GSE Reform: Is There Any Consensus?
A Discussion on Challenges and Prospects of Housing Finance Reform

Friday, June 22, 2018

Hosted by the National Association of REALTORS®

Roundtable Report

NATIONAL ASSOCIATION of REALTORS®

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I. Introduction

It has been more than ten years since the financial crisis and the financial reforms that placed Fannie Mae and Freddie Mac in the conservatorship that remains today. Since then, America's homeownership rate has struggled to match falling unemployment and increasing consumer confidence. With mortgage rates set to rise in the coming years, alterations to the housing finance system could exacerbate affordability issues and limit access for future homebuyers

On Friday June 22, 2018, the National Association of REALTORS® hosted a roundtable event examining the status of comprehensive reform of the secondary mortgage market in an effort to begin identifying potential short-term and long-term solutions to outstanding issues. NAR gathered three panels of academic experts, financial consultants, and policy advisors to determine a consensus, if any, around what shape such reforms might take, what specific issues need to be resolved now and in the future, and how much longer it will take to achieve the desired results.

The discussion largely focused on Fannie Mae and Freddie Mac (government-sponsored enterprises or GSEs) – with each currently playing a key role in the secondary mortgage market that provides the majority of capital for mortgage lending. During the housing finance sector's collapse, private capital withdrew from the market and without support from the GSEs and the Federal Housing Administration (FHA), the recession could have been much worse.

However, the GSEs also play a critical role in good economic times. By providing liquidity and access to affordable mortgage financing for credit worthy borrowers, the GSEs help a broad swath of middle-income Americans achieve homeownership. Since the recession, two administrations and multiple congresses have worked to reshape the entities. These efforts which have been productive but have ultimately failed to complete the reform.

Isaac Boltansky, director of policy research with Compass Point, opened the event outlining the broad sweep of secondary market reform since the crisis and the current state of play. "It is deplorable that Congress has left the GSEs in conservatorship for 10 years, but it isn't all bad news. There have been meaningful administrative improvements that have made the system safer and have advanced the debate," he said. "As a result, the broader policy conversation has shifted from a consideration of remaking the mortgage finance system to an acceptance that a package of narrower reforms could suffice. Effectively, we've gone from consideration of tearing down the whole house for a rebuild to the belief that we should just tweak the house's plumbing and do some landscaping."

Mr. Boltansky's comments provided a starting point for the day's discussion examining how the U.S. financial system is functioning today and the proper role of the federal government. The experts on the panels conveyed general agreement on maintaining portions of the current system with the addition of an explicit government guarantee, but differed in their views on what is working well and the reforms needed to increase competition and drive the private market.

II. Examination of the Current Landscape

Moderator Susan Wachter, professor of real estate and finance at the University of Pennsylvania's Wharton School, led the first panel in an examination the current state of play, focusing on two different proposals for a future system that have dominated the public discourse. Ted Tozer of the Milken Institute and former head of Ginnie Mae argued for allowing the GSEs to compete with private capital to securitize pools of loans, but for Ginnie Mae to provide a government guarantee and the common securitization platform (CSP) for the industry. He noted that, "Ginnie Mae has had a common securitization platform for over thirty years. What the GSEs are trying to accomplish with the CSP and unified MBS, Ginnie Mae has had for years, not only a successful CSP. Ginnie Mae has also managed a multiple-issuer MBS program that has been incredibly successful, allowing over 400 issuers to compete on a level playing field." Furthermore, Mr. Tozer noted that the GSE's CSP will be recognized as, "one of the biggest wastes of tax payers' monies in history…nearly a billion dollars…when they could have just plugged into [the] Ginnie Mae" infrastructure.

Phillip Swagel, also of the Milken Institute and professor at the University of Maryland School of Public Policy, spoke about the features of a system with multiple GSE-style guarantors. This type of system would provide, "competition in the secondary market from new entrants and solve 'too big to fail.'" However, the third panelist, Andy Davidson of Andrew Davidson and Company, chided, "that we do nothing…the last ten years are the strongest in history." Mr. Davidson noted the problem with a multi-guarantor model, where the "only way to get rid of two dominant players is to restrict the market via an artificial construct, but they would eventually return." Mr. Davidson's critique juxtaposed the notion of free competition with the means necessary to attain it such as caps on the GSEs' market share or some other means. He also argued that a Ginnie Mae style model has not been tested in the GSE sense, as Ginnie Mae does not have to manage multiple private guarantors and thus has significantly less counter party risk.

In response, Mr. Swagel added that his hope is that a reformed system, "does not solve 'too big to fail,' but would addresses it" likening the task to comments made by Tyron Hill of his former teammate Allen Iverson; "You can contain him, but you can't stop him." Mr. Davidson responded that he does not want to see them fail, "but to see them succeed and regulate them well - understanding that there will be problems over time." With respect to competition, Mr. Tozer noted that in the reformed system, competition should be "more than rates, it's about programs and parameters at the grass-roots lender level, not a national policy."

