Johnson-Crapo for Dummies *

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Background

Most Americans want to own a home. Homes, however, cost a great deal of money, and, therefore, most Americans must borrow the money needed to buy a home. Those facts have given rise to a mammoth housing finance industry, one that can spur the U.S. economy or deflate it, depending upon how successfully it performs.

Most home loans are made by lenders who are regulated primarily by the Federal Government. To avoid a series of failures by over aggressive lenders, the Federal Government has imposed a variety of regulations relating to how they can finance residential mortgages, including one that assesses heavy penalties if they make loans to consumers whom they do not reasonably believe can repay the loans. The regulation, however, provides protection from those penalties if the loans they make meet certain federally defined standards for what are called Qualified Mortgages, or QMs. The standards have created very conservatively underwritten loans and defaults on them are expected to be very low.

Lenders, particularly bank lenders, must have on their balance sheets a supply of capital to protect against failure when loans go bad. While capital rules are very complex, particularly for the larger banks, capital must be in the range of 6 to 8 percent. Part of the rules judge the risk of assets against which capital provides protection, and residential mortgages, as well as mortgage servicing, are not risk free for capital purposes. Therefore, bank lenders are limited in how much of these assets they can retain.

Therefore, lenders search for ways to make mortgage loans but then remove them from their balance sheets to free up their capital to make more loans. The economy will benefit if good ways to do this can be devised, since lenders will be able to finance more Americans that want to buy homes.

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Americans thought they had found that answer when they created Freddie Mac and Fannie Mae to serve as the catalyst for moving mortgage loans off bank's books. To understand that, first understand mortgage backed securities.

Mortgage backed securities (or MBS) are formed when entities (sometimes banks) aggregate mortgage loans that they make or that they purchase from other originators, bundle them together, then sell the rights to portions of that pool of mortgages as individual securities to third parties. Those are securities backed by mortgages, hence MBS.

The government created Fannie Mae and Freddie Mac to do that, and in addition, to guarantee that the holder of the securities would receive timely payments as the securities indicated they would. That permitted longer term mortgages (30-year mortgages) to be originated, since the government was willing to assume the risk over the entire 30 years. Banks could not assume that same risk because they are funded by shorter term debt (e.g., deposits) and the cost of accounting for that would have required fees and interest rates that would make the loans unavailable to most borrowers. That is why the majority of mortgage loans in the U.S., unlike most countries, are 30-year mortgages rather than 5- or 10- or 15-year mortgages.

From the perspective of the consumer, a 30-year term moves the risk that interest rates will change to the lender and the government; shorter terms would require the consumer to face changed interest rates more frequently. Of course, if interest rates fell during that period, the consumer would benefit, but most consumers would prefer not to assume the interest rate risk.

Fannie Mae and Freddie Mac were called Government Sponsored Enterprises, or GSEs. They were not obligated to hold as much capital on their books as banks for reasons that are not quite clear. Generally, residential mortgages were seen as assets that carried a very low level of default risk, and therefore, a GSE operating in that space was probably seen as not carrying much risk. GSEs had private shareholders and were given many governmental preferences, thereby providing staff and shareholders subsidies resulting in higher profits and compensation than could have been available otherwise. They also were required to meet certain affordable housing goals, the extent of which varied depending upon the government policies. To further their position, the GSEs established a foundation through which they channeled some profits for distribution to whatever groups their staffs chose.

With the housing downturn, many loans the GSEs purchased for their own books became delinquent, and by meeting the insurance obligations, the GSEs exhausted their capital and still faced billions of dollars in losses. At that point, the government put them into conservatorship where they now remain.

The question now is how to revive the secondary market so that additional liquidity can enter the housing finance market, and that's where a bill by Senate Banking Chairman Tim Johnson and Ranking Member Mike Crapo (the Johnson-Crapo bill) comes into play. Here is a dumbed down version of the lengthy and carefully crafted bill, a draft of which was released in March.

Johnson-Crapo

This bill does not try to reform the entire field of housing finance. It simply tries to establish a structure and system that will retain the beneficial aspects of the GSEs without perpetuating the bad. The goals of the legislation are: the continuation in the U.S. of the option of a 30-

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year mortgage; establishment of a system that will encourage the greatest amount of liquidity in the housing secondary market as possible; safety and soundness features that will avoid excessive exposure by the Federal Government to the vicissitudes of the housing and financial markets; and avoidance of subsidies by the Federal Government that accrue to private non-consumer participants in the system.

