BUILDING A NEW PRIVATE SECTOR SECONDARY MORTGAGE MARKET: AN ANALYSIS OF THE PROPOSAL BY THE HOUSING POLICY COUNCIL

James C. Sivon[*]

---

[*] James C. Sivon is a partner in the Washington, D.C. law firm of Barnett, Sivon & Natter, P.C. He serves as a counsel to the Housing Policy Council of the Financial Services Roundtable.

I. INTRODUCTION

The secondary mortgage market is a central feature of our nation's system of housing finance. It accounts for two-thirds of the funding for residential mortgages.[1] Fannie Mae and Freddie Mac (the GSEs) were created to support this market and did so effectively for many years. However, fundamental flaws in the design and operations led to their failure during the recent financial crisis. The financial crisis also precipitated the demise of private-label mortgage securities. As a result, almost all mortgage securities in the secondary market currently are supported by the federal government, through the nationalized GSEs and Ginnie Mae, which guarantees securities backed by FHA mortgages.[2] The current level of federal involvement in the secondary mortgage market is not sustainable in the long run. Private capital, not taxpayers, should support the conventional residential mortgage market.

The Housing Policy Council (HPC) of the Financial Services Roundtable[3] has developed a comprehensive proposal for building a new and stronger secondary mortgage market that addresses the flaws inherent in the structure and operations of the GSEs.[4] The proposal encourages private sector capital to support the secondary mortgage market by replacing the GSEs with several privately capitalized companies. These companies would compete, be subject to market forces, could succeed or fail, and would be

---

[1] Written Statement from Thomas Hamilton, Managing Ed., Barclays Capital, to U.S. S. Comm. on Banking, Hous., and Urban Affairs Subcomm. on Sec., Ins., and Inv., *Examining the Hous. Fin. Sys.: The To-Be-Announced Mkt.* 7 (Aug. 3, 2011), http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=658e191a-203f-462a-b1a2-53be1234ce91.

[2] U.S. DEP'T OF THE TREASURY & U.S. DEP'T OF HOUS. & URBAN DEV., REFORMING AMERICA'S HOUSING MARKET: A REPORT TO CONGRESS 27–30 (2011), *available at* http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf.

[3] The Housing Policy Council represents 32 of the nation's leading mortgage finance companies. Press Release, Fin. Servs. Roundtable, Hous. Policy Council Statement on Admin.'s Proposal for GSE Reform (Feb. 11, 2011), http://www.fsround.org/fsr/media_center/2011/HPC_statement_on_admin_proposal_for_GSE_reform.asp. HPC members originate, service, and insure mortgages. *Id.*

[4] *Legis. Proposals to Reform the Government Sponsored Enterprises (GSEs): Hearing Before the H. Comm. on Fin. Serv.*, 112th Cong. (Mar. 31, 2011) (statement of John Dalton, Pres. Hous. Policy Council).

overseen by an independent regulator. Additionally, the HPC proposal calls for a centralized securitization facility to support the securitization of MBSs issued by these companies. This proposed system would shield taxpayers from the risk of the catastrophic federal guarantee through strong regulation and supervision of the companies. Unlike the current system, the strong regulation would include capital and guarantee fees that are set at a level to ensure the solvency of the companies in periods of severe financial stress. Finally, the proposal also envisions an obligation for these companies to support affordable housing.

For private capital to return to the secondary mortgage market, the HPC believes that a limited, but well-defined, government guarantee on the MBSs issued by these companies is necessary. This backstop or catastrophic guarantee is intended to ensure a steady flow of housing finance, including long-term, fixed-rate mortgages, through all economic cycles. This feature of the HPC proposal has naturally drawn much of the attention in the housing finance reform debate, as the costs to taxpayers from failure of the GSEs continue to mount.

In addition to explaining the details of the proposal, this article provides a background on the goals and principles that stand behind the HPC proposal.[5] Further, this article explains precisely why a limited federal guarantee offers the maximum protection to taxpayers from a future financial crisis. The article continues with a discussion of HPC's analysis of the capital requirements and guarantee fee charges that should apply to the private companies in order to deliver that protection.[6]

II. THE CASE FOR REFORMING THE SECONDARY MORTGAGE MARKET

As stated previously, the secondary market for residential mortgages is a central feature of the nation's system of housing finance.[7] The market facilitates the supply of mortgage credit because it enables banks and other lenders to remove mortgage loans from their balance sheets through securitization and thereby free capital to support new mortgage lending.[8] The secondary market also facilitates the availability of 30-year, fixed-rate mortgages since securitization allows banks and other lenders to transfer the interest rate risk on the long-term mortgages to investors. Currently, two-

---

5 *See infra* notes 19–40 and accompanying text.

6 *See infra* notes 41–105 and accompanying text.

7 *See Examining the Hous. Fin. Sys.*, *supra* note 1, at 7.

8 *Id.* at 2. Securitization involves the pooling of individual mortgage loans into a pass-through security that is sold to investors. The payments made on the loans are passed through to the investors in the form of interest and principal payments.

thirds of all residential mortgage credit flows from pension funds and other investors in the secondary mortgage market.[9]

The GSEs were created to support the secondary mortgage market through the purchase and securitization of mortgage loans from banks and other lenders.[10] For many years they performed this function efficiently and effectively. In the run-up to the financial crisis, however, flaws in the design and operation of the GSEs started to emerge.[11] The interests of private shareholders and the public mission of the GSEs were not always aligned. Additionally, shareholders and investors failed to exercise sufficient market discipline upon the GSEs because of the market's perception of federal support for the two entities.[12]

One manifestation of the flaws in the design and operations of the GSEs was the expansion of their portfolios beyond the levels necessary to provide market liquidity. Specifically, in 1981, the GSEs had a combined portfolio of $64.8 billion; in 1991, that number was $153.4 billion. In 2002 the portfolios increased to $1.21 trillion and to nearly $1.6 trillion by 2008.[13] The portfolios became engines for earnings, not liquidity. Inadequate supervision and regulation also created the opportunity for the GSEs to employ excessive leverage.

