

## CHLA GSE REFORM PLAN

[March 29, 2017]

### MAJOR CHLA OBJECTIVES FOR GSE REFORM

- **Preserve 30-year affordable mortgage with broad consumer access to mortgage credit.** A federal guarantee of qualified mortgage backed securities (MBS) is needed to access sufficient investors to ensure affordable mortgages for all qualified borrowers, with provisions to ensure a federal guarantee is not just used to serve high FICO borrowers.
- **Full & Competitive Small Lender Access to Cash Window & Securitization Execution.** Fannie Mae and Freddie Mac should be preserved to avoid market concentration by Wall Street banks, and facilitate broad lender access with full G Fee/risk-based pricing parity.
- **Protection of Taxpayers.** Essential elements include: (a) private GSE capital to absorb losses, (b) risk-sharing, (c) strong FHFA regulation, and (d) strong underwriting standards.
- **Minimize Transition Risk.** Reform should have a smooth transition and be based on a practical workable plan, to avoid disruptions to the housing market and broader economy.

### SIGNIFICANT REFORMS HAVE ALREADY TAKEN PLACE SINCE 2008

There is a consensus not to go back to the pre-2008 model of GSE “private gain, public loss.” But claims that recapitalization of Fannie and Freddie means going back to the old failed model are largely a straw man argument. While private capital is still needed to complete the process, significant reforms (with bi-partisan support) have already taken place and are irreversible:

1. **Ability to Repay (QM).** A major factor in the GSEs’ conservatorship was their purchase of no doc (Alt A) loans. With adoption of QM, no doc loans are a thing of the past.
2. **Credit Risk Sharing.** The GSEs have been doing risk sharing on over 90% of new loans, and to date have transferred \$49 billion in credit risk to third party private entities.
3. **Portfolio Wind Downs.** The significant interest rate risk that the GSEs were exposed to before 2008 has largely been eliminated with a major winding down of their portfolios.
4. **Strong Regulator.** The 2008 HERA legislation replaced a weak regulator (OFHEO) with a strong regulator (FHFA) that has focused on effective, proactive regulation.
5. **Taxpayer Compensation for Federal Guarantee.** The pre-2008 deal in which GSEs had an implicit guarantee without compensating fees has been replaced by a full profit sweep under the PSPA – and an expectation of fair guarantee fees under GSE reform.
6. **Common Securitization Platform (CSP)/Common Security.** FHFA is engineering a CSP and single security - to create a more uniform, competitive securitization process.

### CONTINUE REFORMS & RECAPITALIZE UNDER A UTILITY MODEL

While Congress must continue to play a strong oversight and advisory role, comprehensive legislation is not needed at this time. This CHLA GSE Reform Plan would recapitalize and re-privatize Fannie and Freddie using a Utility Model under a plan to be developed by FHFA as conservator, and then agreed to by the Treasury Department and Congress. Taxpayers would be protected by private GSE capital, risk sharing, strong FHFA regulation, and sound underwriting. Other provisions in the Plan protect small lender access and consumer access to mortgage credit.

# **CHLA IMPLEMENTATION PLAN FOR GSE REFORM**

## **1. FHA Should Immediately Suspend Fannie, Freddie Dividends, to Build a Capital Buffer up to a .5% capital level – in order to Avoid a contrived Treasury Advance under the existing Sweep Agreement.**

FHFA Director Watt has identified the GSEs' declining capital buffer under the Sweep Agreement as their "most serious risk," warning that a resulting Treasury advance carries investor and political risks. The GSEs' Net Worth is not declining because they are losing money - they have been routinely profitable and have paid back tens of billions of dollars to Treasury above and beyond their 2008 advance. Rather, the GSEs' Net Worth has been declining because the Sweep Agreement sweeps quarterly profits and arbitrarily reduces their Net Worth to zero on January 1, 2018. FHFA, with the support of Treasury, should suspend dividends as long as is necessary to build a capital buffer to cover short term losses.

## **2. FHFA Should Develop a Capital Restoration Plan for Fannie Mae and Freddie Mac – under which they are re-privatized pursuant to a Utility Model and ultimately taken out of Conservatorship.**

FHFA, as conservator, is the appropriate entity to develop a Capital Restoration Plan for the GSEs – with Congress playing an advisory and oversight role in that process.

Further, **CHLA believes that the best approach is a Utility Model**, in which the GSEs build up capital to enable them to exit the conservatorship and re-emerge as private entities, in which they perform a mortgage securitization and standardization role, supported by a government backstop of their MBS. Taxpayers are protected by private GSE capital; third-party credit risk transfers to absorb losses; robust FHFA regulation of underwriting standards and counter-party risk; fees to cover the risk of the backstop.

