, to place these institutions, which had previously fought increased federal controls, into conservatorship.”) and p42 (...Hank called me to tell me that the losses at Fannie Mae and Freddie Mac had grown so large that the two institutions could no longer function on their own but must be, he believed, be put into conservatorship to eliminate a grave threat to the stability of the capital markets and the economy...I told him that I thought he should go full speed ahead.”) and p50 (“We wanted to place Fannie and Freddie into conservatorship over the weekend and make sure that everything was wrapped up before the Asian markets opened on Sunday night.”)

<sup>5</sup> See HERA 1367

<sup>6</sup> Andrew G. Haldane, “Financial Arms Races,” Transcript of speech before the Institute for New Economic Thinking, April 14, 2012, available at:

<http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech565.pdf>

<sup>7</sup> Richard M. Salsman, “Altruism: The Moral Root of the Financial Crisis,” *The Objective Standard* Vol. 4. No. 1., spring 2009, available at:

<https://www.theobjectivestandard.com/issues/2009-spring/altruism-financial-crisis/> (See:

“According to Democrat presidential candidate Barack Obama, “we excused and even embraced an ethic of greed”; “we encouraged a winner-take-all, anything-goes environment”; and “instead of establishing a 21st century regulatory framework, we simply dismantled the old one.”<sup>1</sup> As a senator last fall, Obama decried as “an outrage” the need for a bailout plan “to rescue our

economy from the greed and irresponsibility of Wall Street” (and then promptly voted for it).<sup>2</sup> GOP presidential candidate John McCain said the financial crisis was caused by “greed, corruption, and excess,” as Wall Street “treated the American economy like a casino.”<sup>3</sup> With the *New York Times* in December, President Bush “shared his views of how the nation came to the brink of economic disaster,” citing “corporate greed and market excesses fueled by a flood of foreign cash,” concluding that “Wall Street got drunk.”<sup>4</sup> In his *New York Times* column, Paul Krugman, recipient of the Nobel Prize in economics in 2008, repeatedly blames the crisis on “deregulation” and free-market “dogmas.” Alan Greenspan—who for twenty years headed the Federal Reserve as Washington’s money monopolist and top bank regulator—told Congress last fall that “those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity, myself especially, are in a state of shocked disbelief,” agreed that it was a “flaw” in his ideology, and called for still more government regulation—which led many journalists to declare, with glee, that “Greenspan Admits Free Market Has Foundered.”<sup>5</sup>

<sup>8</sup> Barack Obama, “Renewing the American Economy,” transcript of speech at Cooper Union, March 27, 2008, available at: [http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?pagewanted=all&_r=0)

<sup>9</sup> Gretchen Morgenson and Joshua Rosner, “Reckless Endangerment,” New York, NY, 2011 (See: “Like Subprime 1.0 the Long Term Capital Management event proved to be an opportunity that was ignored by regulators charged with protecting consumers and investors from risky financial institutions and practices.”)

<sup>10</sup> Lewis S. Ranieri letter to the Department of Housing & Urban Development and Department of Treasury, July 21, 2010, available at:

<http://online.wsj.com/public/resources/documents/Ranieri0723.pdf> (See: “To be clear, the economic collapse is not because of the well-underwritten 30 year fixed rate mortgage; it is not because of the securitization process (that has effectively and appropriately spread and dispersed risk for decades); it is not because of the average, prudent home buying consumer; and it is not because of the average house or condominium on the typical city, suburban or rural street. Rather, this exercise has everything to do with what policy makers need to do because of the abuses to our housing finance system -a system that up to as little as eight years ago was a solid, dependable, predictable system of housing finance - and one that was the envy of the world.”)

<sup>11</sup> S. 1217, “Housing Finance Reform and Taxpayer Protection Act of 2013,” 113<sup>th</sup> Congress (2013-2014), available at: [http://www.corker.senate.gov/public/\\_cache/files/1bc94e87-5a8a-4f07-a709-30bb19f15873/06-25-13%20BILL%20TEXT.%20Housing%20Finance%20Reform%20&%20Taxpayer%20Protection%20Act%20.pdf](http://www.corker.senate.gov/public/_cache/files/1bc94e87-5a8a-4f07-a709-30bb19f15873/06-25-13%20BILL%20TEXT.%20Housing%20Finance%20Reform%20&%20Taxpayer%20Protection%20Act%20.pdf)

<sup>12</sup> United States Senate Banking Committee, “Summary of Senate Banking Committee Leaders’ Bipartisan Housing Finance Reform Draft,” available at: [http://www.banking.senate.gov/public/\\_files/SummaryoftheBipartisanHousingFinanceReformDraft\\_update.pdf](http://www.banking.senate.gov/public/_files/SummaryoftheBipartisanHousingFinanceReformDraft_update.pdf)

<sup>13</sup> H.R. 2767, “Protecting American Taxpayers and Homeowners Act of 2013,” 113<sup>th</sup> Congress (2013-2014), available at: <https://www.congress.gov/113/bills/hr2767/BILLS-113hr2767ih.pdf>

<sup>14</sup> United States Senate Banking Committee, “Summary of the Financial Regulatory Improvement Act of 2015,” available at:

[http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=854449cf-73b4-4ac1-9420-da098557cf4d](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=854449cf-73b4-4ac1-9420-da098557cf4d)

<sup>15</sup> David A. Bridewell, Horace Russell and The United States Federal Home Loan Bank Board, “The Federal Home Loan Bank Board and its Agencies: A History of the Facts Surrounding the Passage of the Creating Legislation, The Establishment and Organization of the Federal Home Loan Bank Board and the Bank System, The Savings and Loan System, The Home Owners’ Loan Corporation, and the Federal Savings and Loan Insurance Corporation,” Washington, D.C., 1938

<sup>16</sup> Richard K. Green and Susan M. Wachter, “The American Mortgage in Historical and International Context,” September 21, 2005, available at:

[http://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=penniur\\_papers](http://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=penniur_papers)

<sup>17</sup> George W. Alger letter to New York Governor Herbert H. Lehman, February 26, 1935, available at: [http://www.aei.org/wp-content/uploads/2012/05/-alger-commission-](http://www.aei.org/wp-content/uploads/2012/05/-alger-commission-report_13595669733.pdf)

[report\\_13595669733.pdf](http://www.aei.org/wp-content/uploads/2012/05/-alger-commission-report_13595669733.pdf)

<sup>18</sup> Richard K. Green and Susan M. Wachter, “The American Mortgage in Historical and International Context,” September 21, 2005, available at:

[http://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=penniur\\_papers](http://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=penniur_papers) (See:

“Thus, the invention of the fixed-rate, self-amortizing, long-term mortgage was, above all else, a response to a general financial crisis, as opposed to a design for the promotion of homeownership per se. FHA adopted this form of mortgage to avoid the problem of people needing to refinance, which had clearly led to disaster.”)

<sup>19</sup> Federal Housing Finance Agency Office of Inspector General, “A Brief History of the Housing Government-Sponsored Enterprises,” available at:

<https://origin.www.fhfaog.gov/LearnMore/History#Anchor48>



TIMELINE	
<b>1930s</b>	
1932	Federal Home Loan Bank Act is passed, creating the FHLBank System
1933	Home Owners' Loan Act is passed, creating the Home Owners' Loan Corporation
1934	National Housing Act enacted, establishing the Federal Housing Administration
1938	Fannie Mae established
<b>1940s</b>	
1944	GI bill authorizes VA mortgage loans and Fannie Mae's purchases of such mortgages
<b>1950s</b>	
1964	Charter Act reorganizes Fannie Mae
<b>1960s</b>	
1968	Fannie Mae reorganized as publicly-traded, shareholder-owned company
1968	Housing and Urban Development Act of 1968 created the Government National Mortgage Association ("Ginnie Mae")
<b>1970s</b>	
1970	Freddie Mac created
1971	Freddie Mac offers its first conventional Mortgage-Backed Security
<b>1970s and early 1980s</b>	
Fannie Mae and Freddie Mac pursue differing business strategies: Fannie Mae holds mortgages in portfolio, while Freddie Mac securitizes them	
<b>1980s</b>	
<b>Early 1980s</b>	
Fannie Mae suffers financial deterioration due to rising interest rates, while Freddie Mac's losses are limited due to securitization strategy	
1989	Financial Institutions Reform, Recovery, and Enforcement Act ("FIRREA") is passed to address the savings and loan crisis
1989	Freddie Mac becomes a publicly-traded, shareholder-owned company
<b>1990s</b>	
1992	Federal Housing Enterprises Financial Safety and Soundness Act enacted, creating the Office of Federal Housing Enterprise Oversight
1996	HUD establishes new goals for Fannie Mae and Freddie Mac, requiring them to meet an "affirmative obligation to facilitate the financing of affordable housing for low-income and moderate-income families"
<b>2000s</b>	
2000s	Fannie Mae and Freddie Mac began purchasing Alt-A and subprime mortgages
2006	Housing prices begin to fall nationwide for the first time since the 1930's
2008	Housing and Economic Recovery Act enacted, creating FHFA and FHFA-OIG
2008	Fannie Mae and Freddie Mac enter FHFA-supervised conservatorships

<sup>20</sup> Federal Housing Finance Agency, Office of Inspector General, "A Brief History of the Housing Government-Sponsored Enterprises," available at:

<https://origin.www.fhfa.ig.gov/LearnMore/History#Anchor48>

(See: "The inflation and recessions of the late 1970s and early 1980s and the sharp rises in interest rates that accompanied them put tremendous financial strain on Fannie Mae and many thrifts, which funded their mortgage holdings principally with short term obligations such as deposits. By contrast, Freddie Mac's financial performance was relatively unaffected because of its emphasis on issuing MBS...")