The flaws in the design and operation of the GSEs eventually led to their failure and nationalization. The market for privately issued MBSs also collapsed due to the financial crisis and investors' lost confidence in the

---

[9] *See Mortgage Debt Outstanding*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (last updated Mar. 30, 2012), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm. According to Federal Reserve Board data, of the approximately $10.5 trillion in residential mortgage debt currently outstanding, over $7 trillion has been securitized or sold into the secondary market by banks and other lenders. *See id.*

[10] *See Federal National Mortgage Association Fannie Mae*, N.Y. TIMES BUS. DAY (Mar. 5, 2012, 7:40 PM), http://topics.nytimes.com/top/news/business/companies/fannie_mae/index.html. Fannie Mae was created by Congress in 1938 to purchase FHA-insured mortgages as an effort to rebuild and strengthen the residential mortgage market after the Great Depression. *Id.* Fannie Mae was privatized in 1968, primarily for accounting purposes. *Id.* Congress created Freddie Mac in 1970 to buy mortgage loans from the savings-and-loan industry and securitize them. *Id.*

[11] *See generally Making Sense of Problems at Fannie and Freddie*, N.Y. TIMES BUS., (Mar. 5, 2012, 7:40 PM), http://www.nytimes.com/interactive/2008/07/11/business/20080711_FANNIE_GRAPHIC.html (graphically describing many of the problems that occurred at both Fannie Mae and Freddie Mac); *see also Federal National Mortgage Association Fannie Mae*, *supra* note 10 (explaining that Fannie Mae and Freddie Mac executives may be subject to civil liability for their actions leading up to the financial crisis).

[12] *See* VIRAL ACHARYA ET AL., GUARANTEED TO FAIL 6 (2011) (discussing how the government support of GSEs was misused to enrich the shareholders and executives by backing shoddy loans, eventually losing more than $30 billion).

[13] *Id*. at 18; *see also* FED. HOUS. FIN. AGENCY, REP. TO CONG., 2010 (2011).

quality of those securities.[14] Mortgage credit continued to flow throughout the crisis only because the federal government, through the Treasury Department and the Federal Reserve Board, undertook an aggressive effort to purchase mortgage loans and MBSs issued by the nationalized GSEs and guaranteed by Ginnie Mae.[15]

Today, the secondary mortgage market continues to be supported by the federal government. Mortgage-backed securities issued by the GSEs and guaranteed by Ginnie Mae account for over 95% of new mortgage originations.[16] This level of government involvement in the secondary market is not sustainable in the long run. As the Obama Administration has noted, the essential components of the housing finance system, including the secondary market, are fundamentally private sector activities, and reforms are needed to correct the flaws inherent in the design and operations of the GSEs and to greatly reduce the level of government support for the secondary market.[17]

III. THE GOALS AND PRINCIPLES BEHIND THE HPC PROPOSAL

HPC has developed a proposal to build a new and stronger secondary market based upon private capital. The HPC proposal calls for replacing the GSEs with several private companies competing against one another.[18] These companies would enhance the credit rating of MBSs backed by traditional

---

14 *See Examining the Hous. Fin. Sys.*, *supra* note 1, at 9–10. In the two years preceding the financial crisis, privately issued MBSs accounted for approximately 50% of the funding for new residential mortgages. *Id.*

15 Bd. of Governors for the Fed. Reserve Sys., Agency Mortgage-Backed Securities (MBS) Purchase Program, http://www.federalreserve.gov/newsevents/reform_mbs.htm. The Federal Reserve, utilizing its authority under section 14 of the Federal Reserve Act, purchased $1.25 trillion of agency mortgage-backed securities from January 2009 through March 2010. *Id.* The Department of Treasury purchased $200 billion of MBSs in 2008 and 2009. *See* Housing and Economic Recovery Act, Pub. L. No. 110-289, § 1117, 122 Stat. 2654 (2008) (to be codified at 12 U.S.C. § 1719(g)) (granting Treasury Department authority to purchase obligations and securities).

16 Jim Jubak, *Fannie and Freddie Must Die*, MONEYSHOW (Aug. 3, 2010), http://www.moneyshow.com/investing/article/37/Jubak_Journa-20383/Fannie-and-Freddie-Must-Die/. A few private label transactions have occurred, such as the Redwood Trust offering earlier this year. Kerri Panchuk, *Redwood Trust Plans Nearly $1 billion in Private RMBS Deals*, HOUSINGWIRE (May 6, 2011, 2:22 PM), http://www.housingwire.com/2011/05/06/redwood-trust-plans-nearly-1-billion-in-private-rmbs-deals. However, those transactions have been limited in size and backed by highly-collateralized jumbo mortgage loans (loans over $730,000). *Id.*; *see also* Presentation at MBA's National Secondary Mortgage Market Conference 2010, Phoenix Capital Inc., *Restoring Investor's* [sic] *Confidence in the RMBS Market*, 2–4 (May 2010), http://mbaa.org/files/Conferences/2010/NationalSecondary/SMKT10FraudPanelLau.pdf.

