VIEWPOINT

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Addressing the Housing Finance Conundrum

Barbara Novick
Vice Chairman

Kevin G. Chavers
Global Public Policy Group

Ron Sion
Head of Agency MBS

Shamit Mehta
Financial Markets Advisory Group

Rachel Barry
Global Public Policy Group

In this *ViewPoint*

> *"the United States needs a comprehensive approach to its housing finance policy. With Fannie Mae and Freddie Mac both in conservatorship it is difficult to articulate their long-term role within our housing finance policy. Eight years passed since they entered conservatorship and there has been a significant recovery of housing prices across the country. So that lends itself to be a good time…to address the desired future state we seek for housing finance in our country."*
>
> *— Steven Mnuchin, U.S. Treasury Secretary, Jan. 19, 2017*[1]

Introduction

On Sep. 6, 2008, Fannie Mae and Freddie Mac (collectively, the GSEs) were put into conservatorship by the Federal Housing Finance Agency (FHFA), reflecting the severity of the housing crisis and its impact on the GSEs. In the years following the 2008 Financial Crisis (the Crisis), there have been significant changes in the housing and securitization markets, as well as critical changes to the GSEs. Both the Trump Administration and Members of Congress have indicated an interest in ending the conservatorship status of Fannie and Freddie, which necessitates a discussion of housing policy. While the timing of and commitment to any additional administrative or legislative reforms remains highly uncertain, the dialogue around housing finance principles and the role of the GSEs is once again underway. As discussed in this *ViewPoint*, the housing finance conundrum presents challenges for a clear path forward.

Over the past few years, we have written several white papers addressing housing finance.[2] The guiding principles for reforming housing finance remain unchanged: the need for a clearly defined government role, transparency at all levels, and a framework to attract private capital. These principles are summarized on page 2 and discussed later in the paper. Importantly, they are largely consistent with many of the administrative reforms that have already been implemented.

In this *ViewPoint*, we assess the path forward for housing finance from where we are today. This approach starts with a review of how the markets have evolved and how the GSEs and their programs have changed. We expand on our guiding principles for defining a path forward, and we evaluate the GSE reform proposals that have been made in the context of these guiding principles. We don't believe views on either far end of the spectrum will prevail. Some have called for the Federal government to withdraw completely from housing markets; others have called for a return to the public-private partnership of the pre-Crisis era; and still others have called for an

BlackRock Policy Framework for Holistic Housing Finance Reform

Notwithstanding the significantly changed environment, our Housing Finance Reform Policy Framework still remains mostly unchanged and largely consistent with the administrative reforms to date.

Clearly Defined Government Role

- Guarantors as intermediaries with limited balance sheet
- Appropriately priced explicit Government guarantee on mortgage securities
- Prudent and reasonable level of private capital credit risk absorption via capital markets
- Fungibility of existing GSE MBS with any future MBS, and orderly transition from current system to new system
- Maintenance of a deep and liquid market, including the preservation of the TBA market
- Availability of well underwritten mortgage credit

Transparency at All Levels

- Transparency, accuracy, and accessibility of information along the entire origination chain to end investors
- Standardization of MBS securitization best practices, policies and documentation

Attract Private Capital to Private Label MBS

- Fiduciary standard for servicers and trustees
- National mortgage servicing standards, including protections for investors
- Protect investor rights in legal and regulatory settlements
- Policy and regulatory clarity and certainty

alternative middle ground path. We provide important considerations for evaluating the various proposed approaches. In addition, we suggest ways to attract private capital to return to the mortgage markets. We see this as the beginning of an extended dialogue, as we do not expect much if any Congressional legislative activity on housing finance in 2017 – and perhaps not until 2019 given the political calendar. Most of the housing finance reform dialogue to date has focused on GSE reforms, with much less emphasis on the Federal Housing Administration (FHA) and Ginnie Mae[3] on the federal home loan business.

The financial condition of each GSE was severely damaged in the Crisis. A combination of industry practices, balance sheet leverage, and lack of adequate capital combined to expose the vulnerability of these entities as the housing markets experienced a severe downturn. Under the leadership of then Acting Director Ed DeMarco and current Director Mel Watt, the FHFA has overseen a number of important changes at the GSEs over the past nine years. These changes include significant reductions in the size of the GSEs' portfolios, enhanced underwriting guidelines, increased guarantee fees, innovative structures for introducing private sector credit enhancement, and the ongoing development of a Common Securitization Platform (CSP) and Single Security.[4] Importantly, the GSEs remain in conservatorship and are controlled by the Federal government.

The environment for real estate and housing finance has changed dramatically during the post-Crisis period, and even relative to the last time housing reform was attempted by Congress. Housing prices in most markets have largely recovered. The Consumer Financial Protection Bureau (CFPB) introduced new regulations that address both underwriting standards and mortgage servicing geared toward protecting borrowers. The Dodd-Frank Act (DFA) introduced risk retention requirements for issuers of securitized assets.[5] Rating agencies have significantly revised their ratings criteria and methodologies. More notably, there have been key reforms accomplished by the GSEs at the direction of the FHFA, as their regulator and conservator. There has been significant work on a viable secondary market framework over the past few years, though this is by no means complete. This backdrop is more conducive to pursuing housing reform than at any time since the Crisis.

However, there are aspects of housing finance that still need to be addressed independent of the GSEs. Neither the CFPB nor DFA have addressed mortgage servicing issues from an investor perspective. Litigation stemming from the Crisis continues against servicers and trustees on behalf of investors. Furthermore, investors remain cognizant of the various legal and regulatory settlements with servicers and issuers which unfairly impaired investors' assets.

Given the lingering concerns of investors regarding the mortgage securitization infrastructure coupled with the economics for issuers in this historic low rate environment, it is not surprising that there is a dearth of private label MBS. Accordingly, the housing markets continue to rely on significant levels of government support. A well-functioning private label market is an additional important component of housing finance reform.

Looking forward, housing finance reform requires a holistic approach. Most significantly, **a sustainable plan needs to consider the roles and structures of Fannie Mae, Freddie Mac, and the Department of Housing and Urban Development (which encompasses FHA and Ginnie Mae) as well as their regulatory regimes, keeping in mind multiple constituencies**. For example, home buyers, realtors, lenders, mortgage servicers, and investors each have different perspectives. And, of course, the Federal government has an interest in protecting both the economy and taxpayers. Under existing law, the Treasury is prohibited from selling stock in the GSEs until January 2018.[6] During this window, we encourage a robust dialogue on the trade-offs of various policy decisions. These considerations include weighing the importance of housing to growth and employment and the sources of capital for investing in mortgage debt, as well as considering the implications of various options for the U.S. government balance sheet.

Housing finance reform requires the involvement of multiple members of the Administration and the Congress. Over the past few years, a number of plans have been discussed and/or proposed.[7] Leaders in the new Administration and this Congress have indicated a serious interest in addressing housing finance. On several occasions, Treasury Secretary Mnuchin has commented on the status of the GSEs. Likewise, Senate Banking Chair Crapo and House Financial Services Chair Hensarling have each put housing finance as a priority item on the agendas for their respective Congressional committees to develop new legislation.

There are numerous people and agencies involved in housing finance policy that each have a significant influence over various housing policies. Given the new administration and Congress, there are a number of new voices that join several other important voices in framing U.S. housing policy.