III. Other Industry Perspectives on Reform Objectives

The second panel included representatives of consumer groups, small lenders, and major investors in mortgage backed securities (MBS) and credit risk. While their views were not necessarily reflected in the two models discussed in the first panel, they represented important sectors of the housing market, which seek particular outcomes from a reformed system.

Mike Calhoun, President of the Center for Responsible Lending, argued that a future system should focus on providing credit to the broadest market possible. Because this function is so vital, he argued that it should be run as a market utility. Furthermore, he noted that such a system should include goals for supporting ownership and a duty to serve that could be funded through borrower fees. Mr. Calhoun stated how the role of this utility is critical in breaking the issue of the lack of intergenerational wealth transfer within the African American community, which is a key source of funding a down payment and achieving home ownership.

Wes Hunt who runs Homestar Financial, a non-bank mortgage lender from Gainesville, Georgia, argued that any new system must guarantee access for lenders of all sizes and prevent disparate pricing of guarantees for different players. Community based lenders, provide the bulk of mortgage financing outside of large cities and are successful by competing on service and quality of the consumer's experience. "Well-capitalized GSEs that treat all lenders equally in terms of fees and upfront risk sharing will avoid concentrations of risk and ensure a flow of affordable mortgage money," which is particularly important to families and small business owners in rural communities stated Mr. Hunt."

Kent Smith of PIMCO, one of the world's largest fixed income investment managers, shared the perspective of an investor in GSE mortgage backed securities. With respect to the models dominating the discussion, he argued that, "multiple guarantors won't deliver lower rates to the market, the quality of the guarantee will," and with respect to the issuer-based model, "requiring competition doesn't make sense if you have too many issuers, which risks fragmenting the market resulting in less liquidity and ultimately higher rates for borrowers." Furthermore, "the GSEs aren't broken; they are delivering mortgage credit more fairly and efficiently than they ever did." However, he noted that the reform discussion should go beyond just reshaping the GSEs, but to "restoring balance … and you won't restore the balance until you restore private capital and reform aggressive regulation and enforcement." Mr. Smith said that in order to increase private capital assignee liability must be reduced by reforming the Ability to Repay and Qualified Residential Mortgage rules that make investors responsible for the practices of the lenders from whom they buy mortgages. Accordingly, capital is more expensive, which drives up costs for consumers and reduces access for some borrowers. Risk retention, moreover, adds an unnecessary capital requirement to the issuance of private-label RMBS. He concluded that risk retention is unnecessary, in that the Ability to Repay rule has already resolved the problem – poor mortgage underwriting – that risk retention was established to address.

During the discussion, Mr. Calhoun noted that a system without a duty to serve would limit support for minority groups to the FHA, a change that would be viewed as an "apartheid system" by minority groups. He also noted that in bad times, there should be a liquidity facility for the future GSEs so that they can continue to buy mortgages and sell MBS to investors even if private capital is not available to insure the loans.

IV. Points of Wisdom from a Sage Participant

David M. Dworkin, president and CEO of the National Housing Conference and former Treasury official, provided his perspective on reform efforts through two administrations during a keynote address. "Housing finance reform remains the single largest unfinished business of the housing crisis. The failure of Fannie Mae and Freddie Mac, the taxpayer bailout and repayment that followed, and their unresolved conservatorship continue to demand final resolution, even if Congress does not," he said.

Mr. Dworkin warned that achieving definitive reform would not be easy, though. "The fact is that anyone in this room could redesign our mortgage finance system on the back of a napkin as long as you don't care about the long term, fully-amortizing, pre-payable, fixed-rate mortgage. However, if we want a mortgage finance system that preserves the fundamental element that sets us apart from the rest of the world while providing the only meaningful wealth creation tool available to low-and moderate-income Americans, then [mortgage finance reform is] going to be an incredibly complex exercise, with enormous transition and counterparty risks and incalculable unintended consequences," said Dworkin.

As for the prospects for reform, Mr. Dworkin chided, "Ultimately, however, we may have to wait to be moved to action by another housing crisis, as interest rates continue to rise, and housing affordability continues to decline. That would be a truly tragic outcome and could cost us more than we can imagine."

V. An Alternative Path: Administrative Solutions

Prospects for legislative fixes to the GSEs from Congress this year look dim – a consensus held by all of the panelists. Consequently, the administration may increase its role in the reform debate, making changes to the GSEs' programs to affect the administration's vision of the future of the secondary market. The third and final panel of the day discussed these potential administrative changes and their impact on the mortgage market.