<sup>21</sup> Thomas H. Stanton, "Review: Increasing the Accountability of Government-Sponsored Enterprises: First Steps," September/October 1990, available at: <http://www.thomas->

[stanton.com/pubs/gse/GSE-](http://stanton.com/pubs/gse/GSE-)

[Increasing Accountability of Govt Sponsored Enterprises First Steps.pdf](#)

<sup>22</sup> Gretchen Morgenson and Joshua Rosner, “Reckless Endangerment,” New York, NY, 2011

<sup>23</sup> James A. Johnson, “Showing America a New Way Home: Expanding Opportunities for Home Ownership,” September 1996

<sup>24</sup> Department of the United States Treasury, “Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April 1991, available at:

[http://archive.org/stream/reportofsecretar04unit/reportofsecretar04unit\\_djvu.txt](http://archive.org/stream/reportofsecretar04unit/reportofsecretar04unit_djvu.txt)

<sup>25</sup> <sup>25</sup> Thomas H. Stanton, “Review: Increasing the Accountability of Government-Sponsored Enterprises: First Steps,” September/October 1990, available at: [http://www.thomas-](http://www.thomas-stanton.com/pubs/gse/GSE-)

[stanton.com/pubs/gse/GSE-](#)

[Increasing Accountability of Govt Sponsored Enterprises First Steps.pdf](#) (See: “As was the case for thrift institutions, recommendations for enhanced accountability of GSEs emphasize the need for effective federal oversight and increased capitalization. The politics of the thrift industry’s legislative efforts are also instructive. As were the thrifts in the 1980s, government sponsored enterprises today are powerful and resistant to change. Especially some GSEs that would find it difficult or expensive to comply with the Treasury’s recommendations may try to hamper passage of implementing legislation. Fannie Mae and Freddie Mac are two of the largest financial institutions in the United States, larger than the nation’s largest banks and bank holding companies, and they have concomitant political strength as well. Fannie Mae and the FCS Farm Credit Council each have political action committees.”)

<sup>26</sup> Todd Zywicki, “Regulatory Decadence and Dodd-Frank,” *Library of Law and Liberty*, December 16, 2012, available at: <http://www.libertylawsite.org/book-review/regulatory-decadence-and-dodd-frank/> (See: “By solidifying the “special” status of the largest banks Dodd-Frank has entrenched and expanded the “Fannie Mae” effect—the implicit government guarantee for these institutions will allow creditors to lend to them with lower risk, thereby reducing the cost of acquiring capital for these institutions. In turn, this cost advantage will enable them to out-compete their smaller rivals, promoting a consolidation of the banking industry—making them still-larger and more important. Moreover, when combined with Dodd-Frank’s general thrust of entrenching regulatory discretion it will increase the influence of backroom dealing between these banks and their regulators, enabling them to evade many of Dodd-Frank’s regulations. In turn, this heightened discretion provides a vehicle for the government to use its regulatory power to extract political promises out of these banks, using the Chrysler case as a prototype. Moreover, Skeel notes that Dodd-Frank transfers huge amounts of power from bipartisan regulatory agencies (such as the SEC and Federal Reserve) to the Secretary of Treasury, putting these decisions much closer to the vortex of political power. The end result will likely be crony capitalism at its worst, as the government props up and subsidizes the largest banks while at the same time using them to pursue its political purposes outside of the democratic process.”)

<sup>27</sup> The Conservatorships of Fannie Mae and Freddie Mac: Actions Violate HERA and Established Insolvency Principles, Michael Krimminger and Mark A. Calabria, Cato Institute Working Paper no. 26, February 9, 2015, available at:

[http://object.cato.org/sites/cato.org/files/pubs/pdf/working-paper-26\\_1.pdf](http://object.cato.org/sites/cato.org/files/pubs/pdf/working-paper-26_1.pdf)

<sup>28</sup> Thomas H. Stanton, “Review: Increasing the Accountability of Government-Sponsored Enterprises: First Steps,” September/October 1990, available at: [http://www.thomas-](http://www.thomas-stanton.com/pubs/gse/GSE-)

[stanton.com/pubs/gse/GSE-](#)

Increasing Accountability of Govt Sponsored Enterprises First Steps.pdf (See: “1. Each GSE should be adequately capitalized, meet high credit and operational standards, and be subject to effective government supervision; 2. A private market mechanism should be used to evaluate GSE risk; each GSE should obtain a rating equivalent to triple-A, absent any implicit government guarantee, from at least two of the nationally recognized credit rating agencies; 3. GSEs should be supervised for financial safety and soundness by a regulator different from the program regulators; in other words, a financial regulator such as the Federal Reserve, Federal Deposit Insurance Corporation, or the Treasury itself should supervise safety and soundness of the GSEs while agencies such as HUD remain responsible for overseeing the programmatic activities of GSEs such as Fannie Mae and Freddie Mac; and 4. Each GSE should disclose annually the value of the federal government's credit support; this should be measured as the difference between (1) the cost of funds of the GSE and (2) the cost of funds of a corporation that has the credit rating that the GSE has obtained (again, without regard to the government's implicit guarantee).”

<sup>29</sup> Thomas H. Stanton, “Review: Increasing the Accountability of Government-Sponsored Enterprises: First Steps,” September/October 1990, available at: <http://www.thomas-stanton.com/pubs/gse/GSE->

Increasing Accountability of Govt Sponsored Enterprises First Steps.pdf (See: “In testimony, Assistant Comptroller General Richard L. Fogel largely concurred with the Treasury Department's position. However, the General Accounting Office appears more comfortable applying bank-type capital and regulatory requirements than relying upon the rating of private rating agencies to set capitalization levels. If the Treasury's recommendations were adopted and private rating agencies were used, then Fogel recommended that the federal GSE financial regulator examine closely the assumptions used by each rating agency and the appropriateness of the final capital standard.”)

<sup>30</sup> John C. Weicher, “Setting GSE Policy Through Charters, Laws, and Regulations,” Chapter 7 of “Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac,” compiled by the American Enterprise Institute, 2001, available at: [http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations\\_141142699232.pdf](http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations_141142699232.pdf)[http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations\\_141142699232.pdf](http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations_141142699232.pdf) (See: “The 1992 legislation also modified the language concerning public purpose. It changed *home* to *residential* and rewrote the parenthetical language as “(including activities related to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities).” It also added a new purpose: to “promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas).” These changes in the charter acts appear to be reinforcing the housing goals legislation by telling the GSEs to reach further down in the income distribution.”)

<sup>31</sup> John C. Weicher, “Setting GSE Policy Through Charters, Laws, and Regulations,” Chapter 7 of “Serving Two Masters, Yet Out of Control: Fannie Mae and Freddie Mac,” compiled by the American Enterprise Institute, 2001, available at: [http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations\\_141142699232.pdf](http://www.aei.org/wp-content/uploads/2014/08/-setting-gse-policy-through-charters-laws-and-regulations_141142699232.pdf)

<sup>32</sup> Bingham McCutchen Memorandum For the Record, “Meeting with Tom Lund, former EVP of Fannie Mae Single Family Business,” March 4, 2010, available at: [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/2010-03-04%20FCIC%20memo%20of%20staff%20interview%20with%20Thomas%20Lund,%20Fannie](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-03-04%20FCIC%20memo%20of%20staff%20interview%20with%20Thomas%20Lund,%20Fannie)

[%20Mae.pdf](#) (See: “The housing goals were raised in 2000 and again, substantially, in 2004, and Fannie Mae received pressure from the administration to expand its business beyond the traditional 15- and 30-year fixed-rate mortgages that were previously the core of the Company’s business. Mr. Lund outlined several business practices that Fannie Mae began in 2004 to respond to increasing governmental pressure to meet housing goals. Housing goals were raised by 4% across the various categories in 2004. He stated, “We did a lot of things ex-housing goals that we wouldn’t have done otherwise.” Some examples of these practices include: o “DU bump” – borrowers were given a bump if they met certain housing goal requirements (e.g., low income borrowers). For example, a loan is sent through Fannie Mae’s desktop underwriter and assigned a risk level of 3 which is higher than Fannie Mae’s risk level of 2. If the borrower met a housing goal, then the risk level would be “bumped” up to 2, and the loan would be priced as such by Fannie Mae. o Reduced equity requirements for homebuyers. o Fannie Mae bought bulk loans that contained housing goal loans. ”)

<sup>33</sup> Gretchen Morgenson and Joshua Rosner, “Reckless Endangerment,” New York, NY, 2011 (See: “The administration had proposed an increase in OFHEO’s budget to support a larger investigations and examination staff at the regulator, but [Senator Kit] Bond slipped language into the appropriations bill that would defund OFHEO until Falcon was removed from its directorship”)

<sup>34</sup> Nela Richardson, “The Quiet Shift in Housing Policy,” *Forbes*, January 21, 2015, available at: <http://www.forbes.com/sites/redfin/2015/01/21/the-quiet-shift-in-housing-policy/> (See: “The Clinton and Bush administrations shared a vision of housing as increasing the economic security of the middle class. No policy benefited more from that shared vision than the Affordable Housing Goals created in the final year of President George H.W. Bush’s administration and extended under Clinton and George W. Bush. Those goals require that a certain percentage of purchases by mortgage behemoths Freddie Mac and Fannie Mae be directed at low-income homebuyers.”)