*[Note: though not in CHLA's area, the GSEs' role should also include multifamily loan purchases.]*

## **3. After FHFA Submission of a Capital Restoration Plan, FHFA and Treasury Should Agree on a Plan.**

After FHFA development of a Plan, FHFA and Treasury should then work together to reach agreement on a Capital Restoration Plan – with a goal of either the informal support of Congress or their formal approval by legislation. This should then trigger an amendment of the PSPA – to allow the accumulation of GSE capital, along with modifications of common and preferred stock positions, as follows:

- GSEs should retain & accumulate their profits to help them meet the Plan's capital requirements.
- The debt under the federal government's Senior Preferred stock holding should be deemed extinguished, since the GSEs have paid back 140% of their original advance – and the warrants should be converted or disposed of consistent with the agreed-upon Capital Restoration Plan.
- Existing common and junior preferred stock holders' interests should be eliminated or otherwise reduced as appropriate, consistent with the agreed-upon Capital Restoration Plan.
- Fees should be assessed on MBS to reflect the risk of the taxpayer federal guarantee, consistent with the agreed-upon Capital Restoration Plan and their impact on recapitalization efforts.
- Except and unless modified by Congress, existing HERA statutory Housing Trust Fund and Capital Magnet Fund contributions, housing goals, and Duty to Serve provisions shall continue during implementation of Capital Restoration Plan

#### **4. GSEs Should Continue Back-End Credit Risk Transfer (Risk Sharing), and only allow Up-Front Risk Sharing with PMIs on a loan level basis with small lender protections (e.g., prohibition on volume discounts).**

Up-front risk sharing using a securitization structure could lead to increased market concentration among large lenders, which is bad for consumers. The biggest concern is that this would invite the types of vertical integration abuses that Congress has long been concerned about – where a number of large Wall Street Banks have the size and securities expertise to carry out up-front securitization risk sharing structures and then exclusively use the loan proceeds to originate loans through their bank affiliates. More broadly, up-front risk sharing with a securitization structure creates a choke point – GSE seller-servicers cannot sell loans to the GSEs without third party risk sharing in place.

Up-front risk sharing could be acceptable if done on a loan level basis with PMIs (which don't compete in the loan origination business) – except that there should be formal protections to ensure competitive small lender access - specifically: (1) prohibitions on volume discounts, (2) offering PMI to all eligible seller-servicers, and (3) transparent, publicly available pricing.

#### **5. FHFA should complete work on a Common Securitization Platform (CSP) and Single Security – and should not turn over the CSP to the Too-Big-To-Fail Wall Street Banks (or a new entity that they control).**

Completion of the CSP helps to create a more uniform, competitive securitization process, with the single security avoiding pricing discrepancies between the two GSEs that could result in distortions. Additionally, CHLA believes that, since the CSP was effectively developed with taxpayer dollars, it should not be turned over to a non-profit or other new entity, which is likely controlled by the large Wall Street Banks. Instead, the CSP should continue to be used to exclusively facilitate GSE securitizations.

#### **6. FHFA and the GSEs should continue progress towards full G Fee Parity and full transparency in pricing, in order to ensure broad loan origination access to small and mid-sized lenders.**

The pre-2008 practice of volume discounts, for lenders like Countrywide, encouraged industry concentration and distortive behavior. FHFA and the GSEs should continue the significant progress they have made since then in moving towards G Fee pricing parity – by extending this treatment to include not just the Cash Window, but also buy-up/buy-down grids. Such a requirement for equitable pricing should be incorporated into FHFA regulations, and into Congressional legislation. Formulation of these policies would be enhanced by maximal transparency in both pricing and seller-servicer eligibility qualifications.

#### **7. Congress should ultimately enact legislation to adopt provisions that only Congress can do, e.g., providing an explicit federal guarantee.**

Ultimately, Congress will need to enact legislation to accomplish certain things that can only be done through legislation – as well as to codify key policies that have been developed administratively – i.e.

- Provide an explicit guarantee, along with a requirement to charge fees commensurate with the risk of that guarantee.
- Codify provisions like strong regulation, capital levels, risk sharing, & small lender protections - but flexibly (not in an overly prescriptive manner) to allow for changing market conditions.
- Appropriate Access to Credit requirements, including Housing Trust Fund/Capital Magnet Fund contributions, and Duty to Serve/ housing goal provisions to ensure that the federal guarantee is not used to serve only the highest quality credit borrowers – but is instead used to serve a broad range of qualified borrowers, geographic areas, and appropriate product types.