17 DEP'T OF THE TREASURY & DEP'T OF HOUS. AND URBAN DEV., REFORMING AMERICA'S HOUSING FINANCE MARKET: A REPORT TO CONGRESS, 12 (2011).

18 *See infra* notes 41–105 and accompanying text.

mortgage products. The goals and principles that stand behind this proposal are set forth below.[19]

A. Goals of the HPC Proposal

The HPC proposal is based upon five fundamental goals.

1. Private Capital

The secondary market should be financed and supported by private sector capital. Private sector investors can provide layers of financial protection for taxpayers, promote market discipline, attract management talent, and promote innovative practices.[20]

2. A Stable Flow of Mortgage Credit

The secondary market should ensure a steady flow of reasonably priced mortgages to borrowers in all economic cycles. A stable flow of mortgage credit is important to consumers and the nation's economy.[21]

3. The 30-Year Mortgage

The secondary market should provide consumers with access to long-term, fixed-rate mortgages. The overwhelming majority of consumers prefer long-term, fixed-rate mortgages over adjustable rate mortgages because they provide the security of a fixed payment.[22]

---

[19] *See infra* notes 21–40 and accompanying text.

[20] *See* REFORMING AMERICA'S HOUSING FINANCE MARKET, *supra* note 2, at 2, 3, 12 (noting that private capital reduces taxpayer risk and government involvement in the mortgage market).

[21] *See generally* Mark Zandi & Cristian de Ritis, *The Future of the Mortgage Finance System*, MOODY'S ANALYTICS (Feb. 7, 2011), http://www.economy.com/mark-zandi/documents/Mortgage-Finance-Reform-020711.pdf (describing the history and significance of mortgage credit in the United States and also proposing a plan for reforming the secondary mortgage market in order to benefit homeowners and the economy).

[22] *See id.* at 3–4 (providing a history of the 30-year fixed mortgage); Shelley Smith, *Reforming the Law of Adhesion Contracts: A Judicial Response to the Subprime Mortgage Crisis*, 14 LEWIS & CLARK L. REV. 1035, 1062 (2010) (describing the implementation of the 30-year, fixed-rate, self-amortizing mortgage as an instrumental action of the Federal Housing Administration in replacing the 5-year maturity, balloon-payment mortgage during the mid 1930s).

4. Limit Role of the Government and Maximize Taxpayer Protection

The federal government should provide enough support for the secondary market to give investors confidence in the market while building new protections for taxpayers.

5. Affordable Housing

The secondary market should provide funding to support affordable owner-occupied and rental housing.[23]

B. Principles behind the HPC Proposal

HPC has also identified several principles to guide reform in order to achieve the aforementioned goals.[24] These principles are intended to address the flaws in the design and structure of the GSEs that led to their failure.[25] The principles behind the HPC proposal are listed as follows.

1. Separate the Functions of the GSEs

Currently, the GSEs purchase mortgages from mortgage originators, package those mortgages into securities, and guarantee the payment of interest and principal on those securities. In exchange for the guarantee, the GSEs charge mortgage originators a guarantee fee.[26] Separating and isolating these functions would help address the conflicts inherent in the design and operations of the GSEs and facilitate additional improvements in the operation of the secondary market.[27] It would permit each of these functions to have appropriate management, regulation, ownership, and incentives.[28]

2. Return to the Core Mission of the GSE

Multiple and conflicting missions contributed to the financial problems of the GSEs.[29] Going forward, the core mission of the new private companies and the securitization facility that is part of the HPC proposal

---

23 *Legis. Proposals*, *supra* note 4, at 4.
24 *Id.*
25 *Id.*
26 *Id.*
27 *Id.*
28 *Id.*
29 *See* Fin. Crisis Inquiry Comm'n, Financial Crisis Inquiry Report 41 (Jan. 2011) (including a general discussion of the problematic dual mission of "promoting mortgage lending while maximizing returns to shareholders").

would be limited to providing liquidity, in a safe and sound manner, for prudently underwritten conventional mortgage products.[30]

3. Eliminate the Implicit Guarantee Enjoyed by the GSEs

Financial markets imputed an implicit federal guarantee for the obligations of the GSEs.[31] This gave the GSEs a funding advantage and eventually caused them to take risks that contributed to their failure.[32] The new private companies in the HPC plan would not be backed by explicit or implicit federal support.[33]

4. Establish an Explicit Federal Guarantee for MBSs

While the new private companies should not enjoy any form of federal support, the MBSs issued by the companies should carry an explicit federal guarantee.[34] An explicit guarantee is needed to attract sufficient investor interest in mortgage finance and thereby ensure that consumers have uninterrupted access to reasonably priced mortgages, including long-term, fixed-rate mortgages, in all economic conditions.[35] Federal support for these securities should be structured to be the minimum amount necessary to provide investors with confidence in these securities without creating perverse incentives.

5. Limit Portfolios

The portfolios amassed by the GSEs were a contributing factor in their financial collapse.[36] Going forward, any portfolios maintained by the new private companies should be limited in size and held for liquidity purposes only. It is important that the portfolio not detract from the core securitization functions of the GSEs, or create any unnecessary financial risks to these entities.