<sup>35</sup> Executive Office of the President, “RE: Thursday Meeting on Urban issues,” August 1, 1994, available at <http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/rascomeetings/Box%20058/005%20647140-urban-meeting-bob-rubins-office-5-august-1994-2-00-3-00-pm.pdf> (See e.g. “Use tools of HUD, FHA, Fannie and Freddie to provide low- and no-downpayment loans to eligible low- and moderate-income purchasers”)

<sup>36</sup> Private MI Today, Not Someday, MICA Membership Directory, 2000-2001 Fact Book, Washington, DC: Mortgage Insurance Companies of America

<sup>37</sup> Keynes p.vii (See: “Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. ”)

<sup>38</sup> The White House, Memorandum for the Vice President, “Community Empowerment: Resources and Strategy”, October 5, 1993, p. 1, available at: <http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/105/647386-community-empowerment.pdf>

<sup>39</sup>**The National Homeownership Strategy: Partners in the American Dream, U.S. Department of Housing and Urban Development, The White House Washington, May 2, 1995** available at: <https://confoundedinterest.files.wordpress.com/2013/01/nhsdream2.pdf> (See: The following is a list of the National Partners in Homeownership as of June 1, 1995. **The National Homeownership Strategy: Partners in the American Dream** American Bankers Association American Institute of Architects American Land Title Association American Planning Association America's Community Bankers Appraisal Institute Association of Community Organizations for Reform Now (ACORN) Association of Local Housing Finance Agencies Center for Neighborhood Technology Community Development Financial Institutions Fund Corporation for National Service Council of American Building Officials Council of State Community Development Agencies The Enterprise Foundation Fannie Mae Federal Home Loan Bank System Freddie Mac Habitat for Humanity International Housing Assistance Council Local Initiatives Support Corporation (LISC) Manufactured Housing Institute Mortgage Bankers Association of America Mortgage Insurance Companies of America National American Indian Housing Council National Association for the Advancement of Colored People (NAACP) National Association of Affordable Housing Lenders National Association of Counties National Association of County Community and Economic Development National Association of Home Builders National Association of Real Estate Brokers National Association of Realtors National Bankers Association National Community Development Association National Community Reinvestment Coalition National Conference of States on Building Code Standards National Congress of Community Economic Development National Cooperative Bank National Council of La Raza National Council of State Housing Agencies National Hispanic Housing Council



National Low Income Housing Coalition  
National Trust for Historic Preservation  
National Urban League  
Neighborhood Reinvestment Corporation  
Resolution Trust Corporation  
Social Compact United Homeowners Association United States Conference of Mayors  
U.S. Department of Agriculture  
U.S. Department of Housing and Urban Development U.S. Department of Veteran Affairs

<sup>40</sup> Memorandum for Chris Edley and Steve Redburn, "Housing Policy," Paul Dimond CC: Galston, Reed, Weinstein, Cashin, Seidman, Sterling, Cuomo, Katz, Retsinas, Stegman, May 31, 1994, available at:  
<http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20114/647386-housing-ideas.pdf>

<sup>41</sup> United States Department of Housing and Urban Development, "National Homeownership Strategy," August 1995, available at: <http://www.huduser.org/publications/txt/hdbrf2.txt>

<sup>42</sup> Robert Rubin, Secretary of the Treasury, Department of the Treasury, Memorandum for Gene Sperling, Director of the National Economic Council, "Meeting on tax Cut Options," December 2, 1998, available at:  
<http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box%20126/647386-taxes.pdf>

<sup>43</sup> [http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/2010-03-04%20FCIC%20memo%20of%20staff%20interview%20with%20Thomas%20Lund,%20Fannie%20Mae.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2010-03-04%20FCIC%20memo%20of%20staff%20interview%20with%20Thomas%20Lund,%20Fannie%20Mae.pdf)

<sup>44</sup> Robert Rubin, Secretary of the Treasury, Department of the Treasury, Memorandum for Gene Sperling, Director of the National Economic Council, "Meeting on tax Cut Options," December 2, 1998, available at:  
<http://www.clintonlibrary.gov/assets/DigitalLibrary/BruceReed/Subject/Box-126/647386-taxes.pdf>

<sup>45</sup> White House, "Race Report Meeting," January 20, 1999, available at:  
<http://www.clintonlibrary.gov/assets/storage/Research%20-%20Digital%20Library/Reed-Subject/124/647386-race-book-1.pdf> (See: "Recommendation," Launch a major refocusing of the large housing-related GSEs – FNMA, Freddie Mac and the Federal Home Loan Bank Board System... in general, GSEs commonly assert that they are "private" and cannot be expected to make uneconomic investments. But their profitability is fueled by their access to "cheap" money via a government debt guarantee or a discount Fed window... Specifically, the President should propose to: First, adopt new regulatory and statutory provisions to (a) press the GSEs to focus more of their housing activity on severely distressed communities. And (b) give the GSEs more effective tools to promote targeted lending for community development purposes.")

<sup>46</sup> United States Department of Housing and Urban Development, "The National Homeownership Strategy: Partners in the American Dream," March 10, 2011, available at:  
<https://web.archive.org/web/20010106230700/http://www.huduser.org/publications/affhsg/homeown/chap4.html>



<sup>47</sup> Joshua Rosner, “Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt,” June 29, 2001, available at: <http://ssrn.com/abstract=1162456> or <http://dx.doi.org/10.2139/ssrn.1162456>

<sup>48</sup> E.g. - In 1999, the Congress enacted the “First-time Homebuyer Affordability Act of 1999”. The premise of the Act is that “it is desirable to make funds available from individual retirement plans to encourage first-time homeownership”. This legislation reduces the difficulty a potential buyer may have in financing a down payment, but with risks. In the event of a decline in real estate values or in the event of a foreclosure, some or that borrower’s entire retirement asset may be lost. Also, in 2000, Congress enacted “The American Homeownership and Economic Opportunity Act of 2000”. Title I of the Act is termed “REMOVAL OF BARRIERS TO HOUSING AFFORDABILITY”. Among the bill’s provisions is one that allows families receiving federal rental assistance to accumulate up to a year’s worth of that assistance toward the down payment, appraisal and closing costs of a home. President George W. Bush, based on public comments, seems to have agreed with the previous administration that low-income families should be allowed to apply rental vouchers toward down payments.

<sup>49</sup> Roger E. Niesen, “Audit Report: Family Production Home Ownership Centers,” US Housing and Urban Development, March 30, 2000, available at: <http://archives.hud.gov/offices/oig/reports/internal/ig090001.pdf> (See: HUD’s 1999/2000 internal audit of single family FHA loan production found that 56% of defaulted loans in their study had significant underwriting deficiencies that were not detected by HUD or the contractor. Those deficiencies included fraud, excessive ratios, source or adequacy of funds issues, improper income analysis and/or debt or credit issues.)

<sup>50</sup> Joshua Rosner, “Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt,” June 29, 2001, available at: <http://ssrn.com/abstract=1162456> or <http://dx.doi.org/10.2139/ssrn.1162456>

<sup>51</sup> Fitch Ratings, “Basel II: Refinements to the Framework,” Fitch Ratings Credit Policy Special Report, February 6, 2003, available at: <https://www.bis.org/bcbs/qis/resp3fitch.pdf>

<sup>52</sup> Theresa R. DeVenti, “Fannie Mae and Freddie Mac: Past, Present, and Future,” United States Department of Housing and Urban Development Policy Briefs, Volume 11, November 2, 2009, <http://www.huduser.org/periodicals/cityscpe/vol11num3/ch11.pdf>

<sup>53</sup> Joseph R. Mason and Joshua Rosner, “Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions,” May 3, 2007, available at: <http://ssrn.com/abstract=1027475> or <http://dx.doi.org/10.2139/ssrn.1027475>

<sup>54</sup> Joshua Rosner, “Financial Services Exposures to Subprime, Why we are not ‘Seeing Red,’” Graham Fisher, July 26, 2007, available at: <https://www.scribd.com/doc/254761536/Weekly-July-27-2007-Financial-Services-Exposures-to-Subprime-Why-we-are-not-Seeing-Red>

<sup>55</sup> Joshua Rosner, “How long will investor holding on for returns and when will primary residential purchases drive sales?,” data from the National Association of Realtors, October 18,

2012, available at: <http://www.scribd.com/doc/110442571/October-2012-Housing-Draft>

	Primary Residence	Vacation Hom	Investment Property
2003	67	12	22
2004	64	11	25
2005	60	12	28
2006	64	14	22
2007	67	12	21
2008	70	9	21
2009	73	10	17
2010	73	10	17
2011	62	11	27