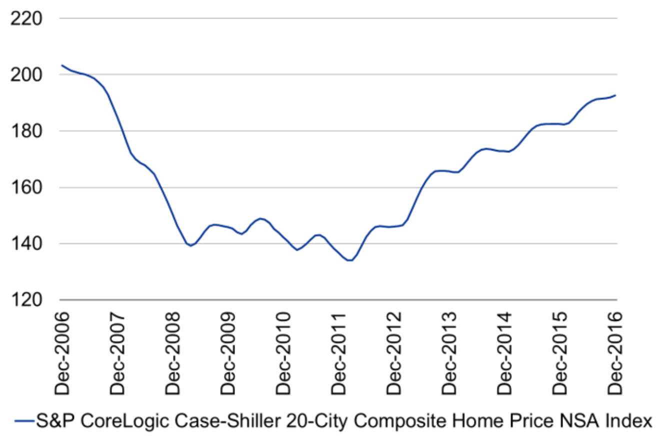
Housing Market Overview

The U.S. housing market has recovered significantly from the historic lows of the Crisis. There has been continued improvement in home prices (Exhibit 2), coupled with a reduction in delinquencies (Exhibit 3) and foreclosures. As home prices have improved since the Crisis, higher prices coupled with higher mortgage rates (Exhibit 4) have reduced affordability somewhat (Exhibit 5). Yet, affordability remains high by historic standards. This should give policy makers greater comfort in pursuing comprehensive housing finance reform with less fear of destabilizing the housing market. With that said, housing market dynamics at the time when policy makers are actually prepared to move forward with reform will certainly influence the outcome.

Exhibit 1: Key Voices in Housing Finance

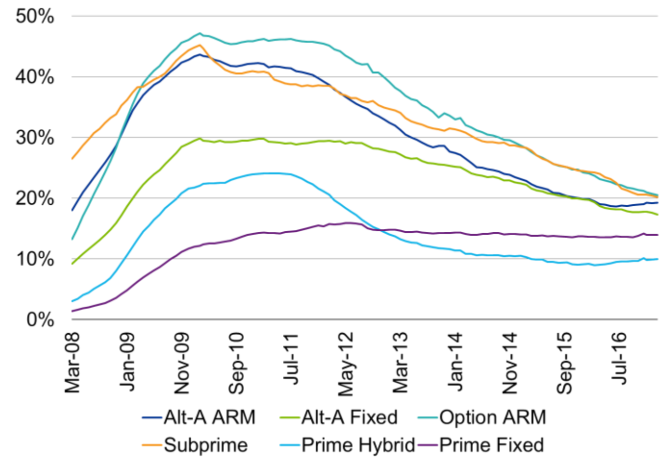
	**Treasury Secretary** *Steven Mnuchin* • **Confirmed**: Feb. 13, 2017 • **Succeeded**: Jack Lew • **Previous Position**: Finance Chairman for Donald Trump for President; Founder, Chairman and CEO of Dune Capital Management
	**NEC Director** *Gary Cohn* • **Confirmed**: Jan. 20, 2017 • **Succeeded**: Jeff Zients • **Previous Position**: Goldman Sachs Group Inc. President
	**HUD Director** *Ben Carson* • **Confirmed:** Mar. 2, 2017 • **Succeeded**: Shaun Donovan • **Previous Position**: Director of Pediatric Neurosurgery at the Johns Hopkins Children's Center
	**FHFA Director** *Mel Watt* • **Confirmed**: Dec. 10, 2013[8] • **Succeeded**: Edward DeMarco • **Previous Position**: U.S. House of Representatives
	**Senate Banking Committee Chair** *Mike Crapo* • **Elected**: Nov. 3, 1998 • **Succeeded**: Dirk Kempthorne • **Previous Position**: Idaho Senate
	**House Financial Services Committee Chair** *Jeb Hensarling* • **Elected**: Nov. 6, 2002 • **Succeeded**: Pete Sessions • **Previous Position**: Vice President, Green Mountain Energy

Exhibit 2: U.S. Home Prices



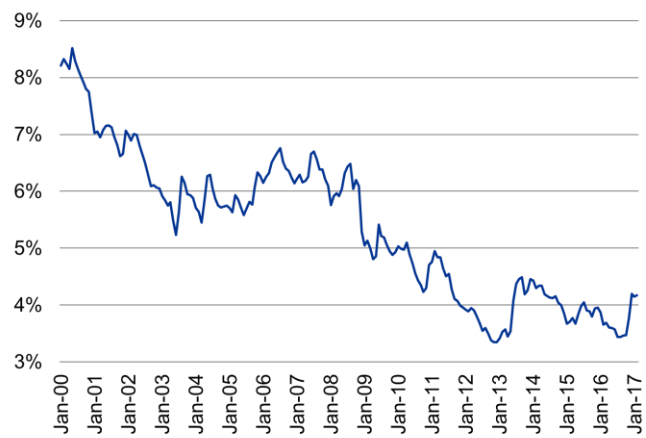
Source: S&P/Case-Shiller. As of Feb. 2017.

Exhibit 3: Levels of 60+ Delinquencies



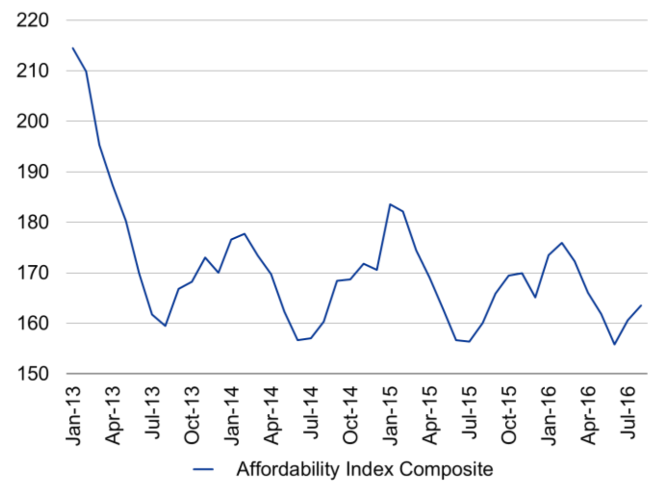
Source: LoanPerformance, CPRCDR.com as of Feb. 2017. "Universe" includes all available 2006 Vintage RMBS in LoanPerformance.

Exhibit 4: 30-Year Fixed Rate Mortgage Rate



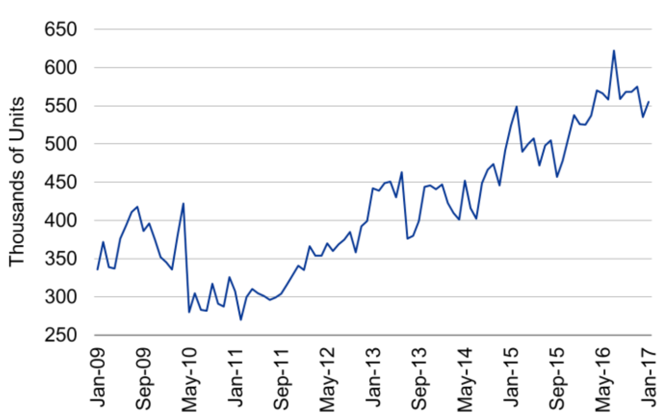
Source: : Federal Reserve Bank of St. Louis. As of Feb. 2017.

Exhibit 5: U.S. Affordability Index



Source: National Association of Realtors. As of Feb. 2017.