6. Eliminate the Dual Mission

The inherent tension between the affordable housing mission of the GSEs and the interests of shareholders seeking a sufficient return contributed

---

30 *Legis. Proposals*, *supra* note 4, at 3.
31 Zandi & de Ritis, *supra* note 22, at 17.
32 *See id.* at 18 n.47.
33 *Legis. Proposals*, *supra* note 4, at 4.
34 *Id.* at 5.
35 *Id.*
36 ACHARYA ET AL., *supra* note 13, at 29 (discussing the inherent risks in the rising interest rates of the GSE mortgage portfolios).

to the failure of the GSEs.[37] The new private companies should not be subject to specific affordable housing goals. However, they could provide a funding source to support affordable housing through programs similar to the FHLB Affordable Housing Program.[38]

7. Provide for World Class Supervision and Regulation

For years the GSEs operated under a weak regulatory and supervisory structure. Their regulator lacked the statutory powers and funding available to banking regulators, and their capital requirements were set by statute, rather than by regulation. Congress corrected many of these problems in 2008 with the creation of the Federal Housing Finance Agency (FHFA).[39] Going forward, FHFA should be given sufficient supervisory and regulatory powers to provide world-class regulation and supervision to the new private companies created under the HPC proposal.

IV. THE HPC PROPOSAL

The HPC proposal calls for replacing the GSEs with several privately capitalized companies and a centralized securitization facility to support the securitization of MBSs issued by these companies.[40] These structures are described below. This section of the paper also includes a discussion of HPC's analysis of the capital requirements and guarantee fee charges that should apply to these companies to provide maximum taxpayer protection in the event of a future fiscal crisis. The rationale for the federal guarantee is discussed later in this article.[41]

---

37 *Id.* at 12, 32.

38 *See generally Frequently Asked Questions: Federal Home Loan Banks' Affordable Housing Program*, FHLBanks (2012), http://www.fhlbanks.com/overview_faqs_housing.htm#q1 (last visited April 1, 2012) (stating that the FHLB (Federal Housing Loan Banks) Affordable Housing Program "is a competitive grant program that serves as the largest source of private sector grants for housing and community development in the country. It provides FHLBanks' member institutions the opportunity to partner with local developers and community organizations.").

39 Housing and Economic Recovery Act, Pub. L. No. 110-289, § 1117, 122, Stat. 2654 (2008).

40 *See* Housing Finance Reform Act, H.R. 1859, 112th Cong. § 3 (2011), *available at* http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.1859.IH (follow "Thomas" hyperlink; select "Campbell, John [R-CA-48]" from "Select a Representative" dropdown menu; follow "Go" hyperlink and follow "H.R.1859" hyperlink). Others have made secondary mortgage market reform proposals similar to the HPC proposal. *See id*; *see also* Zandi & de Ritis, *supra* note 22.

41 *See infra* notes 75–105 and accompanying text.

A. Mortgage Securities Insurance Companies

Under the HPC proposal, the credit enhancement function of the GSEs would be performed by private companies called Mortgage Securities Insurance Companies, or MSICs.[42] The MSICs would guarantee the payment of interest and principal on mortgage securities backed by "traditional" mortgages.[43] MSICs would be, in effect, mono-line insurers for MBSs.[44] They could not engage in mortgage underwriting or servicing or offer any other form of insurance.[45]

Unlike the GSEs, which are chartered by an act of Congress, MSICs would be chartered and supervised by the FHFA, much like national banks are chartered and supervised by the Office of the Comptroller of the Currency. Also, like national banks, MSICs would not be backed explicitly or implicitly by the federal government. They would compete and could succeed or fail based on market forces. MSICs would pay state and local taxes, like banks do, and would be required to register their stock and debt with the Securities and Exchange Commission.[46]

The HPC proposal does not require a particular organizational structure for the MSICs. Instead, the investors in the MSIC would be able to determine the most appropriate organizational structure for a MSIC, subject to the review and approval of the FHFA.

The HPC proposal does not mandate a specific number of MSICs. Presumably, a minimum of four would be needed to serve the residential mortgage market. The greater the number of MSICs, the better insulated the housing finance market would be from the failure of any one company. On the other hand, too many MSICs with different underwriting systems and procedures could become overly burdensome to lenders, particularly smaller lenders.

---

42 *Legis. Proposals*, *supra* note 4, at 4.

43 HPC defines a "traditional" mortgage to include prudently underwritten conventional mortgage products, including various forms of fixed-rate mortgages (e.g., 15- or 30-year loans), and adjustable rate mortgages underwritten to their fully indexed rate at the time of origination.

44 *Legis. Proposals*, *supra* note 4, at 6–7.

45 *Id.* at 6.

46 HPC does not propose to require the registration of the mortgage securities issued by a MSIC in order to preserve the integrity of the to-be-announced, or "TBA," market, which facilitates the purchase and sale of mortgage-backed securities prior to the designation of specific mortgages to the pool of mortgages that back the security. This market allows lenders to sell loans on a forward basis and thereby hedge risks. It also allows borrowers to lock in rates prior to settlement. As a substitute for SEC registration, HPC would support a requirement that investors be provided with information about the composition of each pool of mortgages backing a security, including the average loan-to-value ratio, the average debt-to-income ratio, the average borrower credit score, the number and value of mortgages from each state, the distribution of mortgage coupon rates, and whether the mortgages were originated in broker or non-broker channels.

