Federal Housing Finance Agency
Office of Inspector General

Enterprise Reform

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Introduction

This report offers a framework for understanding proposed reforms of the enterprises in relation to what contributed to their financial difficulties following the 2004-2007 "housing boom" and what they and FHFA have done to fix their problems while they wait for a legislative decision concerning their future role in the housing finance system.

The enterprises continue to dominate the secondary mortgage market where loans are purchased; bundled together into MBS; and then bought, sold, or held as investments. Indeed, since September 2008, the enterprises have owned or guaranteed three out of every four mortgages in the United States.[1]

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Historically, the enterprises were intended to help stabilize the secondary market and facilitate the flow of mortgage credit by purchasing mortgages from lenders, which, in turn, would be freed up to make more mortgage loans.[2] As the housing boom collapsed, however, they became insolvent, resulting in their entering conservatorships under FHFA's supervision in 2008. Since then, the agency has worked to conserve and preserve their assets and ensure that they follow prudent business practices.

Initially, FHFA understood the conservatorships to be more of a temporary "time out" to stabilize the enterprises while, in the Acting Director's words, "Congress and the Administration could figure out how best to address future reforms."[3] But, five years later, the enterprises remain in conservatorship, and their exact role—and that of the larger housing finance system—awaits legislative resolution.

Over time, as it became more obvious that the conservatorships would not be temporary, FHFA amended its strategic plan to better describe its additional conservatorship responsibilities. In its strategic plan, FHFA advises that its objective is (and has been) to guide the enterprises in a way that accomplishes what has generally been agreed to—restoring their financial fitness and reducing their market footprint—while not precluding any of the major enterprise reform proposals, which range from privatizing to eliminating the enterprises.

Below, we briefly summarize the enterprises' history, what caused their liquidity problems, and FHFA's strategy for helping to restore them while leaving open legislative options for reforming them. Against this backdrop, we highlight the major reform proposals on the table and the major stakeholders who offered them. Our goal is not to promote a particular policy but to provide useful information for the coming debate.

Falling Into Crisis

The housing GSEs have a long history. Understanding their role over the years is essential.

The Great Depression of the 1930s Leads to Federal Intervention in the Housing Market

Before the 1930s, housing finance was exclusively the realm of the private sector. Typical loan conditions—up to 50% down payments, terms of 10 years or less, and large balloon payments—put homeownership out of reach for many Americans.[4] Without a nationwide housing finance market, the availability and pricing of mortgage loans also varied widely across the country.[5]

When the Great Depression of the 1930s hit, the effects on housing were disastrous. Unemployment climbed to over 23% in 1932. Up to a quarter of all mortgages were in default by 1933.[6] And due to failures and mergers, half as many commercial banks were operating in 1933 as had been in 1921.[7] As the country approached this economic nadir, the federal government created the FHLBank System in 1932 to serve as a reserve credit system to support housing finance and provide relief to troubled homeowners and lenders.[8] Several other interventions followed.

Creation of Fannie Mae and Freddie Mac

Fannie Mae was established in 1938 as a government-held association. Its mandate was to act as a secondary mortgage market facility to purchase, hold, and sell loans insured by FHA. By purchasing FHA-insured loans from private lenders, Fannie Mae created liquidity in the mortgage market, providing lenders with cash to fund new home loans.[9]

Over the years that followed, Congress altered Fannie Mae's form and function in response to shifts in the country's fiscal and economic situations. In 1954, the Housing Act reorganized Fannie Mae as a mixed-ownership corporation with the federal government and Fannie Mae's lenders as eligible shareholders.[10] The Housing Act required Fannie Mae to: improve the availability of capital for home mortgage financing by providing liquidity for mortgage investments and support the mortgage market if there was a threat to the economy's stability. In 1968, the Housing and Urban Development Act reorganized Fannie Mae as a private, shareholder-owned company with government sponsorship. It also gave HUD regulatory authority over Fannie Mae and required that a reasonable portion of its mortgage purchases serve low- and moderate-income families.[11]

The Depression era reforms and the innovations that they fostered (e.g., the 30-year fixed rate and 80% LTV mortgage) were wildly successful from a homeownership perspective. From 1940 to 1970, homeownership rates rose from about 44% to 63%.[12] But Fannie Mae had also become a monopoly.

With the Emergency Home Finance Act of 1970, Congress sought to create a competitor in an expanded secondary mortgage market while further increasing homeownership. Freddie Mac was created in order to help thrift institutions manage the risk associated with interest rate fluctuations.[13]

Thrifts are depository institutions, primarily for consumer savings, such as savings banks and home loan associations. Often, thrifts funded mortgages—long-term obligations—with short-term debts (e.g., savings deposits). This presents a risk when the interest rates of the short-term debts exceed the long-term obligations.[14]

Freddie Mac thus was initially tasked with purchasing long-term mortgages from thrifts, which increased their mortgage funding capacity and reduced their interest rate risk. In 1989, in the aftermath of the savings and loan crisis of the 1980s that resulted in billions of dollars of losses, Freddie Mac was reorganized as a publicly traded shareholder-owned corporation.[15]

In 1992, given ongoing concerns about oversight of the enterprises, Congress passed the Federal Housing

Enterprises Financial Safety and Soundness Act. The law revised the regulatory structure of enterprise oversight and clarified their roles in housing finance by:

- reemphasizing the enterprises' obligations to support mortgage finance through secondary market activities, especially during periods of economic stress;
- establishing the Office of Federal Housing Enterprise Oversight as an independent agency within HUD responsible for monitoring the enterprises' safety and soundness;
- requiring the enterprises to meet specific annual goals for the purchase of mortgages serving low- and moderate-income families, special affordable housing for families, and housing located in central city, rural, and underserved areas; and
- designating HUD as the regulatory authority of the enterprises, and specifying procedures for reviewing and approving new enterprise mortgage program proposals (i.e., the HUD Secretary had final approval of any new program proposal).[16]