<sup>56</sup> Don Layton, Milken See: 34:32

<sup>57</sup> Joshua Rosner, "Financial Services Exposures to Subprime, Why we are not 'Seeing Red,'" Graham Fisher, July 26, 2007, available at: <https://www.scribd.com/doc/254761536/Weekly-July-27-2007-Financial-Services-Exposures-to-Subprime-Why-we-are-not-Seeing-Red>

<sup>58</sup> The Office of the Secretary of the United States Department of the Treasury letter to the Chairman of the Committee on Banking, Housing and Urban Affairs, Richard C. Shelby, March 20, 2004, available at: <http://www.treasury.gov/press-center/press-releases/Documents/js1281.pdf>

<sup>59</sup> Chairman Alan Greenspan, "Regulatory reform of the government-sponsored enterprises," presented before the United States Senate Committee on Banking, Housing and Urban Affairs, April 6, 2005, available at: <http://www.federalreserve.gov/boarddocs/testimony/2005/20050406/default.htm> (See: The ability of the GSEs to borrow essentially without limit has been exploited only in recent years. At the end of 1990, for example, Fannie's and Freddie's combined portfolios amounted to \$132 billion, or 5.6 percent of the single-family home-mortgage market. By 2003, the GSEs' portfolios had grown tenfold, to \$1.38 trillion or 23 percent of the home-mortgage market. The almost unlimited low-credit-risk profit potential from exploiting subsidized debt has been available to the GSEs for decades. The management of Fannie and Freddie, however, chose to abstain from making profit-centers out of their portfolios in earlier years, and only during the mid-1990s did they begin rapidly enlarging their portfolios.)

<sup>60</sup> Joseph R. Mason and Joshua Rosner, "Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions," May 3, 2007, available at: <http://ssrn.com/abstract=1027475> or <http://dx.doi.org/10.2139/ssrn.1027475>

<sup>61</sup> American Securitization Forum, "ASF Project RESTART: ASF Model RMBS Representations and Warrants, December 15, 2009, available at:

[http://www.americansecuritization.com/uploadedFiles/ASF\\_Project\\_RESTART\\_Reps\\_and\\_Warrants\\_121509.pdf](http://www.americansecuritization.com/uploadedFiles/ASF_Project_RESTART_Reps_and_Warrants_121509.pdf) (See: "On July 16, 2008, the American Securitization Forum ("ASF") announced the public launch of ASF's Project on Residential Securitization Transparency and Reporting ("ASF Project RESTART" or the "Project"), which is a broad-based industry-developed initiative to help rebuild investor confidence in mortgage and asset-backed securities, restore capital flows to the securitization markets, enhance market lending discipline and, ultimately, increase the availability of affordable credit to all Americans. It has been recognized by senior policymakers and market participants as a necessary industry initiative to improve the securitization process by developing commonly accepted and detailed standards for transparency,

disclosure and diligence that each appropriate market participant will be recommended to implement.”)

<sup>62</sup> Stephen Labaton, “New Agency Proposed to Oversee Freddie Mac and Fannie Mae” *New York Times*, September 11, 2004, available at: <http://www.nytimes.com/2003/09/11/business/new-agency-proposed-to-oversee-freddie-mac-and-fannie-mae.html> (See: “The Bush administration today recommended the most significant regulatory overhaul in the housing finance industry since the savings and loan crisis a decade ago... The new agency would have the authority, which now rests with Congress, to set one of the two capital-reserve requirements for the companies. It would exercise authority over any new lines of business. And it would determine whether the two are adequately managing the risks of their ballooning portfolios.”)

<sup>63</sup> “Homesick blues,” *The Economist*, April 13, 2000, available at:

<http://www.economist.com/node/302764> (See: “This week a Republican congressman, Richard Baker, was fretting about the growing risk of these agencies. He argued that they might eventually land the taxpayer with a bill that dwarfs the savings-and-loan mess of a decade ago. The agencies have been increasing their lending at a 20% annual rate in the past couple of years, as, to rather less attention, has the Federal Home Loan system. The federal mortgage agencies already have combined debts of \$1.4 trillion. On current trends, by 2003 they will be bearing some of the risk on half of America's residential mortgages, up from one-third in 1995.”) and “Freddie Mac, Fannie Mae May Face Rival Bills in U.S. Congress,” Bloomberg, July 8, 2003, available at: [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCsCZExf0\\_0c](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aCsCZExf0_0c) (See: “Representative Ed Royce, a California Republican, plans to introduce a bill this week to create a new regulator for the government-chartered companies, Royce spokeswoman Julianne Lignelli said. Fellow Republican Representative Richard Baker introduced a separate bill in late June, after Freddie Mac ousted its three top executives amid an earnings restatement.”)

<sup>64</sup> Stephen Labaton, “New Agency Proposed to Oversee Freddie Mac and Fannie Mae” *New York Times*, September 11, 2004, available at: <http://www.nytimes.com/2003/09/11/business/new-agency-proposed-to-oversee-freddie-mac-and-fannie-mae.html> (See: “After the hearing, Representative Michael G. Oxley, chairman of the Financial Services Committee, and Senator Richard Shelby, chairman of the Senate Banking Committee, announced their intention to draft legislation based on the administration's proposal. Industry executives said Congress could complete action on legislation before leaving for recess in the fall.”)

<sup>65</sup> Congressional Budget Office “Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market,” Congressional Budget Office Report, Pub. No. 4021, December 2010, available at: <http://www.cbo.gov/sites/default/files/12-23-fanniefreddie.pdf> (See: “Initially, Fannie Mae and Freddie Mac pursued different strategies with regard to creating mortgage-backed securities. Although the 1968 Charter Act gave Fannie Mae the power to securitize loans, the GSE was slow to adopt that practice, preferring to buy mortgages to hold in its portfolio. In the late 1970s and early 1980s, Fannie Mae suffered a series of deeply unprofitable years that put its viability in doubt. Much like the savings and loan industry, it had financed its mortgage investments by issuing shorter-term debt, seeking to take advantage of lower short-term interest rates. That strategy exposed Fannie Mae to interest rate risk—when interest rates rose, its borrowing costs increased commensurately, while its income from existing mortgages remained fixed... Freddie Mac, in contrast, initially adopted Ginnie Mae’s approach and concentrated on securitizing conforming mortgages rather than assembling a large portfolio... Freddie Mac, conversely, steadily increased its holdings of mortgages in the early 1990s. (Until the recent financial crisis, portfolio holdings were generally much more profitable for the GSEs than their

guarantee business because those holdings took advantage of the lower borrowing costs that the GSEs enjoyed as a result of the implicit federal guarantee.) By 2001, the operations of the two GSEs looked virtually the same”)

<sup>66</sup> Richard Scott Carnell, “Handling the Failure of a Government-Sponsored Enterprise,” Fordham University School of Law, 2005, available at:

[http://msfraud.org/LAW/Legislative/Failure\\_of\\_GSE.pdf](http://msfraud.org/LAW/Legislative/Failure_of_GSE.pdf)

<sup>67</sup> “Oxley, Baker Look to Tweak GSE Bill in Hurricane's Wake,” September 12, 2005, available at: “<http://www.appraisalinstitute.org/OxleyBakerLooktoTweakGSEBillinHurricanesWake/>

<sup>68</sup> Department of the United States Treasury, “Report of the Secretary of the Treasury on Government-Sponsored Enterprises, April 1991, available at:

[http://archive.org/stream/reportofsecretar04unit/reportofsecretar04unit\\_djvu.txt](http://archive.org/stream/reportofsecretar04unit/reportofsecretar04unit_djvu.txt)

(See: “GSE financial difficulties would not develop overnight, and effective financial regulation should preclude the need to focus on receivership as a regulatory alternative. Nevertheless, given the significance to the economy of a financial failure of the magnitude that a GSE failure would represent, the ability to appoint a conservator may be appropriate. If any of the GSEs were to approach insolvency, Congress might act to avert a GSE failure because of the significant economic impact involved and the implication for domestic social policy. However, such future developments cannot be foreseen. While it is extremely unlikely that conservatorship power would ever be used, it would be prudent for a regulator to have this power in order to manage a fast-moving disaster with both domestic and international economic implications.”)

<sup>69</sup> PBS NewsHour, High-risk Mortgage Foreclosures Likely to Rise

March 12, 2007 at 6:35 PM EDT [http://www.pbs.org/newshour/bb/business-jan-june07-loans\\_03-12/](http://www.pbs.org/newshour/bb/business-jan-june07-loans_03-12/)

<sup>70</sup> Press Release, “Assistant Secretary David G. Nason Testimony on Reforming GSE Regulation Before the Senate Committee on Banking, Housing and Urban Affairs,” United States Department of the Treasury, February 7, 2008, available at, <http://www.treasury.gov/press-center/press-releases/Pages/hp813.aspx> (See: “

Capital Requirements – Under current law, the minimum capital requirements for the housing GSEs are fixed in statute, and the risk-based capital requirement for Fannie Mae and Freddie Mac is based on a highly-prescribed stress test that is set forth in statute. These limitations are inconsistent with the ability of other financial regulators to set both minimum and risk-based capital requirements. The new housing GSE regulatory agency must have the authority to set both minimum and risk-based capital requirements.