Exhibit 6: U.S. Single Family Home Sales



Source: U.S. Census Bureau. As of Feb. 2017. Seasonally Adjusted.

GSEs Overview

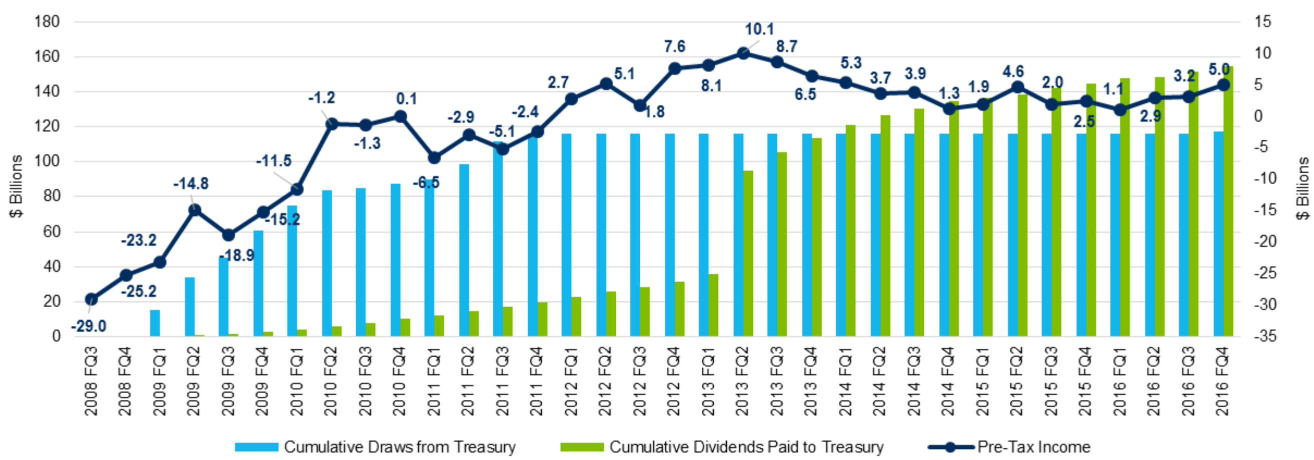
The GSEs are also in a very different condition than they were immediately after entering conservatorship, when they required repeated quarterly capital draws[9] from Treasury to remain solvent. Fannie Mae and Freddie Mac have subsequently paid over $68 billion more in dividends to Treasury than their cumulative draw, and they are currently generating positive pre-tax income on a quarterly basis.

Under the Preferred Stock Purchase Agreements, as amended (PSPA), the GSEs are unable to grow a capital base.[10] Under the PSPA, the GSEs are required to pay out comprehensive income generated from business operations as quarterly dividends to Treasury. The amount of income each GSE is able to retain is considered its capital buffer, which is designed to absorb potential losses and reduce the need for the GSEs to draw additional funding from Treasury. Under the PSPA, the capital buffer is reduced each year. As a practical matter, the GSEs are on target to each have a capital buffer of zero next year. Absent an amendment to the PSPA or some other action by FHFA and Treasury, this will require draws from Treasury in the event they post net losses in any quarter.[12] We believe draws will attract attention to the status of the GSEs and may spur policy makers to take some action.

> *"The most serious risk and the one that has the most potential for escalating in the future is the Enterprises' lack of capital."*
>
> *— Mel Watt, Director Federal Housing Finance Agency, February 18, 2016*[11]

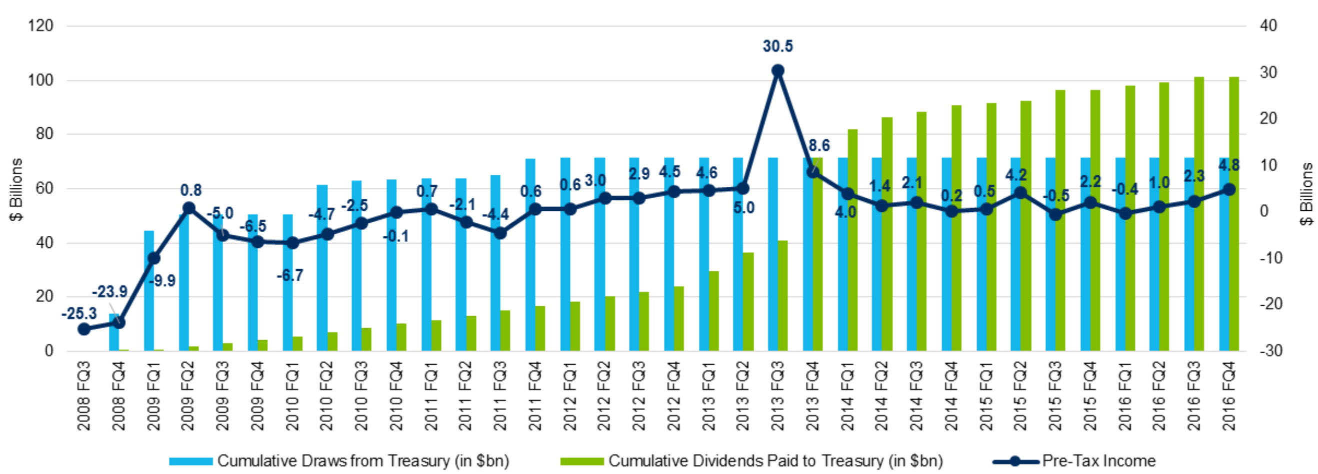
Apart from retained capital, the GSEs are in a much stronger position than they were entering the Crisis. As highlighted in Exhibit 9, the size of the retained portfolios of Fannie and Freddie has been reduced by more than 50%.

Exhibit 7: Fannie Mae Financial Results and Treasury Draw History[13]



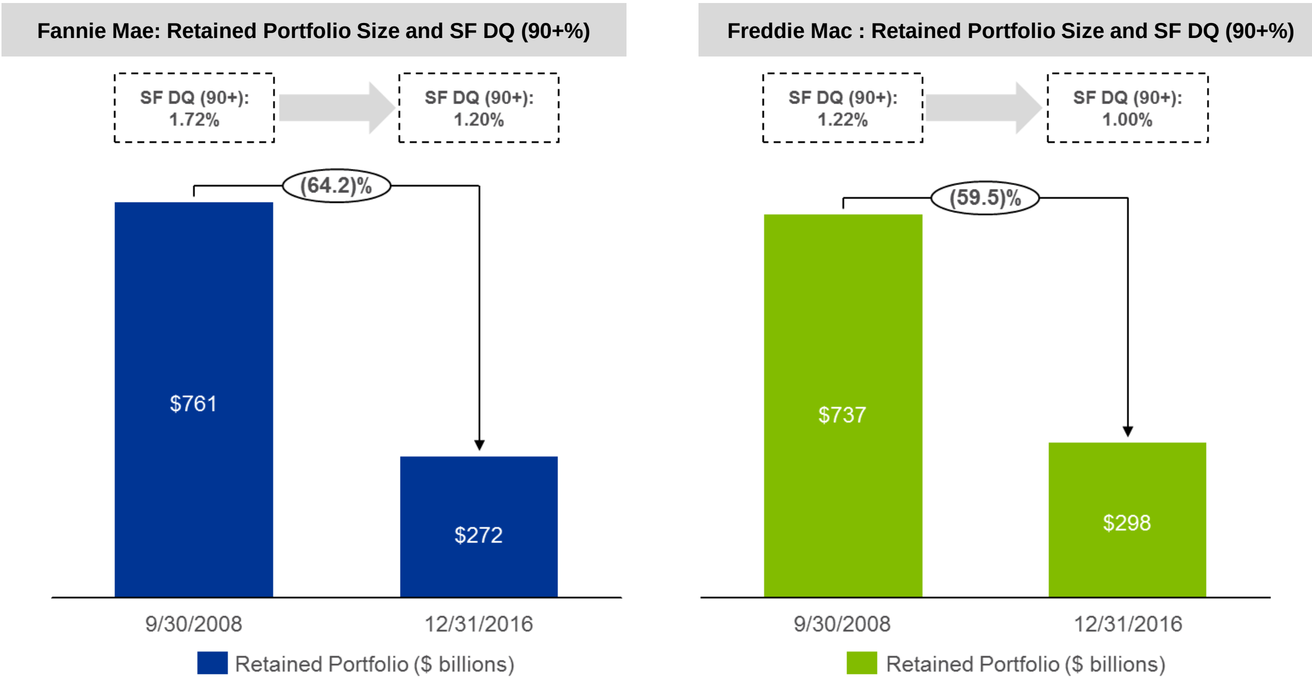
Source: Fannie Mae. As of Dec. 2016.