Recent Housing Crisis Leads to Conservatorship

From 2001 to 2006, the U.S. housing market saw a massive rise in real property valuation. As single-family home prices increased an average of 12% per year, potential homebuyers and financial institutions alike fought to participate in the booming market.[17] As the housing boom proceeded, lenders increasingly approved higher-risk, high-LTV (i.e., the ratio of the loan value to the value of the home securing it) mortgages for borrowers who had little to nothing for down payments, unverified incomes, and high debt ratios. These mortgages were commonly referred to as subprime. The credit risks associated with such mortgages spread throughout the financial system as the mortgages were bundled into publicly traded MBS issued by the enterprises (known as agency MBS) and private companies (known as private-label MBS).[18]

The dominant players in the secondary mortgage market prior to the housing boom, Fannie Mae and Freddie Mac, strove to maintain their market share during the housing boom. In 2001, the enterprises began buying—for their own investment portfolios—private-label MBS, many of which were collateralized by subprime mortgages.[19] According to GAO, the enterprises' purchases of private-label MBS increased rapidly as a percentage of their retained mortgage portfolios from 2003 through 2006.[20] These purchases—and parallel increases in their guarantee businesses—helped Fannie Mae's assets and guaranteed mortgages grow from $1.3 trillion in 2000 to $3.1 trillion in 2008, while Freddie Mac's increased from $1 trillion to $2.2 trillion.[21]

As their businesses multiplied, the enterprises expanded the scope of loans they would agree to purchase and guarantee. Traditionally, the enterprises had confined their business to lower-risk prime loans. For example, Fannie Mae's *Selling Guide* requires down payments of at least 5% (and mortgage insurance for mortgages covering more than 80% LTV) and debt-to-income ratios of 36% in most cases.[22]

But during the housing boom, Fannie Mae issued unprecedented numbers of variances, or exceptions, from its underwriting guidelines that permitted it to purchase, among other things, zero down payment mortgages made to buyers with low credit scores and unverified income and assets.[23]

Beginning in 2006, home prices started declining precipitously and borrowers began defaulting, and the enterprises owned or guaranteed mortgages worth more than $5 trillion—nearly half of the U.S. residential mortgage market.[24] In 2007 and 2008, the enterprises incurred substantial credit losses due to borrowers not repaying their mortgages and declines in the values of homes securing mortgages that they owned or guaranteed or that collateralized the private-label MBS that they had purchased.[25] The enterprises lost billions of dollars on their multi-trillion dollar MBS guarantee obligations and investment portfolios.[26]

In early to mid-2008, investor confidence in the enterprises also deteriorated. This led to a sharp increase in the enterprises' borrowing costs and drastic declines in shareholder equity as measured by the prices of their publicly traded common stock.[27]

In response to the enterprises' deteriorating financial condition and concerns about the stability of financial markets, Congress enacted HERA on July 30, 2008.[28] HERA established FHFA as the regulator of the enterprises and the FHLBank System and set forth its regulatory responsibilities and supervisory powers, which include expanded authority to place the enterprises in conservatorship. HERA also authorized Treasury to support the enterprises financially.[29]

Six weeks later, on September 6, 2008, the enterprises entered into conservatorships overseen by FHFA due to the significant deterioration in their financial conditions.[30] Along with the conservatorships came substantial financial assistance for the enterprises: to date, Treasury has invested $187.5 billion in the enterprises and the Federal Reserve has purchased more than $1.1 trillion of agency MBS.[31]

Enterprises in Conservatorship

Initially, FHFA's conservatorship was regarded as a temporary "time out"—a chance to stabilize the enterprises and housing market while legislative reform was debated and decided. During this time, the agency took steps to stabilize the enterprises by focusing on mitigating their losses, ensuring families could get mortgage loans, and helping borrowers avoid foreclosure.[32] Examples of the agency's stabilization efforts, some of which were the focus of OIG audits or evaluations, are summarized below. Additionally, these efforts ensure that the enterprises are available to implement whatever housing finance system reform is legislated.

Over time, as it became more obvious that the conservatorships would not be temporary, FHFA began to prepare the enterprises for change. FHFA has implemented a variety of programmatic initiatives designed to facilitate any reforms that are ultimately selected.

Working to Stabilize the Enterprises

Remediating Losses

In the aftermath of the housing bust, it became apparent that mortgage seller/servicers and financial institutions had engaged in behavior ranging from questionable to illegal in order to profit from mortgages and private-label MBS sold to the enterprises. FHFA has made efforts to remediate those problems.

Lawsuits Against 17 Financial Institutions

The enterprises did not have access to the mortgages underlying the private-label MBS they so heavily invested in, leaving them to rely on financial institutions to accurately describe the mortgages backing the securities in marketing and sales materials, as required by securities laws. Under these laws, financial institutions must accurately describe the mortgages that back the securities being sold.[33]

During the summer of 2011, FHFA filed lawsuits against 17 financial institutions,[34] alleging violations of federal and state securities laws in connection with the sale of private-label MBS to the enterprises.[35] FHFA is pursuing claims regarding the inadequate disclosures filed in securities offering documents.[36] FHFA alleges in its complaints that the mortgage collateral securing the private-label MBS had materially different and higher risk characteristics than described in the offering materials.[37]

The complaints seek billions of dollars in damages.[38] In addition, FHFA seeks to recover losses for negligent misrepresentations.[39] Any recovered funds resulting from these efforts may ultimately reduce taxpayers' losses from the enterprises' financial difficulties.[40]

Bank of America Buyback Settlement

In early 2008, Bank of America purchased Countrywide, which was on the verge of failure. Countrywide was one of the most aggressive originators of nontraditional mortgages (e.g., Alt-A and no down payment), and it sold a large number of these mortgages to the enterprises. In late December 2010, FHFA approved two agreements settling various repurchase claims between the enterprises and Bank of America, totaling $2.87 billion ($1.35 billion for Freddie Mac and $1.52 billion for Fannie Mae).