Receivership/Conservatorship – Under current law, OFHEO has the authority to place Fannie Mae or Freddie Mac into conservatorship but not into receivership. Should such circumstances arise, the new housing GSE regulatory agency must have more than the powers associated with conservatorship. In particular, the new regulatory agency must have all the receivership authority that is necessary to direct the liquidation of assets and otherwise direct an orderly wind down of an enterprise. The new regulatory agency must also be required to take mandatory receivership actions under certain circumstances. Such receivership authority can be established in full recognition that the Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. Providing the new regulatory agency the ability to complete an orderly wind down of a troubled regulated entity also encourages greater market discipline by clarifying that investors may suffer losses. Enhanced market discipline is essential to promoting safe

and sound operations, which is consistent with maintaining the GSEs' role in our housing finance system and protecting our broader financial system from problems at a GSE.

New Activity Approval and Mission Oversight – Under current law, the Department of Housing and Urban Development (HUD) is responsible for approving new programs, setting housing goals, and overall mission oversight of Fannie Mae and Freddie Mac. The authority for approving new activities of Fannie Mae and Freddie Mac and ensuring compliance with their mission must be transferred from HUD and combined with the other supervisory/enforcement powers of the new housing GSE regulatory agency. This authority is consistent with availability of one of the central tools that every effective financial regulator has – the ability to say "no" to new activities that are inconsistent with the charter of the regulated institutions, with their prudential operation, or with the public interest.

Other Aspects of Enhanced Authority – Housing GSE reform legislation also should include additional measures in order to provide the new regulator with authorities comparable to other U.S. financial institution regulators. Such enhancements should ensure that the GSE regulatory agency has: (1) independent funding outside of the appropriations process; (2) independent litigating authority and other related powers; and (3) the full set of regulatory and enforcement tools.

Government-Appointed Directors – The Federal government should not be involved in the appointment of directors to the boards of Fannie Mae, Freddie Mac, and the FHLBanks. Consistent with long-standing principles of corporate governance, directors of the housing GSEs have a fiduciary responsibility to shareholders. The government appointment of directors does not change this fiduciary responsibility, but does give the impression that the government may have a say or influence in the operation of the housing GSEs. That is not the case, and this should be corrected to improve corporate governance and to clarify further that the housing GSEs are not backed by the Federal government.

Combining the Regulatory Authority of the Housing GSEs – The FHLBanks are regulated by the Federal Housing Finance Board. The FHLBanks should be placed under the same regulator with Fannie Mae and Freddie Mac, and this new regulatory regime should be structured to take into account certain special differences between the FHLBanks and the other GSEs. This would enhance the critical mass of financial expertise needed to oversee the GSEs. At the same time there are many common synergies, such as the FHLBanks' investments in mortgages and MBS, and the mortgage investments of the other housing GSEs. In addition, combining regulatory authority over all of the housing GSEs under one regulator has the potential to increase the stature of the new agency and better enable it to deal with these large and influential companies.”)

<sup>71</sup> The Federal Reserve, “Federal Legislation Developments: Housing and Economic Recovery Act of 2008,” The Federal Reserve 95<sup>th</sup> Annual Report, 2008, available at: <http://www.federalreserve.gov/boarddocs/rptcongress/annual08/sec2/c5.htm> (See, as example: “Title I of HERA significantly reforms the supervisory and regulatory framework for the GSEs, representing the culmination of almost a decade of work by Congress and other relevant parties. For several years prior to the enactment of HERA, the Board had supported legislative changes to improve the supervisory and regulatory framework of the GSEs and to address the systemic risks posed by the retained mortgage portfolios of Fannie Mae and Freddie Mac. For example, the Board had urged the Congress to



provide the supervisor of Fannie Mae and Freddie Mac with the authority to set and adjust the capital requirements for the enterprises in a manner comparable to the capital authority available to the federal banking agencies with respect to insured banks; establish a clear and credible receivership process for the enterprises; and limit the size of the retained portfolios of the enterprises by anchoring them to a well-understood public purpose.

The supervisory and regulatory changes enacted under HERA include provisions that address each of these elements. As a general matter, HERA allows the FHFA director to oversee the prudential operations of the GSEs and to ensure that each GSE operates in a safe and sound manner by, among other means, maintaining adequate capital and establishing adequate internal controls.”)

<sup>72</sup> Federal Housing Finance Agency, Office of Inspector General, “FHFA’s Initiative to Reduce the Enterprises’ Dominant Position in the Housing Finance System by Raising Gradually Their Guarantee Fees,” EVL-2013-005, July 16, 2013, available at: [https://origin.www.fhfaog.gov/Content/Files/EVL-2013-005\\_2.pdf](https://origin.www.fhfaog.gov/Content/Files/EVL-2013-005_2.pdf) (See: “According to FHFA, larger lenders traditionally received guarantee fee discounts based upon the volume of business that they conducted with the Enterprises. Thus, larger lenders tended to pay lower guarantee fees on the MBS they received through the swap programs than the effective guarantee fees paid by smaller lenders on their sales of whole mortgage loans to the Enterprises. In effect, the higher guarantee fees paid by smaller lenders have covered, to some degree, the potential credit losses suffered by the Enterprises on MBS collateralized by larger lenders. This is known as cross-subsidization. Appendix A contains a detailed discussion of cross-subsidization as well as FHFA’s initiatives to minimize it through revisions to the Enterprises’ guarantee fee structures.”)

<sup>73</sup> Paul Jackson, “Mortgage Insurance Woes Grow for Fannie, Freddie,” *Housing Wire*, April 2, 2009, available at: <http://www.housingwire.com/articles/mortgage-insurance-woes-grow-fannie-freddie> (See, as example: “Imagine paying full premium for an insurance contract, and receiving only 60 percent on any claim you make -- that’s the unsavory situation now being faced by both Fannie Mae and Freddie Mac, as well as a bevy of private-market lenders, on their mortgage insurance contracts with troubled mortgage insurer Triad Guaranty Inc.”)

<sup>74</sup> Joshua Rosner, “Housing in the New Millennium: A Home Without Equity is Just a Rental with Debt,” June 29, 2001, available at: <http://ssrn.com/abstract=1162456> or <http://dx.doi.org/10.2139/ssrn.1162456> (See p.6: “The Easing of Credit Standards – A Major Catalyst to the Nineties Housing Boom”)

<sup>75</sup> John Griffith, “The \$5 Trillion Question: What Should We Do with Fannie Mae and Freddie Mac?,” Center for American Progress, March 2013, available at: <https://www.americanprogress.org/wp-content/uploads/2013/03/NewGSEReformMatrix.pdf>

<sup>76</sup> Jim Parrott and Mark Zandi, “Privatizing Fannie and Freddie: Be Careful What You Ask For,” Moody’s Analytics and the Urban Institute, May 15, 2015, available at: <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000229-Privatizing-Fannie-and-Freddie.pdf>

<sup>77</sup> See, as examples:

Mark Zandi, Jim Parrott, Cristian deRitis, Urban Institute, “Putting Mortgage Insurers on Solid Ground”, August 2014, available at: <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413213-Putting-Mortgage-Insurers-on-Solid-Ground.PDF> (See: “Mark Zandi is a director of one mortgage insurance company, and Jim Parrott is an advisor to another.”)



Richard Osborne, Inside Sources, Big Banks Look To Cash In On Fannie-Freddie Reform Using Washington's Revolving Door, available at <http://www.insidesources.com/big-banks-look-to-cash-in-on-fannie-freddie-reform-using-washingtons-revolving-door/> (See: "One of those who helped shape the amendment is Jim Parrott, a senior fellow at the Urban Institute and former senior advisor at the White House's National Economic Council. Parrott has served as a consultant for major banks. *InsideSources* has obtained an email strongly suggesting that Parrott played an advisory role for at least one bank, Bank of America. The email, written by a senior official at the bank, refers to a meeting with Parrott about housing finance reform. In the email, the official also asks about arranging a telephone call to provide details of the Parrott meeting.")

Laurie Goodman, Ellen Seidman, Jim Parrott, and Jun Zhu, Urban Institute, "Guarantee Fees—An Art, Not a Science", August, 14 2014, <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413202-Guarantee-Fees-An-Art-Not-a-Science.PDF> (Note: *The findings of this Urban Institute report were submitted to the FHFA as a comment letter from the Urban Institute and are available at: <https://www.fhfa.gov/AboutUs/Contact/Pages/input-submission-detail.aspx?RFID=139> . It was also cited in several of the comment letters including on page 2 of a comment letter from Americans for Financial Reform [http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/09/AFR-comments-to-FHFA-on-gaurantee-fees\\_FINAL\\_PDF.pdf](http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2014/09/AFR-comments-to-FHFA-on-gaurantee-fees_FINAL_PDF.pdf) )*

Jim Parrott and Mark Zandi, Moody's Analytics and Urban Institute, "Privatizing Fannie and Freddie: Be Careful What You Ask For" May 15, 2015 <https://www.economy.com/getlocal?q=1b7e1c1b-8654-4a8c-a7ea-e86ae760a7c1&app=eccafile> ;

Written Testimony of Mark Zandi, Senate Banking Committee, "Essential Elements of Housing Finance Reform", September 12, 2013, available at <https://www.economy.com/getlocal?q=306BF929-5A1A-41FC-9737-691E189D7D2F&app=eccafile>

<sup>78</sup> Mark Zandi, "Fannie and Freddie don't deserve blame for bubble," *Washington Post*, January 24, 2012, available at: [http://www.washingtonpost.com/realestate/fannie-and-freddie-dont-deserve-blame-for-bubble/2012/01/23/gIQAn3LZMQ\\_story.html](http://www.washingtonpost.com/realestate/fannie-and-freddie-dont-deserve-blame-for-bubble/2012/01/23/gIQAn3LZMQ_story.html)

<sup>79</sup> Josh Rosner, "The Wrong Remedy for Fannie and Freddie," *Wall Street Journal*, March 27, 2014, available at: <http://www.wsj.com/articles/SB10001424052702304418404579462962749649106>

<sup>80</sup> Peter J. Wallison, Thomas H. Stanton, and Berty Ely, "Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How," January 1, 2004, (See: "Study after study has shown that Fannie Mae and Freddie Mac, despite full-throated claims about trillion-dollar commitments and the like, have failed to lead the private market in assisting the development and financing of affordable housing. In a sense, this was never likely to happen, because there was always a conflict between Fannie and Freddie's owner- ship by private shareholders and their responsibility to carry out a government mission. This should be a lesson to lawmakers that attempting to turn shareholder-owned companies into government agencies is bound to fail. The

managements of shareholder-owned companies have fiduciary duties to the shareholders that can and do conflict with the performance of a government mission.”