Exhibit 8: Freddie Mac Financial Results and Treasury Draw History[13]



Source: Freddie Mac. As of Dec. 2016.

Exhibit 9: Retained Portfolio Size of Fannie Mae and Freddie Mac



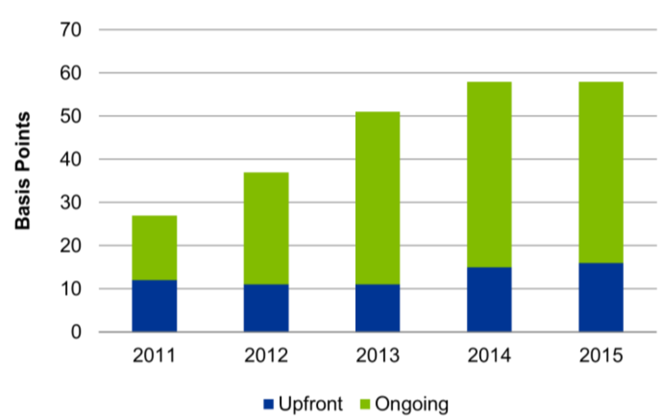
Sources: Fannie Mae and Freddie Mac. As of Dec. 2016. Retained Portfolio size is listed as total unpaid principal balance.

The combined retained portfolio of the GSEs was $1.498 trillion in Sep. 2008 (the month they were placed in conservatorship), and dropped to $570 billion in Dec. 2016 (see Exhibit 9). In addition, delinquencies in the respective guarantee books of business are low and at a quarter of their peak levels. Delinquencies in the Fannie Mae Guarantee book of business peaked at 5.59% in Feb. 2010, and they were 1.2% in Dec. 2016. Delinquencies in the Freddie Mac Guarantee book of business peaked at 4.20% Feb 2010, and they were 1% in Dec. 2016. The GSEs have also improved the credit quality of the loans they are guaranteeing, raised their guarantee fees (see Exhibit 10), and introduced a layer of credit enhancement provided by the private sector. All of these factors combine to make housing finance reform potentially more viable than at any time in the past few years.

Continued Government Footprint

The housing market continues to enjoy large levels of Federal government support. This support includes guarantees from Fannie Mae and Freddie Mac, and Ginnie Mae, as well as outright balance sheet support of agency MBS by the Federal Reserve. As illustrated in Exhibit 11, the Federal Reserve started adding MBS to its balance sheet in January 2009 as part of Quantitative Easing (QE) programs and currently holds approximately $1.8 trillion on its balance sheet. Purchases of agency MBS were initially modest and then increased dramatically in September 2012 as part of QE3, which included purchases of $40 billion per month of agency MBS.[14] The Federal Reserve has recently indicated that it is preparing to reduce its balance sheet. According to the minutes of the Federal Open Market Committee, there is interest in reducing the exposure to MBS, however, it is unclear if this will involve just a multiyear run-off or if outright sales will be part of the reduction

Exhibit 10: Average Guarantee Fees

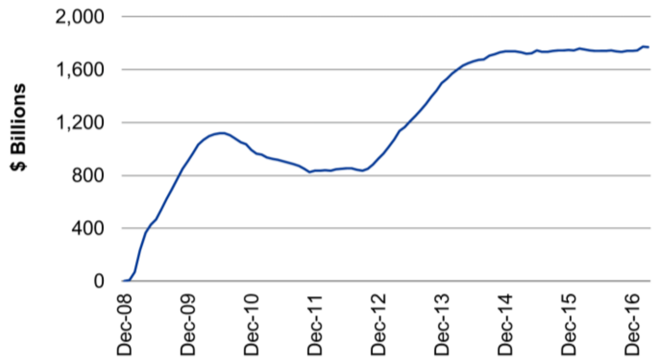


Source: FHFA, Fannie Mae and Freddie Mac Single-Family Guarantee Fees in 2015 (Aug. 2016), available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFee_Report_FINAL.pdf. Data as of Dec. 2015.

program.[15] As highlighted in Exhibit 12, the GSEs' share of single family mortgage originations rose from approximately 30% of the market prior to the Crisis and peaked at 70% just after the Crisis. The GSE share has since declined to under 50% of originations which remains high by historical standards. On the other hand, new issuance in the private label MBS sector remains relatively low. Exhibit 13 demonstrates that non-agency RMBS peaked at over $1.2 trillion prior to the Crisis and then fell off dramatically. As of year-end 2016, private label MBS remain under $100 billion. Various factors, including economic factors and concerns about the quality of the securitization infrastructure (including servicers, trustees, documentation, etc.), have combined to prevent a rebound in this market.

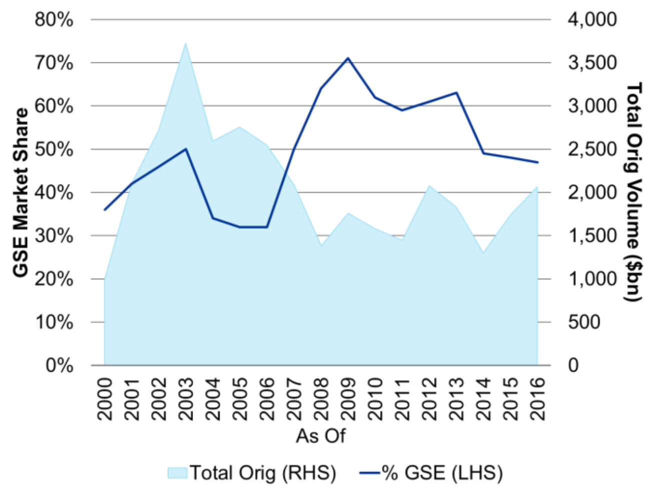
Since the Crisis, Ginnie Mae has been the guarantor for more credit intensive loans via FHA insurance. Though FHA's credit profile has improved since the Crisis, with average FICO scores migrating up to 684,[16] it also encompasses a larger universe of borrowers given FHA's raised loan limits. As these various entities each raised their underwriting standards, access to mortgage credit has been more constrained since the Crisis.