As a condition of their purchases of mortgages, the enterprises require sellers to represent and warrant that their mortgages comply with the enterprises' underwriting and eligibility standards. If mortgages are later found not to comply, then the enterprises can require that the sellers repurchase them. Freddie Mac's settlement resolved most past, present, and future repurchase issues associated with 787,000 loans sold to it by Countrywide. In contrast, Fannie Mae's settlement with Bank of America covered only past and present claims, not future ones.[41]

On January 7, 2013, FHFA approved a supplemental agreement between Fannie Mae and Bank of America worth $11 billion to resolve present and future claims related to mortgages sold to Fannie Mae between 2000 and 2008. In addition, FHFA approved the transfer of servicing rights for roughly 1 million loans from Bank of America to specialty servicers. This transfer of servicing rights benefits borrowers and reduces future credit losses for Fannie Mae. The agreements provide Fannie Mae with a recovery of losses from origination and servicing defects that taxpayers might have had to absorb without a resolution to these matters.[42]

The following minitutorial (see page 7) details OIG's reports on the enterprises' settlements and transactions with Bank of America.

Bank of America Settlements

OIG has issued reports on FHFA's oversight of Freddie Mac's settlement with Bank of America and Fannie Mae's transfer of mortgage servicing rights (MSR) from Bank of America. Regarding Freddie Mac's settlement, in *Evaluation of the Federal Housing Finance Agency's Oversight of Freddie Mac's Repurchase Settlement with Bank of America* (EVL-2011-006, September 27, 2011), we raised concerns about the methodology that Freddie Mac used to determine the number of defective loans purchased from Bank of America that were eligible for repurchase. We determined that Freddie Mac's methodology underestimated the number of defective loans that should have been covered by the settlement because it tended to exclude from its review defective loans that were originated more than two years prior to default. Thus, for loans originated in 2006 alone, nearly 100,000 loans were not reviewed for possible repurchase claims.

In a follow-up report, *Follow-up on Freddie Mac's Loan Repurchase Process* (EVL-2012-007, September 13, 2012), we found that FHFA and Freddie Mac had acted on the concerns raised in the initial report by adopting a more expansive loan review process. Specifically, Freddie Mac changed its policy to review for potential repurchase claims significantly larger numbers of loans that defaulted more than two years after origination. We determined that, as a result of its new loan review process, Freddie Mac will realize between $2.2 billion and $3.4 billion in additional recoveries.

Regarding MSR, in July 2011, Fannie Mae transferred MSR for 384,000 mortgage loans and paid Bank of America a $421 million transfer fee. The deal received media attention, and members of Congress asked OIG to investigate the transaction. In *Evaluation of FHFA's Oversight of Fannie Mae's Transfer of Mortgage Servicing Rights from Bank of America to High Touch Servicers* (EVL-2012-008, September 18, 2012), we concluded the transaction was only the latest in a series of transactions under the High Touch Servicing Program, the concept behind which we deemed to be sound, calling it "a fundamentally promising initiative with the potential to reduce Fannie Mae's—and, by extension, the taxpayers'—losses on mortgage guarantees." However, we found that FHFA could improve its oversight of the program and recommended that the agency consider revising its delegation of authorities to require its preapproval of "unusual, high-cost, new initiatives, like the High Touch Servicing Program."

Lehman Brothers Holdings Inc. Bankruptcy Claim

On September 15, 2008, Lehman Brothers Holdings Inc. filed for Chapter 11 bankruptcy protection, which allows a company to reorganize its business. Many of Lehman's U.S. subsidiaries and affiliates soon did the same (collectively, the Lehman Entities).[43]

When the bankruptcies were filed, Freddie Mac had multiple ongoing business relationships with the Lehman Entities. These business relationships gave rise to several economic claims.[44]

On September 22, 2009, FHFA filed proofs of claim in the Lehman bankruptcies.[45] On December 6, 2011, the bankruptcy court confirmed Lehman's plan for reorganization. Among other things, the plan sets aside $1.2 billion for Freddie Mac's priority claim relating to losses incurred on short-term unsecured loans made to Lehman. In the event that Freddie Mac's claim is not accorded priority status, it will be treated as a senior unsecured claim under the plan and will receive an estimated distribution of 21% (or approximately $250 million) over the next three years.[46]

Strengthening Underwriting Oversight

As mentioned above, Fannie Mae issued a substantial number of variances to traditional underwriting standards to purchase high-risk mortgages, thereby effectively loosening these standards. However, FHFA's efforts to address these practices early in its conservatorship were limited, as OIG reported in 2012.[47]

As the housing market collapsed, Fannie Mae drastically reduced the number of variances it had granted. As of September 2011, the enterprise had reduced outstanding variances from approximately 11,000 for 800 lenders to 638 variances for 188 lenders. Many of the canceled variances related to higher-risk features, such as loans made with unverified income or assets (i.e., Alt-A mortgages).[48]

Preventing Further Losses

Fannie Mae began the High Touch Servicing Program in 2009 when the enterprise discovered that nearly 70% of its losses were the result of nonperforming mortgages held in a particular mortgage portfolio with a principal balance of $300-$400 billion.[49] Fannie Mae decided to transfer to a specialty servicer MSR for that portfolio to reduce further losses.[50] Unlike the typical loan servicer, specialty servicers make significantly more contact with at-risk borrowers, for instance, informing them of the consequences of defaulting and describing ways of avoiding foreclosure. High touch servicing, therefore, has the potential to reduce rates of default and the accompanying foreclosure losses.

Between 2009 and 2011, Fannie Mae invested $1.5 billion in the program in order to transfer 1.1 million mortgages to specialty servicers. As part of the program, Fannie Mae paid transfer fees to the original servicers above the contractual fee.[51] The justification for paying this premium is an estimated savings of 20% on credit losses that Fannie Mae estimates that specialty servicers can generate.[52]

Preventing Foreclosure

From the start of the conservatorships through December 2011, the enterprises completed 2.1 million foreclosure prevention transactions, including permanent loan modifications and other forms of assistance.[53] About 1.8 million of these actions—including nearly 1.1 million permanent loan modifications—allowed borrowers to retain homeownership.[54] Many borrowers had their monthly payments reduced by more than 30%.[55]

FHFA's signature foreclosure prevention initiative is HARP. Introduced in 2009 to help borrowers who were unable to refinance due to a decline in their home's value,[56] the program's goal was to refinance mortgage loans held or guaranteed by the enterprises at a lower interest rate and to a shorter term that would more quickly build equity and get the borrower out of an "underwater" situation.[57]