MSICs could take any organizational form. In other words, a MSIC could be organized as a corporation, a partnership, or a joint venture. It would be up to the investors in the MSIC to determine the most appropriate structure to attract capital, subject to the review and approval of FHFA.[47]

Any individual or entity or any combination of individuals or entities could form a MSIC, provided the organizers demonstrate a capacity to fund and manage the MSIC in a "safe and sound" manner.[48] Also, the organizers of a MSIC could decide to focus on a particular segment of the market. For example, a group of community banks could form a MSIC to purchase mortgages from community banks. A group of developers could form a MSIC to purchase multi-family mortgages from a MSIC.[49]

B. Capitalizing MSICs

The ability to attract private sector capital to MSICs is a key to the success of the HPC proposal.[50] HPC has concluded that MSICs could be capitalized at a level that would permit them to operate through a high stress environment comparable to the recent financial crisis and provide a reasonable return to investors.[51] HPC has also found that this capital and fee structure would keep mortgage costs to consumers at much more reasonable levels than other alternatives.[52] These conclusions are based upon HPC's analysis of the amount of capital, returns, and guarantee fees required of MSICs under various housing price decline scenarios.[53]

The economic model used in the HPC analysis assumed that private sector investors would need to receive a return of 10–15% on their capital contributions.[54] The model also assumed that the mortgages in the pools securitized by a MSIC (i.e., traditional mortgages) had an 80% loan-to-value

---

47 *Housing Finance-What Should the New System Be Able to Do: Part II-Government and Stakeholder Perspectives Before the H. Fin. Servs. Comm.*, 112th Cong. 6 (2010) (statement of Anthony T. (Tuck) Reed, Executive Vice President, Capital Markets SunTrust Mortgage, Inc., on behalf of The Financial Services Roundtable).

48 *Id.*

49 A large bank or bank-holding company could own a MSIC, but current accounting standards likely would require that the MSIC's accounts be consolidated with the parent bank or bank-holding company. This would eliminate the capital advantages that normally accrue to a bank when it sells mortgages into the secondary market. Thus, it seems unlikely that a large bank or bank-holding company would form a MSIC.

50 *Legis. Proposals*, *supra* note 4, at 6.

51 *Id.*

52 *See id.* (stating that "a range of private investors would be willing to invest in these new companies").

53 *See Legis. Proposals*, *supra* note 4, at 6. Hous. Policy Council, The Mortgage and MBS Market Landscape 6 (June 2011) (unpublished analysis) (on file with author).

54 *See* Mortgage and MBS Market Landscape, *supra* note 54, at 5.

ratio, a debt-to-income ratio of 31%, a FICO score of 750, and were fully documented.[55]

HPC first tested this model against an economic scenario that assumed a price decline of 10% over a five year period, level housing prices for the next five years, and then 3% price increases for the life of the mortgage pool.[56] That test showed that a MSIC could continue to operate in such an economic environment if it had initial capitalization of 52 basis points and it charged a guarantee fee of 20 basis points. These results validated HPC's economic model since they approximate the capital and guarantee fee structure of the GSEs prior to their failure.

Given the failure of the GSEs, these results also made it evident that the capital and fee structure for MSICs must withstand a housing price decline greater than 10%. Thus, HPC applied its model to housing price declines of 20, 30, and 40%, using the same assumptions for a required rate of return for investors and the composition of the loan pool.[57] Table 1 shows the results of that analysis.

Table 1[58]
Capital and Fees for MSICs Based Upon Different HPI Declines

	Probability of Housing Price Declines Exceeding the Given Percentage	Present Value of Losses	Initial System Capital	Annual Guarantee Fee
-10%	10%	1.22	0.52	0.20
-20%	4.5 to 2.5%	5.10	2.39	0.66
-30%	.10%	9.61	4.46	1.20
-40%	0.0%	13.39	6.15	1.58
GSEs Pre-Crisis			0.45	0.17
GSEs Post-Crisis			NA	0.35

Of these scenarios, HPC concluded that a 20% decline was the most realistic for planning purposes because it represents the mid-point between the declines recorded by the FHFA housing price index and the Case-Shiller index over the course of the recent financial crisis.[59] Capitalizing a MSIC for

---

55 *Id.* at 4.
56 *Id.* at 3.
57 *Id.* at 6.
58 *Id.*
59 FHFA.GOV, http://www.fhfa.gov/Default.aspx?Page=14 (last visited Apr. 1, 2012). The FHFA index for quarterly purchases only and all transactions shows a 15% decline between the second quarter of 2007 and the first quarter of 2010. *Id.* The comparable decline

that stress level requires approximately 240 basis points in capital, or approximately $24 billion a year to support annual loan originations of $1 trillion.[60] Additionally, the total guarantee fees required with a 20% decline would be 66 basis points, an increase of some 30 to 35 basis points over the guarantee fees currently charged by the GSEs.

These results are not only consistent with capitalization and guarantee fee estimates developed by other sources, but are somewhat more conservative than other estimates, as shown in Table 2.

Table 2
Comparison of HPC Capitalization and Fee Model with Other Models*

Source	Scenario	Capital	Fee
HPC	-20% HPI	240 bps	66 bps
Credit Suisse	'06 to present	170 bps	45 to 55 bps
Goldman Sachs	NA	NA	50 bps
Moody's/Zandi	-20% HPI	NA	44 bps

**Information in this chart was based upon estimates made as of February 2011.*

Finally, HPC estimated the impact on mortgage rates if the capital and fees for MSICs were set to withstand a 20% decline in housing prices. HPC found that the monthly rate on a $250,000, 30-year, fixed-rate residential mortgage loan would increase by approximately 36 basis points or some $56 per month. In other words, HPC found that the cost of mortgages for consumers would increase under the MSIC structure, but, as noted below, the increase under the MSIC structure would be much less than the increase under a structure in which the Federal Government does not provide a catastrophic guarantee on MBSs.