Exhibit 11: Current Face Value of U.S. Federal Reserve MBS Holdings



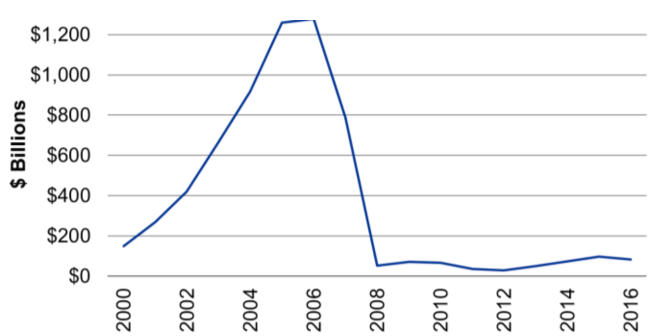
Source: Federal Reserve Bank of St. Louis, Mortgage-backed securities held by the Federal Reserve: All Maturities, available at https://fred.stlouisfed.org/series/MBST. As of Mar. 2017.

Exhibit 12: GSEs' Share of Total Single-Family Mortgage Originations



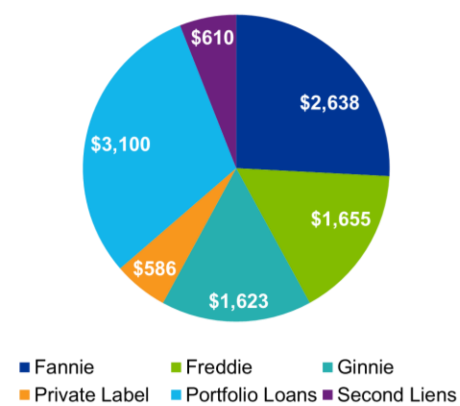
Source: Inside Mortgage Finance, Fannie Mae, Freddie Mac. As of Dec. 2016.

Exhibit 13: Non-Agency Residential MBS Issuance



Source: SIFMA. U.S. Non-Agency Residential MBS Issuance. As of Feb. 2017. Includes resecuritizations and risk transfers.

Exhibit 14: U.S. Single Family Mortgage Market Composition ($ Billions)



Source: Inside Mortgage Finance. As of Sep. 30, 2016.

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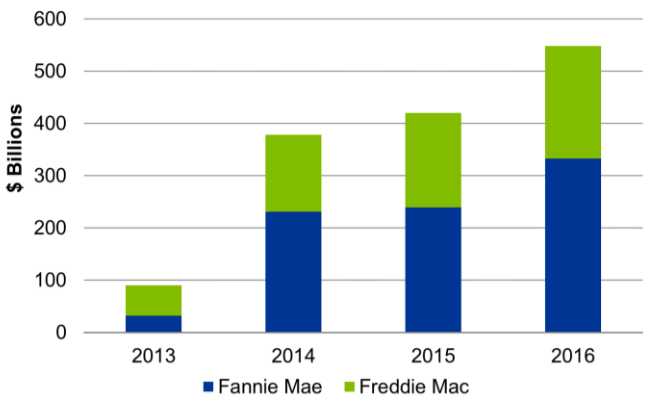
Administrative Reforms

FHFA has overseen various critical reforms of the GSEs, aided by the passage of time and a rebounding housing market. These reforms should support future housing finance reform. Perhaps most notably, the GSEs have developed a Credit Risk Transfer (CRT) market. Under this program, Fannie and Freddie have successfully transferred a portion of credit risk on over $1.4 trillion of unpaid principal balance (out of an aggregate $4.7 trillion) to the private markets.[17] These programs, combined with reinsurance and senior subordinated securitization transactions, provide a framework for dispersing a portion of credit risk to the private markets going forward, thereby protecting taxpayers. As shown in Exhibit 15, CRT activity has been increasing significantly in recent years.

Exhibit 15: GSE Single-Family Mortgage Credit Risk Transfer Activity, Reference Pool Unpaid Principal Balance



Source: FHFA, Credit Risk Transfer Progress Report (Dec. 2016), available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRTProgressReport_Dec2016.pdf. As of Dec. 2016.

FHFA has overseen the launch and ongoing development of the CSP, which can serve as a utility for securitization in a future state. The ongoing efforts toward a GSE Single Security – if implemented correctly – will make this utility more robust and effective.[18] The GSEs have revised and aligned some of their underwriting standards. Furthermore, the GSEs have increased guarantee fees to provide a more stable return and the potential to build an appropriate capital buffer.

All of these initiatives have sought to reduce the risk exposure and market profile of the GSEs and to attract more private capital to assume risk to protect the taxpayer. These changes have been pursued, while the GSEs have maintained their mission to facilitate market liquidity.

We commend the advancement of a number of these reforms. We have indicated our support for leveraging capital markets solutions to attract private capital in our *ViewPoint* U.S. Housing Finance Reform Progress Report: Evolution, Not Revolution, and have written about our general support of the Single Security Initiative in our *ViewPoint* Federal Housing Finance Agency's Single Security Initiative.

BlackRock Policy Framework For Holistic Housing Finance Reform

BlackRock has consistently called for a comprehensive and holistic approach to housing finance reform that respects the rights of investors. We have outlined a number of key principles that should be included in any future reform initiatives. As the Federal government role is reduced to allow for the assumption of additional credit risk by private capital, it is important that there remains a clearly defined government role, including a government guarantee on the MBS to support a deep and liquid market. Importantly, any future policy framework must ensure the fungibility of the existing GSE MBS with any new system.

In the current system and under any future framework, there must be transparency at all levels in order to provide certainty to investors. This includes transparency regarding loan origination, securitization, and access to the secondary market. As we emphasize in our *ViewPoint* US Housing Finance Reform Progress Report: Evolution, not Revolution, we continue to call for national mortgage servicing standards to define servicers' responsibilities to consumers and investors. National mortgage servicing standards would (i) lower costs for servicers, (ii) increase certainty for borrowers, servicers, and investors, and (iii) protect investors by clearly defining the relationships between borrowers and servicers and **between servicers and investors**.

Regulatory policies that recognize and respect the rights of investors are critical to attracting private capital to the housing markets. Special attention should be given to ensure utilization of best practices, protection of investor rights, clarity of policy and regulation, and a fiduciary standard for servicers and trustees. Regulatory policies that make clear a fiduciary standard for trustees would improve investor confidence, addressing the legacy abuses. We urge policy makers to incorporate these principles in any future housing finance reform.

We believe the role of Fannie Mae and Freddie Mac as they exit from conservatorship should be clearly defined in any new housing finance system. Some constraints are necessary to ensure that these important entities do not endanger the housing markets. There should be a limited balance sheet allowed to these entities to hold loans or securities. If structured as corporations, they should not be majority owned by an originator, which creates the possibility of perverse incentives. Their role in the housing finance system should be carefully monitored, clearly defined, and independent of other functions in the housing finance system.

We also believe that a catastrophic government guarantee on mortgage-backed securities is necessary to support a deep and liquid TBA market. The TBA market is a bedrock of the housing finance market because it allows originators to hedge the interest rate risk of 30-year mortgages.[19] This has also created a fungible and high quality security that has drawn investors globally, lowering mortgage rates for U.S. borrowers. This unique structure has supported homeownership and the housing market in the United States, and is an example of a successful component of the housing finance system that should be maintained. Without this support, we believe credit would be more expensive and more difficult to obtain, which would negatively impact housing markets.