To offer the benefits of HARP to more borrowers, FHFA changed the program in 2011 (referred to as HARP 2.0). Highlighted changes include the removal of certain risk-based fees, LTV ceilings, and particular property appraisals. Certain representations and warranties procedures were also waived.[58] In addition to reducing foreclosure risk, these changes reduce the enterprises' credit risk and bring greater stability to the mortgage markets.[59] The program's end date has been extended to December 31, 2013.[60]

Preparing for Change

In February 2012, FHFA recognized that there was "no near-term resolution in sight" for the enterprises and released a five-year strategic plan for the enterprises that would "support any outcome of the leading legislative proposals." The plan focuses on extending actions that FHFA has already begun or implemented to meet its mandates of putting the enterprises on sound financial footing and reorganizing, rehabilitating, or winding up their affairs.

Pointedly subtitled *The Next Chapter in a Story that Needs an Ending*, FHFA's strategic plan for the conservatorships is part of its more general aim to lay the groundwork for housing finance reform. Specifically, the agency's goals for its conservatorships are to:

- build a new infrastructure for the secondary mortgage market;
- contract the enterprises' market presence and shrink them; and
- maintain its attempts to prevent foreclosures and to keep money for mortgage loans available.[61]

A few months later, in October 2012, the agency's general objective to prepare for housing reform was made explicit when FHFA released its own strategic plan titled *Preparing a Foundation for a More Efficient and Effective Housing Finance System*.[62] The agency's overarching strategy incorporates key components of its more specific plan for the enterprises under conservatorships in order to "set the stage for recovery and an improved system of housing finance."[63] FHFA sees its conservatorship work of contracting the enterprises and building a new mortgage market infrastructure to be part of its more general goal of preparing for the future of housing finance.[64]

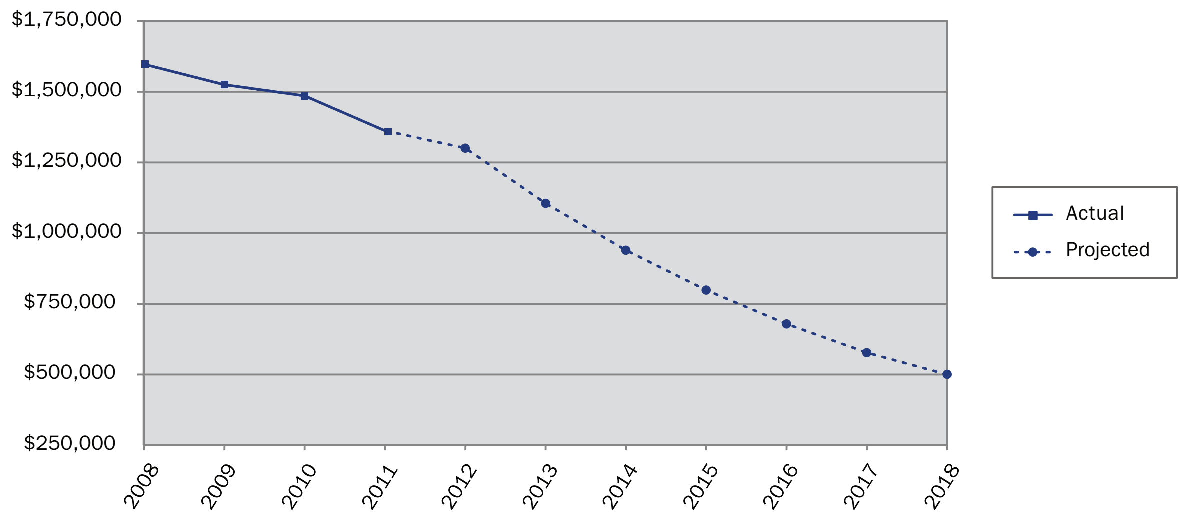
Below, we briefly summarize what FHFA has done and plans to do under its strategic goal to set the enterprises on a path toward reform.

Additionally, FHFA has made it a goal to shrink the enterprises under its conservatorship; the agency sees this as consistent with many of the reform proposals, which generally envision their reduced role and an increased role for the private sector. For example, FHFA worked with Treasury to amend the PSPAs—the investment mechanisms used to rescue the enterprises from insolvency. Now, every cent of enterprise net worth (above a specified amount) must go back to the taxpayers (who have invested $187.5 billion in their operations to date), and the enterprises must reduce their investments portfolios by 15% each year.[65]

Senior Preferred Stock Purchase Agreement Amendments

HERA authorized Treasury to buy obligations and other securities from the enterprises.[66] On September 7, 2008, Treasury established individual PSPAs with the enterprises through FHFA. The PSPAs legally bind the U.S. government, through Treasury, to provide the capital necessary to maintain the enterprises' net worth at or about zero (subject to a cap), thereby, helping to reassure investors concerning the enterprises' debt and their guaranteed MBS.[67] Treasury's purchases were intended to prevent

Figure 1. Actual and Projected Year-end Values of Total Retained Portfolios Under the Terms of the PSPAs ($ millions)



the enterprises' insolvency and to improve investor confidence in the enterprises' ability to meet their obligations and provide the mortgage market with liquidity.[68]

On May 6, 2009, Treasury amended the initial agreements by doubling the funding commitment to each enterprise, increasing the maximum size of each enterprise's retained mortgage portfolio, and allowing each enterprise to increase its indebtedness (i.e., the amount of money it owed). On December 24, 2009, Treasury and FHFA agreed to further amendments to the PSPAs, which included additional financial support for each enterprise through the end of 2012 and changes to the limits on their retained mortgage portfolios.[69]

On August 17, 2012, Treasury and FHFA again amended the PSPAs. The most notable change was the replacement of the fixed 10% dividend payment with a quarterly sweep of the enterprises' net worth above a specified amount.[70] This was intended to ensure stability, fully capture financial benefits for taxpayers, and eliminate the need for the enterprises to continue borrowing from Treasury to pay dividends.[71] According to FHFA's Acting Director, "As Fannie Mae and Freddie Mac shrink, the continued payment of a fixed dividend could have called into question the adequacy of the financial commitment contained in the PSPAs."[72]

The August 2012 amendments to the PSPAs also require a quicker reduction of their investment portfolios. The annual reduction rate is now 15% instead of 10% (the rate required by the previous iterations of the PSPAs).[73] Such a rate of reduction is estimated to enable the enterprises to reach a maximum retained portfolio of $250 billion each (or $500 billion combined) by 2018. Figure 1 (see above) shows the actual and projected declines in the enterprises' retained mortgage portfolios pursuant to the revised PSPAs.