<sup>81</sup> Don Layton, Milken See: 35:41

<sup>82</sup> Jeffrey A. Goldstein, “Action Memorandum for Secretary Geithner,” United States Department of the Treasury, December 20, 2012, available at:

<http://graphics8.nytimes.com/packages/pdf/business/Tab25.pdf> (See: “the administration’s commitment to ensure existing common equity holders will not have access to any positive earnings from the G.S.E.’s in the future.”)

<sup>83</sup> United States Federal Deposit Insurance Corporation, “Federal Deposit Insurance Act,” available at: <https://www.fdic.gov/regulations/laws/rules/1000-100.html>

<sup>84</sup>

<sup>85</sup> National Association of Insurance Commissioners and the Center for Insurance Policy and Research, “Mortgage Insurance brief,” May 12, 2015, available at:

[http://webcache.googleusercontent.com/search?q=cache:CYrfIVyF9jMJ:www.naic.org/cipr\\_topics/topic\\_mortgage\\_insurance.htm+&cd=9&hl=en&ct=clnk&gl=us&client=safari](http://webcache.googleusercontent.com/search?q=cache:CYrfIVyF9jMJ:www.naic.org/cipr_topics/topic_mortgage_insurance.htm+&cd=9&hl=en&ct=clnk&gl=us&client=safari)

<sup>86</sup> Mortgage Insurance Companies of America, MICANEWS, June 20 2000<

<http://www.micanews.com/issues/testimony/testimony.cfm?ID=1>> (May 7 2001)

<sup>87</sup> Economists’ Outlook Blog, “Share of Mortgage Insurance Market (by \$volume),” National Association of Realtors, available at:

<http://economistsoutlook.blogs.realtor.org/files/2013/02/Capture31.jpg>

<sup>88</sup> “Servicing Guide Announcement SVC-2014-13,” Fannie Mae, July 1, 2014, available at:

<https://www.fanniemae.com/content/announcement/svc1413.pdf>

<sup>89</sup> <https://origin.www.fhfaig.gov/Content/Files/AUD-2014-013.pdf> (See: “Because of their financial condition and inability to meet the state’s minimum risk-to-capital ratio requirement of 25:1, five of the ten mortgage insurers eligible to conduct business with the Enterprises are considered financially weakened (see Table 2, page 9). Additionally, three of

the five financially weakened mortgage insurers—PMI Mortgage Insurance Co. (PMI), Triad Guaranty Insurance Corporation (Triad), and Republic Mortgage Insurance Company (RMIC)— are in run-off and no longer able to issue new mortgage insurance policies. Moreover, these mortgage insurers have established deferred payment obligation (DPO) agreements that require a percentage of their claims obligations, to the Enterprises, to be deferred”).)

<sup>90</sup> Laurie A. Redmond letter to Freddie Mac Sellers’s and Servicers, “Subject: Mortgage Insurance Coverage Requirements and Freddie Mac Remedies for Compliance Violations,” Freddie Mac, August 12, 2011, available at:

<http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/iltr081211.pdf>

<sup>91</sup> George W. Alger letter to New York Governor Herbert H. Lehman, February 26, 1935,

available at: [http://www.aei.org/wp-content/uploads/2012/05/-alger-commission-report\\_13595669733.pdf](http://www.aei.org/wp-content/uploads/2012/05/-alger-commission-report_13595669733.pdf)

<sup>92</sup> Federal Housing Finance Agency, Office of Inspector General , “CohnReznick LLP’s Independent Audit of FHFA’s Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers,” AUD-2014-013, May 8, 2014, available at:

<http://fhfaig.gov/Content/Files/AUD-2014-013.pdf>

<sup>93</sup> Federal Housing Finance Agency, Office of Inspector General, “CohnReznick LLP’s Independent Audit of FHFA’s Oversight of Enterprise Monitoring of the Financial Condition of Mortgage Insurers,” AUD-2014-013, May 8, 2014, available at:

<http://fhfa.ig.gov/Content/Files/AUD-2014-013.pdf>

<sup>94</sup> [https://www.fanniemae.com/content/eligibility\\_information/private-mortgage-insurer-eligibility-requirements.pdf](https://www.fanniemae.com/content/eligibility_information/private-mortgage-insurer-eligibility-requirements.pdf)

<sup>95</sup> <http://www.freddiemac.com/singlefamily/pdf/PMIERS.pdf>

<sup>96</sup> Ben Lane, “Fitch: Even in new forms, GSE risk-sharing bonds remain strong,” *Housing Wire*, April 28, 2015, available at: <http://www.housingwire.com/articles/33710>

<sup>97</sup> Laurie Goodman, Ellen Seidman, Jim Parrott, Sheryl Pardo, Jun Zhu, Wei Li, Bing Bai, Taz George, Maia Woluchem, and Alison Rincon, “Housing Finance At A Glance: A Monthly Chartbook,” The Urban Institute, January 2015, Available at:

[http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-13/view/full\\_report](http://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-13/view/full_report)

<sup>98</sup> Brian Collins, “Watt Plan Would End Second-Fiddle Status of Freddie MBS,” *National Mortgage News*, May 19, 2015, available at:

<http://www.nationalmortgagenews.com/news/regulation/watt-plan-would-end-second-fiddle-status-of-freddie-mbs-1041818-1.html>

<sup>99</sup> Robert Devlin, “Debt and Crisis in Latin America: The Supply Side of the Story,” Princeton University Press, 1986 (See: Page 12)

<sup>100</sup> Richard K Green, “Introduction to Mortgages & Mortgage Backed Securities,” Elsevier, Waltham, MA, 2014, available at:

[https://books.google.com/books?id=AYtqAAAAQBAJ&pg=PA221&lpg=PA221&dq=%22natural+monopoly%22+fannie.&source=bl&ots=pgDPduVAmA&sig=x3B\\_hrB2IH2xXpW0IXVFVOdvpE4&hl=en&sa=X&ved=0CB0Q6AEwATgKahUKEwjaj5i2sYXGAhXEF5IKHdCkCKM#v=onepage&q=%22natural%20monopoly%22%20fannie.&f=false](https://books.google.com/books?id=AYtqAAAAQBAJ&pg=PA221&lpg=PA221&dq=%22natural+monopoly%22+fannie.&source=bl&ots=pgDPduVAmA&sig=x3B_hrB2IH2xXpW0IXVFVOdvpE4&hl=en&sa=X&ved=0CB0Q6AEwATgKahUKEwjaj5i2sYXGAhXEF5IKHdCkCKM#v=onepage&q=%22natural%20monopoly%22%20fannie.&f=false) (See: page 221)

<sup>101</sup> Dwight Jaffee, “The Interest Rate Risk of Fannie Mae and Freddie Mac,” *Journal of Financial Services Research*, Volume 24 Issue 1, Pages 5-29, 2003, available at:

<http://faculty.haas.berkeley.edu/jaffee/papers/FinalJFSR.pdf> (See: p.6 “For the mortgage securitization line, F&F purchase and transform sets of whole mortgage loans into mortgage-backed securities(MBS), which are then sold to capital market investors (hereafter referred to as F&F investor-held MBS). F&F guarantee these MBS against the risk of default, for which they obtain an annual guarantee fee. F&F retain no direct interest rate risk on the investor-held MBS, since all cash flows are owned by the investors.”)

<sup>102</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at:

[https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: “Most plans for the privatization of Fannie Mae and Freddie Mac founder on two shoals: that the companies, when privatized, will still be so large as to be “too big to fail” and that privatization will disrupt the process of residential financing, thus harming the U.S. economy. The plan outlined in this memorandum [the Privatization Plan], developed for the American Enterprise Institute by Thomas H. Stanton, addresses both objections. The “too- big-to-fail” problem is addressed by shrinking the size of Fannie’s and Freddie’s asset portfolios [principally, mortgages and MBSs] as they shift their activities away from the GSE form; the problem of mortgage market disruption is addressed by continuing the securitization of mortgages and providing for a gradual transition of this activity into a non-GSE, private- sector format.”)