We believe there is a role for a utility to support the securitization and management of mortgage securities. Such a utility can underpin the TBA market described above. It can also provide the critical function of standardization of data and servicing, transparency, and accuracy for end investors. One of the lessons of the period prior to the housing crisis was the need for accurate and complete data to be available to end investors of mortgage securities. Entrusting that role to a utility is preferable than solely relying on an entity along the origination and securitization chain, which may not have the interests of investors in mind. This information will help ensure that investors are empowered to make well-informed decisions, and will help avoid creating the investor losses experienced during the Crisis, which in turn reduced credit availability for mortgages.

It is as important to determine a safe and orderly transition to a new system as it is to define that new system. There are currently over $4 trillion in outstanding Fannie Mae MBS and Freddie Mac participation certificates (PCs) held by investors globally. There are hundreds of billions of dollars of newly originated securities issues by the GSEs each year. It is imperative to avoid disruption to the housing finance market and to ensure the continuity of liquidity that the market currently supports. This requires clear and simple fungibility between current securities and any new securities, if they take on a different form; a full faith and credit guarantee on the current securities; and an appropriate transition time.

“Any reform proposal needs to start with an understanding of the housing and mortgage markets today as well as an understanding of the current business models and balance sheets of the GSEs.”

Housing Finance Reform Proposals

Over the past few years, a number of housing finance reform proposals have surfaced. We judge these proposals based on our principles for housing finance reform described above. On one end of the spectrum, some proposals envision almost zero government involvement in housing finance. On the other end, some call for a return to the pre-Crisis public-private structure. Both of these extremes fail to meet the dual goals of a well-functioning housing finance system and protection of the taxpayer. As discussed in this paper, the current circumstances are very different from 2008 when the GSEs were first placed into conservatorship, and we are now in a better place. The housing markets have largely recovered, the financial conditions of the GSEs has stabilized, and the GSEs have undertaken a number of important reforms. That said, Fannie Mae and Freddie Mac remain in an uncertain state of conservatorship.

There have and continue to be an array of housing finance reform proposals shaping the policy debate. Some of the most frequently discussed housing reform proposals include:

I. Recapitalization of the GSEs and reoffering them in the public markets (Recap and Release);[20]
II. A More Promising Road to GSE Reform Proposal (Promising Road) proposed by Jim Parrott, Lew Raneiri, Gene Sperling, Mark Zandi, and Barry Zigas;[21]
III. The Milken Institute Proposal (Milken Institute Proposal) proposed by Ed DeMarco and Michael Bright;[22]
IV. The Mortgage Bankers Association Proposal (MBA Proposal);[23]
V. The Johnson-Crapo Bill introduced by Senators Johnson and Crapo in 2014;[24]
VI. The PATH Act introduced by Jeb Hensarling in 2013.[25]

A review of the proposals suggests that the Recap and Release proposal and the PATH Act, respectively, represent two diametrically opposite poles of the policy debate. Recap and Release, in effect, represents a return of the GSEs to their pre-conservatorship status as privately-owned government-sponsored enterprises which enjoy the benefit of an implicit government guarantee.

This approach is fraught with ambiguity regarding the nature of the guarantee going forward and would potentially return the GSEs to the same conflicted governance framework that gave rise to excessive risk taking. At the other end of the spectrum, the PATH Act would eliminate the GSEs and eliminate any role for the government in the mortgage markets other than a reduced FHA/Ginnie Mae program. This approach would negatively impact the housing sector by reducing the availability of credit and increasing its cost, which would affect millions of potential and existing homeowners.

Each of the other proposals calls for some form of express government guarantee at the MBS level and posits alternative mechanisms to deliver it, as well as mechanisms to lay off some credit risk in the capital markets. We believe these are necessary components of a viable framework. In addition, **we believe that there is a need for both (i) an explicit government guarantee to support the housing sector and (ii) a cushion to protect taxpayers.** In order to succeed at meeting these dual objectives, housing finance reform must address a number of key areas, including the appropriate level of private capital, how to achieve that level of capital, and the appropriate level of cross-subsidization across an array of credit and geographic cohorts.

In addition to these fundamental issues, there are a number of other important factors to consider in housing finance reform. Investors value the fungibility and liquidity of MBS, and this capital is critical to the housing sector. As a result, investors will be watching closely the transition to a new system and the fungibility of legacy MBS in the new system. Another key issue is the transparency and certainty afforded to investors. Basic respect for the rights of private capital will be critical to the ability to preserve deep and liquid MBS markets. Policy makers should consider appropriate GSE and FHA loan limits as they seek to attract private capital to the housing markets. Finally, it is important to consider the legal and regulatory implications of conservatorship, receivership,[26] and the array of outstanding shareholder litigation.[27]

Following is a high level summary of the various proposals.

Recap and Release

The Recap and Release concept has been championed by some academics, housing policy advocates, community lenders,[28] GSE equity investors, and others. Recap and Release calls for Fannie Mae and Freddie Mac to suspend dividend payments to Treasury, allowing them to build sufficient capital to eventually be released from conservatorship. This approach would not necessarily require legislation and could potentially be executed purely on an administrative basis by the Treasury and the FHFA via amendments to the PSPA.

Recap and Release faces a host of economic and legal challenges including the mechanism and timing of building an adequate capital base, resolving outstanding litigation, garnering Congressional support, and ensuring support for legacy exposures. Further, the future state of Fannie and Freddie would again create private shareholder-owned entities with an implicit government guarantee with the inherent governance conflicts. It is not clear how the market would perceive an "implicit" guarantee, and any uncertainty about the nature of the guarantee would be problematic. Once the GSEs lose their substantial government support, their securities may lose their regulatory standing in terms of capital and liquidity treatment. This also raises the question: would the new Fannie and Freddie be deemed systemically important financial institutions (SIFIs)? The questions and uncertainties of Recap and Release coupled with an expected unfavorable reaction by Congress[29] suggest there will be significant challenges to this approach. Recap and Release would likely be disruptive to the market and would fail to provide an explicit government guarantee.

Promising Road

The Promising Road proposal was introduced by housing policy advocates from the Urban Institute, Moody's Analytics, the Consumer Federation of America, the financial services industry, and former White House officials. This proposal would move Fannie Mae and Freddie Mac into a single wholly owned government corporation known as the National Mortgage Reinsurance Corporation (NMRC). The NMRC would perform many of the operational functions that the GSEs perform today and would provide an explicit government guarantee of issued mortgage backed securities, while laying off a portion of the credit risk to taxpayers in the capital markets. The government corporation would leverage the current development of the CRT market and the CSP infrastructure to facilitate ease of execution.

Many components of this proposal merit consideration. For example, this proposal would provide a government guarantee at the MBS level and ensure liquidity and preserve the TBA market. In addition, by leveraging the existing CRT, reinsurance, and securitization technology, some risk would be assumed by private capital providing protection for taxpayers.

Milken Institute Proposal

The Milken Institute Proposal, proposed by the Milken Institute Center for Financial Markets Director Michel Bright and former FHFA Director Ed DeMarco, would convert the GSEs into cooperatively owned front-end credit enhancers. This proposal would welcome new entrants to market in order to syndicate taxpayer credit risk in the capital markets. The proposal utilizes the existing Ginnie Mae infrastructure and processes to guarantee the MBS.