The faster reduction in the retained mortgage portfolio will further reduce risk exposure and simplify the operations of the enterprises.[74] FHFA expects the amendments to help wind down the enterprises' investment portfolios more quickly and make sure that their earnings benefit taxpayers; support the flow of mortgage credit during a transition to a reformed housing finance market; and provide greater certainty regarding the financial strength of the enterprises.[75]

FHFA also plans to simplify and shrink the enterprises' operations to reduce their dominance in the market across all three of their lines of business—single-family, multifamily, and capital markets (issuing debt securities).[76] Among other means, FHFA is working to achieve this by increasing guarantee fee pricing.[77]

Increasing Guarantee Fees

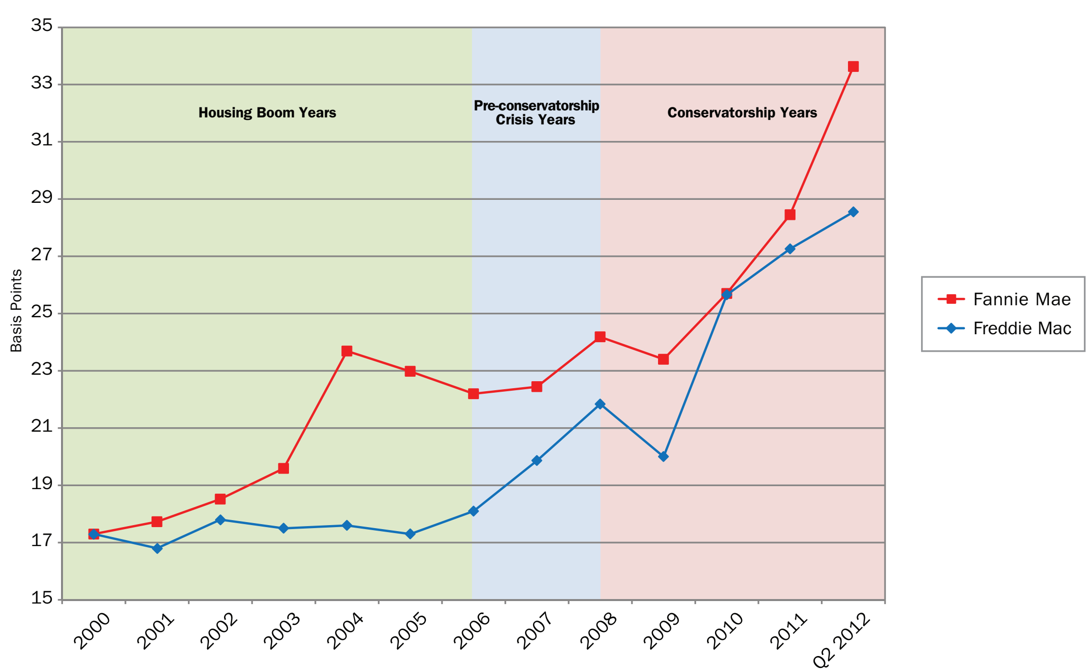
Like insurance companies, each enterprise charges a premium in the form of a guarantee fee for its guarantee of principal and interest payments on the loans covered by its MBS. This guarantee fee is intended to offset expected credit losses from borrower defaults. Lender guarantee fee payments are generally ongoing monthly payments and frequently include an up-front payment at the time of purchase. A lender typically passes the cost of the guarantee fee on to the borrower.[78]

The enterprises consider many factors in determining the rates of guarantee fees, including the estimated cost of guaranteeing specific mortgages, competitive conditions in the market for bearing mortgage credit risk, the relative pricing of each enterprise's MBS, the enterprises' public mission, and targeted returns on capital.[79]

In September 2011, FHFA announced its intention to continue on a path of gradual price increases based on risk and the cost of capital.[80] The Temporary Payroll Tax Cut Continuation Act of 2011 also directed FHFA to raise the average guarantee fees charged in 2012 by at least 10 basis points greater than the average guarantee fees charged in 2011 (1 basis point is equivalent to 1/100 of 1 percentage point, in this example, the 10 basis points equals 0.10%).[81]

On August 31, 2012, FHFA announced that the enterprises will again raise guarantee fees on single-family mortgages by an average of 10 basis points.[82] This increase will increase borrowing costs and will make the guarantee fees for lenders delivering large volumes of loans more uniform with fees for lenders delivering smaller volumes. According to FHFA, this increase is also intended to reduce the subsidization of higher-risk mortgages by lower-risk ones. It will do this by applying larger increases on guarantee fees for loans with maturities longer than 15 years.[83] Figure 2 (see below) represents the increasing trend in guarantee fees from 2000 to the present.