1. First it eliminates Fannie and Freddie over a five year period with the possibility of extending that a bit. It then establishes a government agency, the Federal Mortgage Insurance Corporation, that it models on the Federal Deposit Insurance Corporation to oversee the housing finance system. That agency will provide a guarantee of the payment of amounts due on any MSBs that are approved by FMIC, but only after prior private guarantees are exhausted. To provide reserves against which any such payments might have to be paid in the future, the FMIC will be required to establish a reserve (think — the FDIC's Deposit Insurance Fund as a comparable) which it will fund from fees that it charges those that want to use the system. The Mortgage Insurance Fund would be funded initially by assessments on Fannie and Freddie as they were being wound down, and afterwards by assessments on participants. FMIC will be governed by a presidentially appointed Board of Directors. FHFA will continue but as a department of FMIC.

2. FMIC would establish securitization and underwriting standards for any MBS that carry the government guarantee. Loans covered would have to meet the QM standards, and would have to include down payments of from 3.5 percent to 5 percent, depending upon whether the borrower had owned a home previously.

3. FMIC's insurance would not come into effect on a defaulted security until the private protection was first exhausted. That private protection could be in the form of a guarantee by a private guarantor, or by contractual language in the securities themselves that require the securitizer or other private party to absorb the first 10 percent of loss in the MBS. The government would be exposed to any loss beyond that, but with the loans in the pools being QM eligible loans, the chances are very slim that the 10 percent loss would be breached. The losses the GSEs experienced during the past downturn, even when loans were not limited to loans of high quality such as QM loans, were well below that number, somewhere in the neighborhood of 4 to 5 percent. It is not clear if there is a limit to the loss that the guarantor can be expected to absorb; it appears that the guarantor would have to exhaust all of its ability to absorb losses before the government guarantee would be activated, if that form of protection was used. If by contract in the capital market, the contractual provision would ensure that the government backstop did not take place before 10 percent of the loss in the securities had been taken by the private sector.

4. The MBS will be issued through a system or platform that will be the same for all MBS that are guaranteed by the government. The platform will be governed by a board composed of at least five members, one of whom will represent the interests of small lenders. The platform will be required to meet standards established by FMIC. There will be separate platforms for each of the products to the extent necessary, and there will be a focus on assuring the liquidity of the 30-year fixed rate product. The common platform will create efficiency in the market.

5. The GSE requirement to meet affordable housing goals will be eliminated, and affordable housing will be addressed through the funding of existing affordable housing funds and the

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establishment and funding of an additional such fund. The funds will be provided by an assessment in the form of fees to those securitizing MBS that receive the government backstop and over time would become quite substantial. FMIC would have the discretion to use these funds in ways to promote affordable housing.

6. Fannie and Freddie will phase out of existence, with the first benchmark for total withdrawal being five years after the effective date of the bill. If that proves to be too short a time period, the period can be extended.

Clearly, a bill this significant raises many issues that must be discussed and considered before final passage. But the broad outline of the bill addresses the major purpose, namely reform of the current government presence in the secondary markets: (1) It ensures liquidity in the market, thereby making home loans accessible to a broad group of U.S. consumers; (2) It severely restricts the exposure of the U.S. government to a downturn in the housing market; (3) It places loss to the private sector before loss to the government in any such downturn; (4) It eliminates the inequity of private shareholders benefitting from government subsidies; and (5) It provides private sector funding of government affordable housing funds to assist consumers who cannot qualify for loans under the QM rules.

Mark-up scheduled

A markup is scheduled in the Senate Banking Committee late this month. While the full scope of the bill will, of course, be open to consideration by the committee, a few issues seem to be surfacing: What is the proper array of powers that any one private sector entity can have? What kinds of protections should be in place if the system does not begin as quickly and as fully as expected? Has the bill adopted the proper balance between those concerned about the losses suffered by the government in the protection of Fannie and Freddie during the recent downturn, and those who want to perpetuate the 30-year mortgage? What is the proper scope of powers that FMIC and the securitization platform should exercise?

And, of course, the big question, how to craft a bill that can get strong bipartisan support in the committee to provide the Senate with a strong bargaining position in any conference with the House Financial Services Committee on the companion bill that that committee has already passed?

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