This approach achieves many of our requirements for a viable housing finance market and it can be developed into a robust framework. Further, we recognize the simplicity of this framework, which takes advantage of the current infrastructure of the housing finance system. However, the Milken Institute Proposal poses some challenges. The proposal contemplates the creation of an industry of monoline guarantors, beginning with the legacy Fannie and Freddie entities as cooperatively owned mutuals to be joined by new market entrant competitors. The history of monoline guarantors in the mortgage bond market is troubling.[30] It should also be noted that while the Ginnie Mae moniker is widely recognized and readily understood in the markets, the Ginnie Mae operating platform is based on a relatively small staff of employees that manage the organization and leverage a series of vendors. One possible solution is to merge Common Securitization Solutions (the company in charge of creating the CSP) and Ginnie Mae, and reforming a host of administrative impediments to Ginnie Mae's efficient operation. The possibility of such a merger is promising.

MBA Proposal

The MBA proposal was recently issued by the Mortgage Bankers Association, the national association representing the real estate finance industry. This proposal would convert the GSEs to privately-owned regulated utilities with regulated rates of return that issue MBS with explicit government guarantees. It provides for new entrants to compete with the GSEs in that role. It also converts the CSP into a government corporation that issues government guaranteed MBS and offers securitization access to the GSEs and other competing guarantors – with one objective of this approach being to ensure fair access for lenders of all sizes. Furthermore, the MBA proposal advocates for a multi-year transition period that minimizes market disruption, including advocating for various alternatives to provide an appropriate MBS-level backstop for the GSEs' existing MBS.

We commend this proposal for maintaining an explicit government guarantee at the MBS level with some credit risk shared by private guarantors, including the reconstituted version of the GSEs as private regulated utilities. The proposal is generally in line with our principles for housing finance reform.

Johnson-Crapo Bill

The "Housing Finance Reform and Tax Payer Protection Act of 2014" (the Johnson-Crapo Bill) is based on legislation introduced by Senators Corker (R-TN) and Warner (D-VA). The bill was marked up and voted favorably out of the Senate Banking Committee but did not come to a vote. It proposed, amongst other things, to eliminate Fannie Mae and Freddie Mac. In their place, it would have established a new entity, the Federal Mortgage Insurance Corporation (FMIC), to provide an explicit full-faith-and-credit guarantee on covered mortgage backed securities, provided the mortgage aggregator has obtained 10% first-loss credit support in the form of private capital from either a guarantor or the capital markets.

This bill had many components that merit consideration. In our *ViewPoint* US Housing Finance Reform Progress Report: Evolution, Not Revolution, we provided a detailed analysis of this bill and explore some of the benefits and challenges of this approach. For example, we applauded the bipartisan support for a government guarantee and we appreciated the bill's inclusion of an adequate transition period. We agreed with many of the propositions of the bill, which generally aligned with our principles for housing reform. We would support the bill's framework, which includes an explicit government guarantee, guarantors with a regulator, and standardized polices, practices, and documentation for MBS utilizing a common securitization platform.

We raised some concerns relating to the legislation's reliance on the private guarantor model to provide the required credit support, and it was unclear whether there is sufficient private capital available to assume the 10% credit risk position mandated in the legislation without raising the costs to consumers to prohibitive levels. The complexity of implementation of this new framework is also challenging.

PATH Act

In July 2013, House Financial Services Committee Chairman Hensarling introduced the PATH Act. The PATH Act proposed to eliminate Fannie Mae and Freddie Mac over a five year period and to accelerate the reduction of their retained portfolio. This bill would not have replaced Fannie Mae and Freddie Mac with any form of government guarantee. The proposed PATH Act passed out of the House Financial Services Committee on a straight party line vote but did not come to a vote on the House floor.

We examined this bill in our *ViewPoint* US Housing Finance Reform Progress Report: Evolution, Not Revolution. While we commended the PATH Act for seeking to attract private capital to the sector to absorb mortgage credit risk, we raised concerns that the bill called for no future role for government support in the housing finance market beyond a reduced role for the FHA/Ginnie Mae. This approach would likely materially impair the availability and increase the cost of mortgage credit to consumers, which would have a resultant impact on the nation's housing markets. This bill remains important, as House Financial Services Committee Chair Hensarling has indicated he will reintroduce it this year.

Exhibit 16: GSE Reform Proposal Comparison

Description	Recap and Release	Promising Road	Milken Institute Proposal	Housing Finance Reform & Tax Payer Protection Act (Johnson Crapo)	MBA Proposal	Protecting American Taxpayer & Homeowners (PATH Act)
General Description	• Fannie & Freddie suspend dividend payments to Treasury • Entities build sufficient capital, at which point they are released from conservatorship	• Fannie & Freddie merged into gov't corp - National Mortgage Reinsurance Corp (NMRC) with FHFA oversight • NMRC would have regulated rates of return • CRT to absorb 3.5% of losses; NMRC Mortgage Insurance Fund (MIF) to absorb 2.5% (funded by industry fees); MIF backstop	• Fannie & Freddie become lender-owned mutuals that syndicate credit risk & provide securitization access; FHFA oversight • Ginnie is made a stand-alone entity • CRT assumes 300 to 500 bps of loss & Mutuals assume 200 bps • Government backstop through FHFA-managed MIF	• Federal Mortgage Insurance Corporation (FMIC) created & regulates Fannie & Freddie; Supports secondary market, Approves CRT • Fannie & Freddie eliminated over time • Establishes MIF which covers credit risk after 10% loss absorbed by private investors / guarantors	• Multi-guarantor model with Fannie & Freddie successors as initial guarantors & others approved by regulator • Private capital through CRT & guarantor capital • Federal guarantee only on MBS, supported by MIF • Equitable access to all lenders • Guarantors are monolines with regulated returns & SIFI-like capital requirements • Multi-year gradual transition	• Fannie & Freddie phased out over 5 years; no replacement • National Mortgage Market Utility established to set securitization standards and operate platform – no government guarantee • Rules established for covered bond marketplace • FHA focused on 1st time & low-to-mid income buyers with insurance coverage lowered from 100% to 50%
Government Role Clearly Defined	• Government role not explicitly defined • Unclear private capital requirements	• Clear NMRC / gov't role • 3.5% CRT & 2.5% insurance level higher than Fannie / Freddie crisis loss experience	• Clear GSE / gov't role • 4% CRT & 2% mutual capital level higher than Fannie / Freddie crisis loss experience	• Clear FMIC role • 10% CRT level is high relative to other proposals	• Clear government / regulator role relative to guarantors	• Elimination of GSE role • Limited role for FHA • High reliance on credit investors
Explicit Government Guarantee	• Guarantee not "explicit"	• Clear point at which NMRC MIF absorbs losses	• Clear point at which FHFA MIF absorbs losses	• Clear point at which FMIC absorbs loss	• Explicit Guarantee for MBS only with clear trigger point	• Limited government support for FHA loans
Fungibility of Legacy Securities	• Unclear treatment of legacy securities	• GSEs' legacy financial assets and liabilities would remain with them and be steadily wound down	• GSEs' legacy securities would remain backed by Treasury • Considers re-securitization of some securities through Ginnie	• Authorizes FMIC to insure outstanding MBS issued by GSEs and facilitate their exchange	• Advocates for Congress to direct Treasury & FHFA to amend PSPA to provide backstop for existing MBS; Also, suggests alternatives	• Silent on treatment of legacy securities
Transparent At All Levels	• Continues current role of GSEs	• Transparency for large FIs • Small / mid-sized lenders have access to NMRC cash window	• Transparency for large FIs • Small / mid-sized lenders have access to cash window	• Transparency for large FIs • Access for small / mid-sized lenders • Monoline guarantor use may add systemic risk & reduce transparency	• Fair access to secondary market for lenders of all sizes (no special treatment based on volume)	• Standards set by NMMU
Attracts Private Capital	• Potentially continues MBS standardization • Limited policy & regulatory clarity / certainty	• Promotes MBS standardization & policy / regulatory clarity	• Promotes MBS standardization & policy / regulatory clarity	• Promotes MBS standardization and policy / regulatory clarity	• Promotes MBS standardization through FHFA overseen CSP to facilitate MBS issuance	• MBS standardization and policy / regulatory clarity through NMMU
Comments	• Unclear path / timing to recapitalize entities	• Can 3.5% CRT consistently be achieved? Can 2.5% insurance fund be raised?	• Open question of whether mutualization is possible (cost / timing) • Can 4% CRT consistently be achieved?	• Open question of whether 10% CRT can be achieved • Capital level will impose significant market costs	• Open question on guarantor ability to raise sufficient capital • Open question on new entrant ability to compete with Fannie/Freddie	• Elimination of GSE role would likely limit credit availability and have broad impacts to economy