Figure 2. Enterprises' Single-Family Guarantee Fee Pricing Over Time



FHFA has stated that raising guarantee fees also may lead to greater private-sector participation in the mortgage market by potentially bringing the enterprises' fees more in line with what private entities—without government support—would be expected to charge.[84]

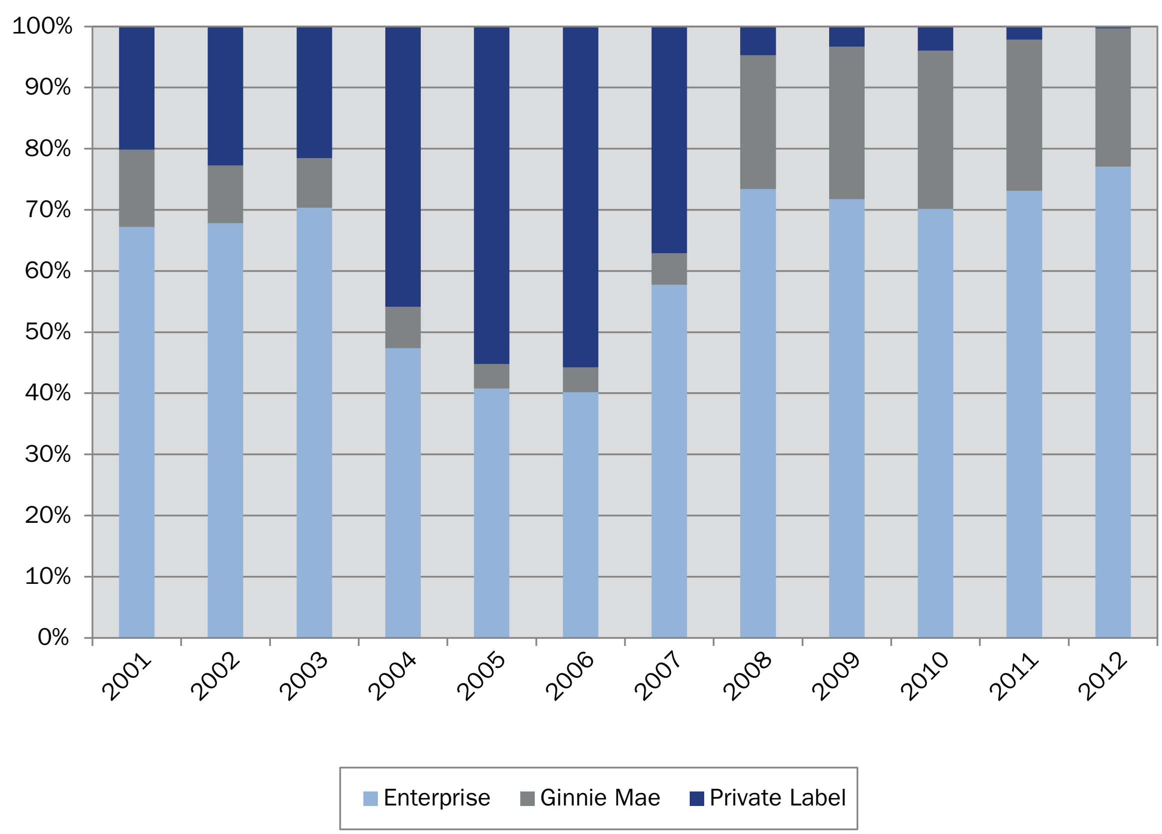
However, despite FHFA's steps to shrink the enterprises' footprint in the secondary mortgage market, there is currently no private-sector entity that can fill their shoes; new mortgages alone account for $100 billion in capital per month.[85] And, as shown in Figure 3 (see below), the enterprises have once again assumed the dominant position in the MBS market since 2008; indeed, Fannie Mae, Freddie Mac, and Ginnie Mae issued approximately 100% of MBS in 2012.

In recognition that the enterprises' dominant position in the market may change, FHFA intends to create a new market infrastructure that, among other things, may reduce obstacles to private participation.[86] For example, FHFA has been standardizing business practices across both enterprises and is exploring the implementation of a new securitization platform (the mechanism that bundles mortgages into securities that are sold to investors). In addition, FHFA is examining mortgage servicing reform across multiple areas and improved loan-level data and document storage. The agency plans for all these elements to comprise an open, accessible structure to encourage investor confidence and entry into the market.[87]

Securitization

On March 4, 2013, FHFA announced that a new business entity will be established between the enterprises.[88] FHFA believes a new securitization infrastructure, separate from the two enterprises, is important

Figure 3. Enterprises' Dominance in the MBS Market



to support a new secondary mortgage market.

According to FHFA, the new entity will function as a market utility and is not intended to rebuild the infrastructures of the enterprises. Initially, it will be owned and funded by the enterprises, but its functions will be designed to operate as an independent infrastructure—operable across several platforms and physically located separate from the enterprises. FHFA states that the combination of these attributes will allow access and input from industry participants. With the overarching goal to create something of value for the future mortgage market, FHFA believes that the design is flexible so it can meet the direction and goals policymakers set for housing finance reform.

According to FHFA, a new mortgage market needs new securitization infrastructure

The governance and ownership structure described above is for the initial phase of the new securitization platform. However, as the enterprises move forward, their securitization infrastructure must be updated and maintained as well, and where possible, taxpayers' dollars should be invested once, not twice.[89]

Servicing Alignment Initiative

FHFA's SAI outlines common guidelines for servicing enterprise loans with special attention to servicing delinquent loans.[90] The initiative has incentives and penalties intended to encourage servicer compliance with the updated guidelines.[91]

An important feature of the initiative involves loan servicer outreach to delinquent borrowers earlier than has ordinarily occurred in order to reduce delinquencies and mitigate credit losses.[92] In June 2012, FHFA issued new guidance focusing on three major servicing areas (i.e., borrower contact, loan modification, and foreclosure timelines) and introduced a standard borrower response package allowing the servicer to simultaneously evaluate a borrower for multiple foreclosure prevention possibilities, as well as new mortgage modification and evaluation options. The package also includes borrower contact timelines and call center standards.[93]

Joint Mortgage Servicing Compensation Initiative

The enterprises launched the Joint Servicing Compensation Initiative in January 2011 to reform the servicing model for single-family mortgage loans.[94] The current model consists of a servicing fee included in the loan's interest rate. When the servicer collects a payment from the borrower, it receives a portion of the interest as payment for servicing the loan.[95] In general (i.e., in an environment of pre-housing boom default rates), this small percentage of the mortgage interest payment is more than enough to cover the expense of servicing the loan. However, when a large number of a servicer's loans are nonperforming (i.e., the borrowers are not making their mortgage payments), the traditional fees received from the performing loans do not cover the servicer's expenses.[96]

According to FHFA, the Joint Servicing Compensation Initiative is intended to ensure a profitable and accessible business model for servicers, execution and nonperforming loan management options for originators, and the preservation of consumer choice and market liquidity.[97]