C. MBS Securitization Facility

In addition to the creation of MSICs, the HPC proposal calls for the creation of an MBS securitization facility.[61] This facility would create, label, and administer mortgage securities for MSICs and investors. In addition, this would "place and administer the federal catastrophic guarantee on the [mortgage securities]. In other words, this facility would perform functions similar to those performed by Ginnie Mae for the [Federal Housing

in the Case-Shiller index was 32 percent. *See* S & P/Case-Shiller Home Price Indices, STANDARD AND POORS, http://www.standardandpoors.com/indices/sp-case-shiller-home-price-indices/en/us/?indexId=spusa-cashpidff--p-us---- (last visited Apr. 1, 2012).

60 Capitalization at 240 basis points would cover 95.5–97.5% of all possible outcomes.

61 *Legis. Proposals*, *supra* note 4, at 6.

Administration]."[62] The facility could be part of FHFA, but Ginnie Mae could be selected to perform the services of the facility on a contract basis.[63]

This facility would also facilitate the creation of a single mortgage-backed security.[64] Currently, "there are some differences in the terms and repayment characteristics of the [mortgage securities] marketed by the two GSEs. These differences can, from time to time, result in differences in market liquidity."[65] The HPC proposal would require all MSICs to adhere to a standard form for the mortgage securities they issue that provides for common repayment terms and other conditions.[66] A common form would promote better understanding of the securities issued by MSICs, and it would enhance the liquidity of the market,[67] ensuring that "homebuyers have consistent access to reasonably priced home financing."[68]

D. Affordable Housing

The HPC proposal calls for replacing the numerical housing goals that applied to the GSEs with an obligation for MSICs to indirectly support "owner-occupied and rental housing for extremely low and very low income families."[69] Specifically, the HPC proposal would require each MSIC to dedicate a specified percentage of its revenue to affordable housing.[70] These could be distributed under an application and grant program similar to the FHLB Affordable Housing Program, or they could be transferred to HUD for subsequent distribution by a formula to state and local housing finance authorities.[71]

E. World Class Regulator

Finally, to "ensure the safe and sound operation of MSICs" and reduce the potential for the federal government to perform on its guarantee, HPC proposes that MSICs be subject to world class regulation by FHFA.[72] This regulatory regime should include strong capital, liquidity, and other prudential standards, as well as strong underwriting standards that ensure that mortgages purchased by a MSIC are "prudentially underwritten."[73]

---

62 *Id.* at 6–7.
63 *Id.* at 7.
64 *Id.*
65 *Id.*
66 *Id.*
67 *Legis. Proposals*, *supra* note 4, at 7.
68 *Id.*
69 *Id.*
70 *Id.*
71 *Id.*
72 *Id.* at 10.
73 *Legis. Proposals*, *supra* note 4, at 6.

V. THE CASE FOR A LIMITED BUT WELL-DEFINED FEDERAL GUARANTEE

A central feature of the HPC proposal is an explicit federal guarantee on the MBSs issued by MSICs.[74] To be clear, this federal guarantee would not apply to the MSICs themselves; it would apply only to the MBSs that they issue.[75]

HPC believes that this explicit federal guarantee is needed to give the broadest possible range of investors confidence in the mortgage securities issued by the MSICs while also creating a catastrophic reinsurance fund made up of private capital.[76] This would "ensure a steady flow of mortgage finance at a reasonable cost to borrowers" during all economic conditions while offering maximum taxpayer protection in the event of a crisis.[77] Without such a guarantee, HPC believes it is likely that MBS investors will seek alternative investments, the overall level of funds available for housing finance will decline, and the cost of mortgage credit will increase. Furthermore, as shown in the recent crisis, "in times of market stress, even well-capitalized firms can find that funding becomes prohibitively expensive or even inaccessible, and this can prevent them from continuing to provide new credit when borrowers need it."[78]

The HPC case for this federal guarantee is based largely on the nature of the firms that purchase MBSs in the secondary market.[79] As was noted at the outset of this article, two-thirds of the funding for residential mortgages is provided by the secondary market.[80] Many of the investors in this market are rates-driven fiduciaries acting on behalf of clients. In other words, they are not credit risk-takers, and historically, they have purchased MBSs issued by the GSEs and Ginnie Mae on the basis of the implicit (and now explicit) federal guarantee of those securities.[81] Table 3 lists the major holders of MBSs issued by the GSEs and Ginnie Mae as of 2010.

---

[74] *Id.* at 17.

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *Housing Finance*, *supra* note 48, at 7.

[79] *See* PHILLIP SWAGEL, MILKEN INST., REFORM OF THE GSES AND HOUSING FINANCE 19–21 (2011). Some academics also make the case for a guarantee on the assumption that the Federal Government will always support the housing market in periods of economic stress and, thus, it is preferable from an economic perspective to recognize that support with an explicit guarantee and price for it accordingly in advance. *See id.*; *see also* Testimony of Adam Levitin, Professor of Law, Georgetown Univ. Law Ctr., before U.S. S. Comm. on Banking, Hous., and Urban Affairs, *Housing Finance Reform: Should there be a Government Guarantee* (Sept. 13, 2011).

[80] *See supra* note 10 and accompanying text (describing the portion of residential mortgage credit that derived from the secondary mortgage market itself).

[81] *See* ACHARYA ET AL., *supra* note 13, at 13 (stating that because GSEs' debt is "implicitly guaranteed by the U.S. government, GSE debt is relatively risk insensitive").

Table 3
Agency MBS Holders in 2010[82]

Money Managers	23%
Federal Reserve and Treasury	23%
Commercial Banks[83]	22%
Foreign Investors	13%
GSEs	11%
Other Investors	6%
State and Local Governments	2%

Absent the certainty of a federal guarantee, HPC believes that many of these investors would place funds in other markets, and the volume of funds available for residential mortgage credit would diminish—possibly markedly. Credit Suisse, for example, has estimated that a purely private secondary market could be less than half its current size, as many investors have a limited appetite for mortgage credit risk or face fiduciary and other limitations on investments.[84] This means that annual mortgage originations could fall from approximately $1.5 trillion to $750 billion in the absence of a federal guarantee.