<sup>103</sup> Jason Thomas and Robert Van Order, “Housing Policy, Subprime Markets and Fannie Mae and Freddie Mac: What We Know, What We Think We Know and What We Don’t Know,” November 2010, available at: [https://research.stlouisfed.org/conferences/gse/Van\\_Order.pdf](https://research.stlouisfed.org/conferences/gse/Van_Order.pdf) (See: “Rather than brewing for a long time, their downfall was quick and had to do with purchases of risky-but-not-subprime mortgages and insufficient capital to cover the decline in property values.”)

<sup>104</sup> HR 3221, “Housing and Economic Recovery Act of 2008,” 110<sup>th</sup> Congress (2007-2008), available at: <https://www.congress.gov/bill/110th-congress/house-bill/3221>

<sup>105</sup> Press Release, “Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac,” United States Department of the Treasury, August 17, 2012, available at: <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

<sup>106</sup> 12 U.S. Code § 4617(a)(7), available at: <http://www.law.cornell.edu/uscode/text/12/4617> (See: “(7) Agency not subject to any other Federal agency When acting as conservator or receiver, the Agency shall not be subject to the direction or supervision of any other agency of the United States or any State in the exercise of the rights, powers, and privileges of the Agency.”)

<sup>107</sup> 12 U.S. Code § 4614, available at: <http://www.law.cornell.edu/uscode/text/12/4614>

<sup>108</sup> 12 U.S. Code § 4612 (a)(1)(2)(3), available at: <http://www.law.cornell.edu/uscode/text/12/4612>

<sup>109</sup> Gretchen Morgenson, “The Untouchable Profits of Fannie Mae and Freddie Mac,” *The New York Times*, February 15, 2014, available at: [http://www.nytimes.com/2014/02/16/business/the-untouchable-profits-of-fannie-mae-and-freddie-mac.html?\\_r=0](http://www.nytimes.com/2014/02/16/business/the-untouchable-profits-of-fannie-mae-and-freddie-mac.html?_r=0)

<sup>110</sup> News Release, “FHFA Announces Suspension of Capital Classifications During Conservatorship,” Federal Housing Finance Agency, October 9, 2008, available at: <http://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Suspension-of-Capital-Classifications-During-Conservatorship-and-Discloses-Minimum-and-RiskBased-Cap.aspx> (See: “The Director has determined that it is prudent and in the best interests of the market to suspend capital classifications of Fannie Mae and Freddie Mac during the conservatorship, in light of the United States Treasury’s Senior Preferred Stock Purchase Agreement. FHFA will continue to closely monitor capital levels, but the existing statutory and FHFA-directed regulatory capital requirements will not be binding during the conservatorship.”)

<sup>111</sup> 12 U.S. Code § 4614, available at: <https://www.law.cornell.edu/uscode/text/12/4614>

<sup>112</sup> Hearing before the Committee on Financial Services, “Sustainable Housing Finance: An Update from the Federal Housing Finance Agency on the GSE Conservatorships,” The United States House of Representatives, March 19, 2013, available at: <http://mfile3.akamai.com/65722/wmv/sos1467-1.streamos.download.akamai.com/65726/hearing031913.aspx>

<sup>113</sup> <http://www.gpo.gov/fdsys/pkg/BILLS-110hr3221enr/pdf/BILLS-110hr3221enr.pdf>

<sup>114</sup> Joshua Rosner, “FHFA: The Little Agency that Could (but Hasn’t),” Graham Fisher & Co., February 3, 2015, available at: <http://www.valuwalk.com/wp-content/uploads/2015/02/254729408-02-03-15-FHFA-The-Little-Regulator-That-Could-but-Hasn-t.pdf>

<sup>115</sup> Jeffrey A. Goldstein, “Information Memorandum for Secretary Geithner,” United States Department of the Treasury, January 4, 2011, available at:

<http://www.housingwire.com/ext/resources/files/Editorial/Documents/Treasury-Memo-on-housing.pdf> (See: “**Option 2: FHA-only option: Wind Down of the GSEs (FHA-only option)**”

- The bank-centric model reduces distortion in the allocation of credit and preference for housing. However, this model benefits larger institutions that have better access to funding and the capacity to hold fully diversified portfolios of residential mortgage risk. This could lead to increased concentration in the banking sector and higher costs for borrowers served by smaller institutions.
  - o Many countries rely more heavily on their banking systems to provide mortgage credit, but often still have other strong forms of government involvement and support.
  - o To counteract the tendency for banks to become larger, we would have to effectively apply Dodd-Frank provisions, including SIFI surcharge, increased prudential regulation, concentration limits, etc, to limit taxpayer losses in future housing crises.”)

<sup>116</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at: [https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: Page 24)

<sup>117</sup> “Fannie Mae and Freddie Mac,” Professional Risk Managers International Association, available at: [http://www.prmia.org/sites/default/files/references/Fannie Mae and Freddie Mac 090911 v2.pdf](http://www.prmia.org/sites/default/files/references/Fannie%20Mae%20and%20Freddie%20Mac%20090911%20v2.pdf) (See: “Fannie Mae ceased to be the guarantor of government-issued mortgages, which was now the responsibility of the new Government National Mortgage Association (Ginnie Mae).”)

<sup>118</sup> “Investor FAQ,” Freddie Mac, available at: <http://www.freddie.mac.com/investors/faq.html>

<sup>119</sup> Lewis S. Ranieri letter to the Department of Housing & Urban Development and Department of Treasury, July 21, 2010, available at:

<http://online.wsj.com/public/resources/documents/Ranieri0723.pdf>

<sup>120</sup> Press Release, “Remarks by Treasury Secretary Henry M. Paulson, Jr.,” United States Department of the Treasury, January 7, 2009, available at: <http://www.treasury.gov/press-center/press-releases/Pages/hp1345.aspx>

<sup>121</sup> Citigroup presentation on Mortgage Market Trends, available at:

[http://fcic-static.law.stanford.edu/cdn\\_media/fcic-docs/0000-00-00 Citigroup PowerPoint Presentation Overview and Summary Recommendations Mortgage Market Trands Monoline Lifecycles Phineas Valuation Citigroup Recommendations.pdf](http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/0000-00-00_Citigroup_PowerPoint_Presentation_Overview_and_Summary_Recommendations_Mortgage_Market_Trands_Monoline_Lifecycles_Phineas_Valuation_Citigroup_Recommendations.pdf) (See: page 4)

<sup>122</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at: [https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: “But it points out that a sudden shock at Fannie and Freddie is not the same as a sudden shock at an ordinary bank, even a large one. The systemic danger from a bank’s failure is its connections to other financial institutions, particularly other banks. If a bank cannot meet its obligations, other banks might also be unable to meet theirs. In this way, a shock at a large bank can spread through the financial system and cause losses in the real economy as economic activity slows or stops while the crisis continues.

However, a shock at Fannie or Freddie will move differently through the economy. If either is unable to function, the housing market could be directly and immediately affected: Mortgage



rates could rise, financing of housing could slow, housing starts could decline, and all the other industries in the U.S. economy that depend on housing (furniture, appliances, and construction, among many others) could be adversely affected. Moreover, if the value of Fannie's or Freddie's debt securities falls, large numbers of banks will have impaired capital, at least on a marked-to-market basis, and may reduce or stop lending until their capital position improves. This would add a further depressing effect on economic activity.")

<sup>123</sup> "350,000 Mortgages: A Snapshot," Freddie Mac, May 20, 2015, available at:

[http://www.freddiemac.com/blog/notable/20150520\\_mortgages\\_snapshot.html](http://www.freddiemac.com/blog/notable/20150520_mortgages_snapshot.html)

<sup>124</sup> Todd W. Schneider, "Mortgages Are About Math: Open-Source Loan-Level Analysis of Fannie and Freddie," June 9, 2015, available at:

<http://toddwtschneider.com/posts/mortgages-are-about-math-open-source-loan-level-analysis-of-fannie-and-freddie/>

<sup>125</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, "Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How," January 1, 2004, available at:

[https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: "As it happens, we have a recent example of how this occurs. In

the late 1980s, it had become clear that the S&L industry was not recovering along with the economy. Many S&Ls were insolvent, kept open only by regulatory forbearance and the fact that deposit insurance enabled them to raise funds despite their ill health. However, efforts to close down S&Ls were resisted by the industry, and few in Congress were willing to insist that this action be taken or provide the funds necessary for an industry cleanup. Because of delays, the problem became worse and worse, as S&Ls, "gambling for resurrection," made risky bets with government-insured funds in the hope of recovering their lost capital.

The S&Ls, although a powerful industry, were not remotely as powerful as Fannie and Freddie are today. Yet they were able to stall necessary regulatory action for years while losses multiplied. This history should be a lesson for those who believe that the risks created by Fannie and Freddie can be easily contained through tighter regulation and a change in their regulator. We still live in a political system where political imperatives can trump substance, and no one should be confident that, when the time comes for a regulator to take steps adverse to Fannie and Freddie's interest, the political context will favor or even permit this action.")