In September 2011, FHFA presented two alternative compensation structures. The first consists of a reduced servicing fee and a reserve account containing the remainder of the servicing fee available to the servicer for expenses incurred on nonperforming loans.[98]

The second proposed model is a "fee for service" model, in which the guarantor of the loan pays the servicer a fee per loan, regardless of the size of the mortgage or whether or not the loan is performing. The interest portion of the borrower's mortgage payment is the source of funding for fees paid to the servicer under both models.[99]

Uniform Mortgage Data Program

On May 24, 2010, FHFA announced an initiative to improve the consistency and quality of data for appraisals and other loan information. This initiative will enhance the collateral, borrower, and loan data submitted to the enterprises. The Uniform Mortgage Data Program is a long-term joint effort to create uniform data standards and collection processes.[100] Though the enterprises are working together on this initiative, each enterprise operates as a separate business and, according to FHFA, will continue to exercise independent business judgment on the use of loan data.[101]

FHFA believes that a common framework will result in better lender efficiency and enterprise risk management. Likewise, common data standards are expected to lead to more consistent data submissions from appraisers, mortgage lenders, servicers, and others. The enterprises will deploy the data standards program in phases, through a common platform that will include stakeholder input.[102]

A long-term goal of this initiative is to reduce representation and warranty risk through up-front monitoring of loan quality.[103]

New Representations and Warranties Framework

Loan sellers' representations and warranties to the enterprises are intended to protect the enterprises from credit losses on loans that do not meet their eligibility standards. In effect, they are a lender's assurance that the enterprises can rely on certain facts (representations) and circumstances (warranties) about the loans they are selling. Representations and warranties are outlined in lender contracts and purchasing documents, such as underwriting and documentation standards. Representation or warranty violations may breach the lender contract, which provides the enterprises with contractual remedies, including demanding that the lender repurchase the defective loan (known as a "put back" or "buy back").[104] Pursuing a buy back remedy may help compensate an enterprise for losses that are the legal responsibility of another party. Still, such remedies are costly and, some argue, have delayed market recovery because they led to new mortgages being underwritten to stricter standards than the enterprises require.[105]

On September 11, 2012, FHFA announced that the enterprises would be launching a new representation and warranty framework for conventional loans (loans not insured or guaranteed by FHA, VA, or USDA) funded, acquired, securitized, or guaranteed on or after January 1, 2013. The new framework clarifies lenders' long-term repurchase risk on loans by setting time limits on when repurchase claims can be asserted (no such time limits exist on loans originated prior to 2013).[106] The objective of the new framework is enhanced transparency for lenders and other industry participants, which is expected to result in greater efficiency and better access to mortgage financing.[107]

As long as the mortgages have an acceptable payment history for at least 36 months and meet other eligibility requirements, lenders will not be subject to repurchase demands.[108] The lender's responsibility to meet the requirements for loan quality, including responsible underwriting, remains the same.[109]

In a recent speech, FHFA's Acting Director noted cautious optimism about the housing market's future due to the signs of stabilization he saw in some sectors of the market.[110] Still, one of the biggest challenges remaining to FHFA is the lack of guidance or consensus from the Administration and Congress on ending the conservatorships of the enterprises.

Indeed, last month before the House Financial Services Committee, Acting Director DeMarco testified that "the biggest impediment, I suppose, for me, or the thing I could use most from Congress is . . . legislative direction."[111] Today, the future of the housing finance system is uncertain.

The following identifies various stakeholders and describes reform proposals that they have offered.

Reformers and Reforms

In July 2010, Congress enacted a wide-ranging legislative response to the nation's recession: the Dodd-Frank Wall Street Reform and Consumer Protection Act.[112] The law contains several housing finance reforms that are intended to address practices that contributed to the housing boom, including reducing the risk of borrower default. It also requires MBS issuers, in some circumstances, to retain credit risk in the assets they securitize, that is, to keep some skin in the game.[113] Although this law was intended to address some important problems that led to the housing crisis—lenders with little to lose loaning to borrowers with little to repay—it did not resolve other fundamental concerns about the current housing finance system, such as the appropriate role for the federal government in housing finance.

In February 2011, Treasury and HUD, on behalf of the Administration, issued a report to Congress, *Reforming America's Housing Finance Market*, which addresses the role of housing finance reform and outlines varying degrees of government support. Since then, other interested parties have proposed plans to reform housing finance, government support, and the enterprises. Congress, academics, industry experts, and interest groups have proposed comprehensive and incremental reforms.[114]

Below, we identify some of the key reformers and summarize the major categories of their reform proposals.

Reformers

The Administration

The Administration seeks to change the government's role in housing, make the private market the primary source of mortgage credit, and ultimately phase out the enterprises' role in the mortgage market.[115] The government, according to the Administration, should provide robust oversight, consumer and investor protection, targeted assistance for low- and moderate-income homeowners and renters, and support for market stability and crisis response.[116]

With these principles in mind, *Reforming America's Housing Finance Market* outlines three options for a privatized system of housing finance with targeted assistance from USDA, FHA, and VA. The primary difference between these proposals is that in option one, there is no broad government guarantee; in option two, there is a broad government guarantee only in times of crisis; and in option three, there is a standing government guarantee with significant private capital requirements.[117]

Legislative Proposals

Congressional enterprise reform bills have included a modification of the enterprises' current charter or the creation of a new private or government-owned company that would purchase and securitize mortgage loans with guarantee features.[118] Proposals concerning the existing enterprises generally focus on improving accountability, lowering the cost to the government, and reducing their competitive advantage in the marketplace.[119] Additionally, during the 112th Congress, members of Congress introduced four bills with deadlines for the enterprises to either return to shareholder control or be dissolved.[120]

Academics, Industry Experts, and Interest Groups

Academics and industry experts have suggested a wide range of enterprise reform proposals. Interest groups, representing consumers, the banking industry, mortgage originators, and other housing finance groups have also made reform proposals.[121] Though the proposals vary, they generally envision a private mortgage market backed by some type of governmental guarantee or reinsurance.[122]