Such a reduction in the availability of mortgage funding would translate into higher mortgage costs for consumers. Mark Zandi of Moody's Analytics has estimated that the increase could range from 40 to 140 basis points, and it is possible the increase could be even greater.[85]

The absence of a federal guarantee for investors in MBSs also would translate into fewer 30-year, fixed-rate mortgages. Today, over 94% of borrowers choose a fixed-rate mortgage over an adjustable rate mortgage.[86] They do so because they prefer certainty provided by the fixed-rate, even when an adjustable rate mortgage may carry a lower annual payment. Again, Zandi has estimated that only 10–20% of borrowers would have access to a 30-year, fixed-rate mortgage if MBSs were not backed by a federal guarantee.[87]

---

[82] This chart is based on unpublished data. For similar data, see Alan Boyce et al., Streamlined Refinancings for up to 14 Million Borrowers 12 (Aug, 2011), *available at* http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=7218735.

[83] Banks typically purchase MBSs for liquidity purposes.

[84] *See* MAHESH SWAMINATHAN, CREDIT SUISSE, WHY A GOVERNMENT BACKSTOP FOR CONVENTIONAL MBS IS NECESSARY 6 (May 2011) (describing the holdings of non-bank private institutions).

[85] Zandi & de Ritis, *supra* note 22, at 10.

[86] On average, 81 percent of consumers have selected fixed-rate mortgages since 1995. FED. HOUS. FIN. AGENCY, ANNUAL, ALL HOMES, 1963-2010, *available at* http://www.fhfa.gov/Default.aspx?Page=252.

[87] Zandi & de Ritis, *supra* note 22, at 12.

Banks cannot be expected to step in and fill the gap left by the departure of traditional MBSs investors. There is simply not enough capacity on bank balance sheets. Currently, the total mortgage market in the United States (both residential and commercial) is almost $14 trillion, and total assets of banks are just over $16 trillion.[88] Moreover, mortgages, as a percentage of United States bank assets, are near an all-time high. One to four family residential mortgages are around 17% of total United States bank assets and total real estate asset concentrations are close to 33%.[89]

Additionally, recent experience shows that private mortgage securities markets are subject to investor runs, much like bank runs. In the mid-2000s, private label securities accounted for up to 40% of new mortgage originations.[90] In the wake of the financial crisis, however, that market has largely disappeared.

Arguably, the rates-driven investors in MBSs could adjust to a market that does not include a federal backstop. However, it would take years for investors to reach that point, and it is debatable whether the market would ever resume current levels of mortgage originations. In the interim, the consequences for consumers would be dramatic, as Table 4 shows.

---

88 *See Examining the Hous. Fin. Sys.*, *supra* note 1, at 5.

89 FED. DEPOSIT INS. CORP., *Quarterly Banking Profile Balance Sheet*, http://www2.fdic.gov/qbp/index.asp (last visited Mar. 20, 2012).

90 FED. HOUS. FIN. AGENCY, CONSERVATOR'S REPORT ON THE ENTERPRISES' FINANCIAL PERFORMANCE SECOND QUARTER 2010 4 (2010), *available at* http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf.

Table 4
Federal Guarantee or No Federal Guarantee[91]

	Federal Guarantee	**No Federal Guarantee**
Total Annual New Mortgage Originations	$1.5 trillion	$750 billion
Cost of Mortgages to Consumers	+36 bps (assuming MSICs are capitalized to withstand a 20 percent decline in housing prices)	+40 to140 basis points or more
Access to 30-Year, Fixed-Rate Mortgage	80 to 90 percent of borrowers currently select long-term, fixed-rate mortgage loans	Only 10 to 20 percent of borrowers would have access to long-term, fixed-rate mortgage loans
Access to Mortgage Credit in Stress Conditions	Yes	Reduced
Pre-Financed Fund to Cover Potential Taxpayer Exposure in Stress	Yes	No

HPC recognizes that a federal guarantee imposes an obligation on taxpayers.[92] However, rather than run the risk of the consequences summarized in Table 4, HPC believes that the better course of action is to

---

[91] *See* Zandi & de Ritis, *supra* note 22, at 8 (presenting similar analysis).

[92] *Legis. Proposals*, *supra* note 4, at 5. HPC also recognizes that other major developed countries have stable housing finance systems and high levels of homeowners without a federal guarantee. David Min, Ctr. for Am. Progress, *True North: The Facts About the Canadian Mortgage Banking System* (Aug. 26, 2010), *available at* http://www.americanprogress.org/issues/2010/08/true_north.html. However, it is difficult to compare the United States housing market to the housing market in other countries. As noted above, the United States market is huge. The mortgage market in Canada, for example, is one-tenth the size of the United States market. *Id.* Also, mortgage products and legal rights are significantly different in other countries. *Id.* ARM products, not 30-year, fixed-rate mortgages, are the dominant mortgage product. *Id.* Lenders can assess prepayment penalties on borrowers, and even pursue all of a borrower's assets if the borrower defaults on a mortgage loan. *Id.* Additionally, most developed countries provide substantial indirect support to housing through support of the sovereign banking systems, which are much more concentrated than the United States market. *See id.*; *see also* Mark J. Perry, *Due North: Canada's Marvelous Mortgage and Banking System*, THE AM. (Feb. 2010), *available at* http://www.american.com/archive/2010/february/due-north-canadas-marvelous-mortgage-and-banking-system.

structure the guarantee to offer maximum taxpayer protections and market certainty in times of stress.