Conclusion

The residential housing market is vital to the overall economic well-being of the United States. Importantly, the US housing markets have experienced significant recovery since the Crisis. While the nation's housing finance system continues to largely function well, it relies on underpinnings that have significant structural uncertainties. For example, Fannie Mae and Freddie Mac remain in conservatorship and government control. Though they have materially changed through administrative reforms, their future remains uncertain. The new issue private label MBS market remains very small by historical standards, in large part due to the economics, but also due to the lingering investor concerns about the infrastructure underpinning that market. Finally, FHA has expanded its share of the market and supports more credit-challenged borrowers, while still raising its credit standards. Yet legal and regulatory actions have made the program less appealing to many bank originators.[31]

Given the importance of housing to the economy and the importance of MBS to the markets and our clients, BlackRock has consistently called for a comprehensive and holistic approach to housing finance reform that respects the rights of investors. We have outlined a number of key principles that should be included in any future reform initiatives. As the government role is reduced to allow for the assumption of additional credit risk by private capital, it is important there remains a clearly defined government role, including a government guarantee to support a deep and liquid market. Importantly, any future policy framework must ensure the fungibility of the existing GSE MBS with any new system. In the current system and under any future framework, there must be transparency at all levels in order to provide certainty to investors. This includes transparency regarding loan origination, mortgage servicing standards, securitization, and access to the secondary market. In order to attract additional private capital to the mortgage market, special attention should be given to ensure best practices, protection of investor rights, policy and regulatory clarity, a fiduciary standard for servicers and trustees, and appropriate GSE and FHA loan limits. We urge policy makers to incorporate these principles in any future housing finance reform.

The beginning of a new Administration and a new Congress has once again drawn attention to the need to address comprehensive housing finance reform. A recovering housing market and GSEs, which have and continue to undertake a series of administrative reforms, provide the context. Despite the housing market recovery, there is ongoing policy uncertainty regarding the future state of the US housing finance delivery system and its implications for investors and other market participants. There is consensus that there is a need for private capital to support the sector. While not unanimous, the preponderance of the policy proposals acknowledge the need for a government guarantee to absorb catastrophic risks in order to ensure continued liquidity. In addition, the proposals contemplate leveraging the capital markets to absorb credit risk in order to protect the taxpayer. We commend this approach, and recommend the adoption of the policy that will prove the least disruptive with the greatest ease of execution and fungibility between the current and any future state. Ultimately, private capital in the mortgage market requires a transparent process that provides certainty and respect for the rights of investors, both in the current framework and in any transition to a future system.

“*We continue to call for policy makers to approach housing finance reform on a holistic basis which respects investors' rights and attracts private capital to the sector while maintaining a deep and liquid mortgage market.*”

The prospect for the enactment of legislation this year is low, as the Administration and Congressional stated priorities are centered on healthcare reform, tax reform, infrastructure investment, and Dodd-Frank adjustments.[32] Notwithstanding the low probability of the enactment of comprehensive housing finance reform legislation, the contours of the debate continue to evolve and the mortgage market continues to be reformed by the administrative actions by FHFA. We continue to call for policy makers to approach housing finance reform on a holistic basis which respects investors' rights and attracts private capital to the sector while maintaining a deep and liquid mortgage market. From 2000 to 2016, housing's contribution to gross domestic product (GDP) has averaged 16.6%, comprised of 4.2% of GDP in the residential housing market and 12.4% of GDP in consumption spending on housing services including rents and utilities.[33] Given the significance of housing markets to the nation's economy, policy makers should take the time to get housing finance reform right.

Related Content

- BlackRock, *ViewPoint* – Federal Housing Finance Agency's Single Security Initiative (Mar. 2016)
- BlackRock, *ViewPoint* – US Housing Finance Reform Progress Report: Evolution, Not Revolution (Aug. 2014)
- BlackRock, *ViewPoint* – Housing Finance Update: The Conundrum Continues (Aug. 2013)
- BlackRock, *ViewPoint* – The Housing Finance Conundrum (Jan. 2013)
- US Treasury and the Department of Housing and Urban Development – Reforming America's Housing Finance Market: A Report to Congress (Feb. 2011)

For access to BlackRock's full collection of public policy commentaries, including the *ViewPoint* series and comment letters to regulators, please visit www.blackrock.com/corporate/en-us/insights/public-policy.

Endnotes

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8. Despite the change in presidential administrations, Mel Watt, the Director of FHFA, has a five year term ending in Jan. 2019 and can only be removed for cause, unless he chooses to resign before the end of his term.
9. As of 1Q17. Fannie Mae required 13 quarterly draws between the third quarter of 2008 and the fourth quarter of 2011. Freddie Mac required 10 quarterly draws between the third quarter of 2008 and the second quarter of 2011.
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11. FHFA Director Mel Watt, Prepared Remarks at the Bipartisan Policy Center (Feb. 18, 2016), available at https://www.fhfa.gov/Media/PublicAffairs/Pages/Prepared-Remarks-Melvin-Watt-at-BPC.aspx.
12. Id.
13. In 2013, both Fannie and Freddie saw an increase in pre-tax income as a result of the release of their deferred tax asset (DTA). The value of the DTA will be affected by the outcome of any tax reform package, absent a specific carve out.
14. See Federal Reserve, Press Release (Sep. 13, 2012), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20120913a.htm.
15. Federal Reserve, Minutes of the Federal Open Market Committee Mar 14-15, 2017 (published Apr. 5, 2017), available at https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170315.pdf.
16. Ellie Mae, Origination Insight Report (Mar. 2017), available at https://cdn.elliemae.com/origination-insight-reports/Ellie_Mae_OIR_MARCH2017.pdf.
17. FHFA, Credit Risk Transfer Progress Report (Dec. 2016), available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRTProgressReport_Dec2016.pdf.
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24. Johnson-Crapo Bill.
25. PATH Act.
26. The Housing and Economic Recovery Act of 2008 provides for minimal control or relief for shareholders in the case of receivership. See Fed. Reg. 76, No. 118, 35724-35735 (Jun. 20, 2011).
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