Certain academic proposals argue for less volatility in housing credit and more protection in times of financial crisis by having an entity step in as a buyer "of last resort" providing additional liquidity.[123] Another proposal argues for splitting the enterprises into entities that respectively hold their collective good and bad assets (e.g., one enterprise takes control of their combined "good" assets and the other takes the "bad" assets).[124]

Reforms

Regardless of the source, the reform proposals generally fall into one of three broad categories:

- government model;[125]
- private model;[126] or
- hybrid model.[127]

Within these broad categories, some proposals seek modest reforms that may be implemented more rapidly, while others seek more fundamental changes with longer implementation periods—some as long as 15 years.[128] Some proposals suggest the creation of a new government or private entity that will purchase and securitize mortgage products; a few directly address the existing enterprises and their potential resolution.[129] What the proposals all have in common is that they have not progressed beyond general concepts and have been presented only at a high level. More granular issues, such as establishing underwriting and mortgage eligibility standards have not been addressed, but they need to be resolved if the reforms are intended to respond to the causes of the financial crisis.

Government Model

Generally, in the government model, a wholly owned government corporation would replace the enterprises for the purpose of purchasing approved residential mortgage products, securitizing them, and selling them to investors. Approved mortgage originators would pay a guarantee fee to the corporation in order to secure timely payment of interest and principal on the resulting security. This type of proposal requires the federal government to back all of the corporation's obligations.[130] Alternatively, the corporation under another variant of this proposal can guarantee the principal and interest payments of MBS without purchasing the underlying security similar to the security wrap provided by Ginnie Mae.[131]

The enterprises could be converted into a government corporation similar to Ginnie Mae under this model. Further, like Ginnie Mae, the government corporation could contract out aspects of its operations to minimize staffing.[132]

Private Model

The private model would allow private companies to purchase and securitize mortgages from lenders and guarantee the payment of principal and interest on the resulting securities. Under this model, there is no explicit guarantee of the securities or companies by the federal government. The key to most of the private model options is the wind down of the existing enterprises over 10- or 15-year periods.[133] In theory, this will incentivize the private sector as guarantee fees increase to what the market will bear. One variation on the private model proposes that private companies should purchase and securitize mortgages from loan originators, but a governmental agency would continue to guarantee the timely payment of the principal and interest on those securities. This agency is then phased out after a 10-year period.[134]

Some variants on the private model propose utilizing the existing enterprises as the private securitizer(s). Existing stockholders in the enterprises would receive shares in the new private company formed from the existing enterprises that would trade on one or more stock exchanges. This proposal notes that if the existing enterprises' market share is considered too dominant, multiple smaller companies may be formed or even split into specialized market segments.[135]

Hybrid Model

There are many variants of the hybrid model that envision blended roles for the government and private sector. Some of the hybrid models advocate full replacement of the enterprises; others are more modest and suggest modifying them. In the broadest context though, all the proposals in this group call for a private entity or group of entities to purchase and securitize mortgages from approved originators with some form of guarantee from the federal government.[136]

The proposals vary widely regarding the government's position as guarantor of principal and interest on the resulting MBS. Some proposals suggest the creation of a Federal Deposit Insurance Corporation-type agency to function as the first-in-line guarantor of repayment.[137] Other proposals recommend that the private issuers initially guarantee repayment, with the federal government providing some form of reinsurance or catastrophic loss backstop.[138] A similar hybrid approach suggests using private capital and possibly private mortgage insurance to absorb credit losses before the federal guarantee is tapped.[139]

Interplay between the private issuance of a security and a governmental guarantee is at the heart of most hybrid proposals.[140] The degree of government support tends to account for the variations among the proposals.

Among the hybrid model proposals there are divergent opinions on the appropriate level of federal participation in guaranteeing MBS. For instance, one proposal suggests limiting the federal guarantee under normal circumstances.[141] A similar proposal sets the target during normal market conditions at less than 10%.[142]

Pricing of the guarantee also is a significant issue for the plans. Risk-based pricing proposals, which price the guarantee fee based on estimates of risk, are common. One proposal estimates that the fair value of the guarantee fee lies between 45 and 55 basis points.[143] Another option seeks to finance the guarantee through a risk-based tax on the users of the system.[144]

Various hybrid models propose governmental intervention mechanisms in times of economic hardship. For example, there are proposals that suggest leaving the mortgage securitization market largely privatized, while having a government-owned corporation operating in that market at very low levels during periods of normal market activity. However, in the event of a market disruption, such as the one in 2008, the government-owned corporation would step in and stabilize the marketplace during the crisis.[145]

Conclusion

In February 2012, FHFA's Acting Director described the difficulty of fulfilling the agency's oversight responsibilities in the midst of uncertainty about the enterprises' future:

> At FHFA we are faced with a fundamental task of directing the operations of two companies that account for roughly three-quarters of current mortgage originations and have approximately $5 trillion in outstanding obligations and credit guarantees. FHFA's task is complicated by the uncertain future of the Enterprises and increasing dissatisfaction with various aspects of their business operations.[146]

In other words, FHFA must effectively direct the enterprises' operations—which comprise the engine of residential real estate transactions in the United States—while fundamental questions about their future roles and the future of housing finance remain unanswered.

It is now time for policymakers to begin to make the decisions that will shape that future.

Figure Sources

Figure 1. Federal Housing Finance Agency, "Historical Data Tables," *2011 Report to Congress*, at 75, 92 (June 13, 2012). Accessed: April 11, 2013, at www.fhfa.gov/webfiles/24009/FHFA_RepToCongr11_6_14_508.pdf. Department of the Treasury, *Treasury Department Announces Further Steps to Expedite Wind Down of Fannie Mae and Freddie Mac* (August 17, 2012). Accessed: April 11, 2013, at www.treasury.gov/press-center/press-releases/Pages/tg1684.aspx.

Figure 2. Data provided by FHFA's Division of Housing, Mission and Goals, Office of Policy, Research and Analysis, based on Fannie Mae and Freddie Mac data. The data represent the estimated average guarantee fees charged by the enterprises for single-family mortgages delivered from 2000 through June 30, 2012.

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