<sup>126</sup> Erika Morphy, "Watt: Only Congress Can End GSE Conservatorship," *Globe St.*, November 24, 2014, available at: [http://www.globest.com/news/12\\_994/national/multifamily/Watt-Only-Congress-Can-End-GSE-Conservatorship-352830-1.html](http://www.globest.com/news/12_994/national/multifamily/Watt-Only-Congress-Can-End-GSE-Conservatorship-352830-1.html)

<sup>127</sup> Denny Gulino, "US Tsy Hsg Offl: Hope to Open Joint Securitization to Non-GSEs," *MNI News*, March 5, 2015, available at: <https://mninews.marketnews.com/content/us-tsy-hsg-offl-hope-open-joint-securitization-non-gses>

<sup>128</sup> Clayton Browne, "Fannie Mae, Freddie Mac Reform Requires Congress," *ValueWalk*, May 22, 2014, available at: <http://www.valuewalk.com/2014/05/fannie-mae-freddie-mac-reform-requires-congress/>

<sup>129</sup> UST Report

<sup>130</sup> Jonathan R. Lang, "The Endgame Nears For Fannie and Freddie," *Barron's*, August 18, 2008, available at: <http://online.barrons.com/articles/SB121884860106946277> (See: "An insider in the Bush administration tells *Barron's* Fannie and Freddie are being jawboned by the Treasury Department and their new regulator, the Federal Housing Finance Agency (FHFA), to raise more equity. But government officials don't expect the agencies to succeed.")



<sup>131</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at: [https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: “Ordinarily, without the government’s backing, companies with the thin capitalizations and high risks of Fannie and Freddie would be unable to attract funds at a price that would enable them to acquire portfolios of mortgages or MBSs. With the government’s backing, they are able to do this, but in the process they are placing the risk of loss on the taxpayers while retaining the profits for themselves.”)

<sup>132</sup> Congressional Budget Office, “Controlling the Risks of Government-Sponsored Enterprises,” Congressional Budget Office Report, As required by the Omnibus Budget Reconciliation Act of 1990, April 1991, available at: [https://www.cbo.gov/sites/default/files/04-1991-gses\\_rev2.pdf](https://www.cbo.gov/sites/default/files/04-1991-gses_rev2.pdf) (See: Page xvii)

<sup>133</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at: [https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: “In this plan, the portfolios of mortgages and MBSs held by Fannie and Freddie are not permitted to grow and are required to meet a phase-out schedule that will result in the liquidation of the entire portfolio within five years.”)

<sup>134</sup> “Paulson’s announcement on Fannie, Freddie,” *CNN Money*, September 7, 2008, available at: <http://money.cnn.com/2008/09/07/news/economy/paulsonstatement/>

<sup>135</sup> Press Release, “Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac,” United States Department of the Treasury, August 17, 2012, available at: <http://www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx>

<sup>136</sup> Financial Stability Oversight Council, “Nonbank Designations – FAQs,” United States Department of the Treasury, February 4, 2015, available at: <http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx#1> (See” By statute, the FSOC is composed of 10 voting members and 5 nonvoting members. The voting members are the Secretary of the Treasury (who serves as the Chairperson of the FSOC), the Chair of the Board of Governors of the Federal Reserve System (Federal Reserve), the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chair of the Securities and Exchange Commission, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Commodity Futures Trading Commission, the Director of the Federal Housing Finance Agency, the Chairman of the National Credit Union Administration, and an independent member with insurance expertise who is appointed by the President, by and with the advice and consent of the Senate. The five nonvoting members are the Director of the Office of Financial Research, the Director of the Federal Insurance Office, and state insurance, banking, and securities regulators.”)

<sup>137</sup> IBID

<sup>138</sup> Congressional Budget Office, “Controlling the Risks of Government-Sponsored Enterprises,” Congressional Budget Office Report, As required by the Omnibus Budget Reconciliation Act of 1990, April 1991, available at: [https://www.cbo.gov/sites/default/files/04-1991-gses\\_rev2.pdf](https://www.cbo.gov/sites/default/files/04-1991-gses_rev2.pdf) (See: Page 56 - “The government could also obtain private assessments of each GSE’s overall risk by requiring the enterprises to issue subordinated debt that did not carry an implicit federal guarantee and, therefore, exposed investors to the risk of default. Market prices of such debt would provide indicators of the government’s relative exposure to each GSE and of changes in that exposure. Two types of obligations have been proposed: subordinated income bonds and

potable (redeemable) subordinated debt.<sup>8</sup> Both types of securities would have a junior claim on an enterprise's assets and could be repaid only after other debts with a senior claim, including any loans by the Treasury, had been repaid. The obligations would differ from the subordinated debt now issued by some GSEs in that strict loan covenants would lead investors to expect to incur losses under certain clearly defined conditions.”)

<sup>139</sup> Alex J. Pollock, “Fannie and Freddie are obviously SIFIs,” *American Banker*, April 21, 2014, available at: <http://www.aei.org/publication/fannie-and-freddie-are-obviously-sifis/>

<sup>140</sup> Jeffrey A. Goldstein, “Information Memorandum for Secretary Geithner,” United States Department of the Treasury, January 4, 2011, available at: <http://www.housingwire.com/ext/resources/files/Editorial/Documents/Treasury-Memo-on-housing.pdf>

<sup>141</sup> S. 1217, “Housing Finance Reform and Taxpayer Protection Act of 2013,” 113<sup>th</sup> Congress (2013-2014), available at: [http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=512757b1-e595-4b85-8321-30d91e368849](http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=512757b1-e595-4b85-8321-30d91e368849) (See” **AUTHORITY TO PROTECT TAXPAYERS IN UNUSUAL AND EXIGENT MARKET CONDITIONS.**

(a) IN GENERAL.—If the Corporation, upon the written agreement of the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, and in consultation with the Secretary of Housing and Urban Development, determines that unusual and exigent circumstances have created or threaten to create an anomalous lack of mortgage credit availability within the single-family housing market, multifamily housing market, or entire United States housing market that could materially and severely disrupt the functioning of the housing finance system of the United States, the Corporation may, for a period of 6 months—

(1) provide insurance in accordance with section 303 to any single-family covered security regardless of whether such security has satisfied the requirements of section 302; and (2) establish provisional standards for approved entities, notwithstanding any standard required under subtitle B or section 703, pursuant to section 607. (b) CONSIDERATIONS.—In exercising the authority granted under subsection (a), the Corporation shall consider the severity of the conditions present in the housing markets and the risks presented to the Mortgage Insurance Fund in exercising such authority. (c) TERMS AND CONDITIONS.—Insurance provided under subsection (a) shall be subject to such additional or different limitations, restrictions, and regulations as the Corporation may prescribe.”)

<sup>142</sup> Donald Layton, “Housing Finance and Private Capital,” Presentation at the Milken Institute Global Conference, April 28, 2014, available at: <http://www.milkeninstitute.org/events/conferences/global-conference/2014/panel-detail/5016> (See: 37:00)

<sup>143</sup> Peter J. Wallison, Thomas H. Stanton, and Bert Ely, “Privatizing Fannie Mae, Freddie Mac and the Federal Home Loan Banks: Why and How,” January 1, 2004, available at:

[https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book\\_172113483872.pdf](https://www.aei.org/wp-content/uploads/2013/12/-privatizing-fannie-mae-book_172113483872.pdf) (See: “Section 208. Offset fund

Requires the regulator to establish a fund and to allocate to that fund all fees and other payments by the enterprises pursuant to this Act; after creation of a nonprofit affordable housing corporation pursuant to section 305, the Director shall allocate all funds to that corporation”)

<sup>144</sup> Philip Swagel, “Reform of the GSEs and Housing Finance,” Milken Institute, July 2011, available at: <http://www.synergeticinvestmentgroup.com/resources/Milken/MilkenHousingFinanceReform-7->

[11.pdf](#) (See: “A government backstop on mortgage-backed securities (MBS) is needed to ensure that Americans can obtain mortgages at reasonable rates under all market conditions, including the 30-year fixed-rate mortgages that dominate the U.S. housing system... Since government support is latent, it would be better to make the government backstop explicit and place a value on it rather than give it away for free.”)

<sup>145</sup> “Common Securitization Platform: A Joint Venture between the Government-Sponsored Enterprises,” Cross Country Consulting, 2014, available at: [www.crosscountry-consulting.com/LiteratureRetrieve.aspx?ID=197325](http://www.crosscountry-consulting.com/LiteratureRetrieve.aspx?ID=197325) (See: “The primary objective of the CSP is to reduce credit risk exposure of the GSEs, increase participation of private capital in the mortgage market and provide benefit to a broader group of stakeholders, such as investors, lenders, borrowers and ultimately, the taxpayers. Accordingly, the CSP is an important step towards accomplishment of FHFA’s four strategic goals as described in ‘FHFA Strategic Plan Fiscal Years 2013 – 2017’:

- Safe and Sound Housing GSEs
- Stability, Liquidity, and Access in Housing Finance
- Preserve and Conserve Enterprise Assets
- Prepare for the Future of Housing Finance in the U.S.

The CSP will provide services at the time of security issuance, and later with servicing of loans, distribution of principal and interest to the investors, and reconciliation and disclosure of balances and loan performance data.”)

<sup>146</sup> R. Kenneth Skinner, “Planning for Capital Investment in Regulated Energy Markets,” *Natural Gas and Electricity*, January 2012, available at:

<http://www.integralanalytics.com/files/documents/related-documents/Regulated%20Investment%20Planning%20Jan2012.pdf>

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