Accordingly, HPC proposes that the federal guarantee be triggered *only* after several layers of private capital are exhausted.[93] The layers of private capital standing before the government's guarantee would be:

- "The down payment on a mortgage made by the homebuyer;"[94]
- Any private mortgage insurance or other private guarantee on the mortgage loan (if the loan-to-value is greater than 80%);[95]
- "The shareholders' equity in the MSIC; and"[96]
- "[A reserve fund] established by fees paid by MSICs in return for the government's guarantee."[97]

As discussed above, the capital and guarantee fee structure for MSICs could be set at a level that ensures the survival of MSICs in even the most stressful environments.[98] For example, if a MSIC is capitalized to withstand a 20% decline in housing prices and is required to pay guarantee fees commensurate with that risk, the probability that it would fail and expose taxpayers to any risk is no greater than 4.5%.

The proposed reserve fund would operate similar to the fund maintained by the Federal Deposit Insurance Corporation.[99] Part of the guarantee fee paid by MSICs would be deposited into this fund in return for the federal guarantee.[100] The reserve fund would be tapped to make principal and interest payments to MBSs investors in the event of the failure of a MSIC.[101] The federal government would be required to perform on the federal guarantee only if that fund were exhausted.[102]

HPC has also stated in testimony to Congress that it would support a recoupment provision as part of its proposal.[103] Such a provision would require MSICs to repay taxpayers in the event that the reserve fund which stands behind the federal guarantee is exhausted. This is similar to how the FDIC insurance fund currently operates.

---

[93] *Legis. Proposals*, *supra* note 4, at 5.
[94] *Id.*
[95] *See id.*
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Legis. Proposals*, *supra* note 4, at 5.
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.* Congress refers to the recoupment provision as "special assessment." *See id.*

In sum, HPC believes it is possible to design a limited, but well-defined, federal guarantee that provides sufficient confidence to MBSs investors while providing maximum taxpayer protection.[104]

VI. A FINAL NOTE ON TRANSITION

The transition from our current secondary market system to a new system will take some time and will involve many difficult issues. HPC has identified some of the issues that should be addressed during this transition.[105]

HPC believes that it is important to continue the operations of the GSEs until the new system is in place. Without the continued operation of the GSEs, the flow of housing finance could be severely disrupted.[106] Additionally, "borrowers should have uninterrupted access to reasonably priced housing finance along with other benefits they enjoy today (for example, access to 30 year fixed rate mortgages and the ability to lock a rate while loans are in process)."[107] Furthermore:

> The transition must ensure the continued liquidity of today's agency MBSs market and the "to be announced" (TBA) MBSs market in particular which allows lenders to better insulate consumers from the uncertainty of markets and to hedge their risks (thereby reducing borrowing costs) . . . . The transition must find a fair and equitable way to deal with the legacy assets and liabilities of the [GSEs and]

---

[104] *See* Press Release, Fin. Servs. Roundtable, *supra* note 3. For example, HPC indicated:

> [Additionally], if the fees for the federal guarantee are set properly, the federal guarantee would be budget neutral. Under existing federal credit procedures, the cost of federal credit [programs] in a [given] year is the net present value of all expected future cash flows from guarantees and direct loans disbursed in a year. For loan guarantees, cash inflows consist primarily of fees charged to insured borrowers, and cash outlays consist mostly of payments to lenders to cover loan defaults. FHA and Ginnie Mae are models for [such] budgetary treatment. In the case of both FHA and Ginnie Mae, the fees paid for the federal guarantee provided by those agencies normally cover claims on the guarantees and other operational expenses.

Legis. Proposals, *supra* note 4, at 5–6.

[105] *See* Housing Finance Reform Act, H.R. 1859, 112th Cong. § 3 (2011), *available at* http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.1859.IH (outlining a transitional process that begins with the development of a transitional plan by the FHFA and includes enhancements to FHFA personnel and resources, along with the development of a regulatory and supervisory regime for FHFA to charter, supervise, and regulate new private firms that would replace the GSEs after a specified period of time).

[106] *Legis. Proposals*, *supra* note 4, at 8.

[107] *Id.*

> should seek to utilize the valuable infrastructure of the [GSEs].
>
> [Finally, t]he transition should be allowed sufficient time for proposed changes to be clearly communicated. Where possible, gradual steps should be used and "tested" before proceeding to broader implementation. Given the size, importance, and complexity of the housing finance system, expectations should be for this transition to potentially take multiple years to be realized.[108]

VII. CONCLUSION

HPC has developed a comprehensive proposal for building a new and stronger secondary mortgage market that seeks to address the flaws inherent in the structure and operations of the GSEs. The proposal encourages private sector capital to support the secondary mortgage market by replacing the GSEs with several privately capitalized companies. The proposal seeks to ensure a steady flow of reasonably priced conventional mortgages to consumers, including 30-year, fixed-rate mortgages, through the placement of a backstop or catastrophic federal guarantee on the mortgage securities issued by the firms that succeed the GSEs. At the same time, the proposal seeks to shield taxpayers from any risk due to this guarantee through several layers of private capital and strong regulation and supervision of the entities that replace the GSEs, including capital and fee standards that are designed to allow those entities to withstand another financial crisis.[109] Finally, the proposal envisions a continued obligation for the secondary market to support affordable housing.[110]

---

[108] *Id.*
[109] *Id*. at 5.
[110] *Id.*