Pat Lawler of the American Enterprise Institute and former Chief Economist for the Federal Housing Finance Agency (FHFA) argued that, "most of the benefits of government participation go to upper-income borrowers, driving up home prices." Mr. Lawler noted that the GSEs' dominance in the market can be restrained through lower loan limits, higher guarantee fees, or changing the type of products offered. He emphasized the importance of taking small, gradual steps to make any market disruption unlikely, and pointed out that restricting large GSE loans used for refinancing might actually lower rates on GSE loans used for purchases. He noted that in any event rates typically fluctuate by more than 100 basis points per year and that shrinking the GSEs' footprint gradually would not affect the to-be-announced (TBA) market. The TBA market is widely credited with providing liquidity and stability to much of the mortgage market, which translates to lower cost and less volatility for homebuyers.

Jim Parrott, a scholar at the Urban Institute and owner of Falling Creek Advisors, took a different tact, arguing for changes that will increase competition and private capital within the GSE space rather than shrinking its market share. He acknowledged that lower loan limits might help to stimulate a private MBS industry and asserted that the GSEs need competition to reduce the market's dependence on them, which could be achieved through the chartering of more GSEs, not less.

Chrissi Johnson of Quicken Home Loans, the largest non-bank mortgage lender, discussed the benefits of the current system including a broad, national market with low costs and broad access for homebuyers. She noted with concern that a system that relies on depository banks would function to reduce competition and choice for consumers. The GSEs function as an important counter weight under stress, arguing that, "we need a system that doesn't pull back when times get tough" and that some reform proposals shrinking the GSEs could actually make markets worse during recessions.

"If I'm teaching an industrial organization class and I ask my students what type of organization you would have in an industry with huge barriers to entry, huge positive and negative externalities, and infrastructure that is common, the answer better be a regulated utility," quipped Richard Cooperstein of Andrew Davidson and Company. He asserted that given this optimal structure, the most important role for the reformed system is to have entities that set standards, provide liquidity to the market, and fulfill a required duty to serve as a prerequisite for the oligopoly that they will enjoy. "They seem like regulated entities…wishing that away for competition won't solve the problem."

Ted Tozer kicked of a vigorous open discussion of reducing the GSEs' footprint, stating that, "low income workers will not be affected by reform done wrong since they can go to the FHA, but middle income car plant workers will." He followed up by emphasizing Chrissi Johnson's earlier comments on how Quicken "spends more time on the small share its business done outside of the GSEs as it does on the bulk of its business which is inside the GSE space." Ken Smith added that the clear public good provided by the GSEs, is in effect, a national rate. In other words, regardless of where they are, borrowers with the same characteristics – e.g. loan-to-value, credit score and debt-to-income – receive the same rate. In a fully private mortgage market, there would be significant dislocation in the availability and price of credit across the country, while Pat Lawler countered that, "pricing in markets across the country has been well-integrated for decades and national investors will continue to ensure." Jim Parrott was adamant that as loan limits are lowered, it will draw down the ability to cross subsidize. Andy Davidson responded that "limits should be reduced to restore PLS (private-label mortgage backed securities), but if lowering limits is intended to eliminate the GSEs, then I'm opposed to a single dollar of reduced limits."

On the topic of stimulating the private MBS market, Richard Cooperstein quipped that the, "CRT (credit risk transfer) market proved that the PLS market is archaic because there is no counter party risk on the other side in CRT and you can be confident [as an investor]." Furthermore, he noted, a system dependent on rating agencies has a critical principle-agent problem. In short, restoring the PLS market is a slow road and even if it works, it will not solve all problems.

Finally, moderator Susan Wachter asked participants what they hoped for out of administrative reform. Mike Calhoun stated that, "we have a system that is working now, but we shouldn't change unless we have something better." While Andy Davidson was less sanguine about reform, responding that, "we can't get something out of the guys on the Hill unless things are burning."

Richard Cooperstein sought a $100 billion private equity backstop with a fully penetrated CRT program for a regulated entity and more focus for the FHA's role in the market, while Jim Parrot rounded out the responses hoping for more institution-based capital in the GSEs space, a good FHFA director to replace Melvin Watt, and improved technology in for the FHA.

VI. Is There Any Consensus?

While the panelists' views varied and some were in direct competition, all participants on the panels proposed or favored a role for the federal government in the reformed market. A surprisingly large number favored keeping the current system going with minor tweaks in lieu of wholesale change. Finally, most of the participants expressed some level of concern toward changes to the market intended to stimulate competition or privatization. NAR will continue to engage policy makers, analysts, academics, investors, lenders, insurers - the full spectrum of participants to drive thought and consensus toward completing the critical process of secondary market reform and safeguard the dream of homeownership across America.