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A Blueprint for Administrative Reform of the Housing Finance System

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RESEARCH

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INTRODUCTION

This paper sets out proposed administrative actions to reform the housing finance system in the absence of legislation. The goal is to build upon the progress that has been made toward a safer and more effective housing finance system with Fannie Mae and Freddie Mac in conservatorship, while ensuring the continued operation of the system. Ultimately, Congress must act to create an explicit, paid-for government guarantee of qualified mortgage-backed securities (MBS) and to provide the housing finance regulator with the authority to charter new firms to compete with Fannie and Freddie. While the policy debate over legislation continues, administrative measures can advance the government-sponsored enterprises (GSEs) toward an end-state vision that ultimately requires legislative action to finalize.

The action steps outlined in this Milken Institute paper do not lead to the end of the conservatorship absent legislation because we do not see a viable path by which administrative measures can fix critical flaws in the GSE charters—and fixing these flaws should be viewed as a necessity.[1] Even so, administrative measures can address many of the stumbling blocks to legislative action and thereby set the stage for further reform that includes changes to the GSE charters. Importantly, the administrative measures we recommend are consistent with a number of possible longer-term end-states for the GSEs and the secondary housing finance market. This policy brief takes no position on the precise end-state to be accomplished with legislation.[2] Instead, the focus is on administrative steps that advance the broad goals of housing finance reform and for which we believe there could be bipartisan support.

We oppose releasing the GSEs from conservatorship without fixing the critical flaws in the GSE charters. The GSEs have accomplished a great deal post-crisis and their management and staff deserve

[1] See Kaplan, Eric, Michael Stegman, Phillip Swagel, and Theodore Tozer, "Bringing Housing Finance Reform over the Finish Line," Milken Institute, January 2018, https://www.milkeninstitute.org/publications/view/898.

[2] However, in "Bringing Housing Finance Reform over the Finish Line," the authors lay out – and reiterate here – key reform principles for any housing finance reform end-game, including (i) making private capital the primary source of mortgage credit and bearer of credit losses, (ii) reducing taxpayer exposure to the housing finance system, (iii) ensuring access to sustainable mortgage credit on competitive terms, and (iv) enabling the entry of competitors to the GSEs or any successor on an equal footing.

considerable credit for continuing to innovate and improve the housing finance system while in conservatorship. Still, it must be recognized that the GSEs' post-crisis success has occurred: (i) under a protected duopolistic status that impedes entry and competition, (ii) with unparalleled access to capital with explicit government backing, and (iii) in a strong economic environment that reflects historically low delinquencies. Releasing the GSEs from conservatorship without a plan in place to resolve the charter flaws—most notably, the privatizing of profits and socializing of losses—would be to disregard the lessons of the firms' failures during the financial crisis.

The paper first discusses steps to complete the existing business underway in the conservatorship, and then turns to other administrative measures that should be taken to make progress on housing finance reform beyond determining the future of the GSEs.

COMPLETE EXISTING BUSINESS IN CONSERVATORSHIP

REVISE AND COMPLETE THE GSE CAPITAL RULE PROPOSED BY THE FHFA[3]

Because of its importance and complexity, the Federal Housing Finance Agency (FHFA) should follow the practices of other financial regulators by completing the GSE capital rule through an iterative process involving more than a single round of public input. At a minimum, re-proposing the rule is necessary to provide the public with more insight into the FHFA's analytical constructs, assumptions, and data that went into the initial formulation of capital and leverage requirements. Getting this rule right is critical to creating a housing finance system driven by private capital that can survive future downturns and maintain liquidity for credit-worthy borrowers throughout the economic cycle. The rule will also guide the pricing of guarantee fees and provide potential investors with critical information on the economics of the future housing finance system featuring a security-level government guarantee.

Two key issues with the rule are the amount and quality of capital required and the framework with which to address the pro-cyclicality of the initial proposal.

Required Capital

The authors of this paper agree that that the capital rule should require the GSEs and any future entrants into government-guaranteed securitization to fund themselves with enough capital to protect taxpayers and to align the incentives of investors to exercise prudence by ensuring that their own funds are at risk. While we do not agree on the appropriate amount of capital, we do agree that a capital requirement of 2.5 percent would have been enough for the GSEs to make it through the 2008-09 financial crisis *only with the full panoply of emergency measures taken by the Treasury, Fed, and FDIC.*

[3] "Enterprise Capital Requirements," Federal Register, July 17, 2018, https://www.federalregister.gov/

The goal should be to ensure that there is sufficient capital to support the continued operation of the housing finance system without the need for future extraordinary measures. We also recommend avoiding capital arbitrage by considering comparable capital treatment of other regulated entities in shaping the capital rule.

Pro-Cyclicality

The FHFA should maintain mark-to-market benchmarking of loan-level capital requirements as proposed, but also include in the final rule a rules-based countercyclical component that increases capital requirements during a housing market boom and reduces the requirements during a downturn. Partly because of its opacity, there is little agreement on the extent to which the proposal is pro-cyclical. For example, in its comment letter on the rule, Fannie Mae estimates that the amount of capital required for single-family performing loans would increase by 80 percent during stress cycles, leading Fannie to maintain higher capital during good times to avoid the need for a rapid capital increase.

ALLOW THE GSES TO REBUILD RETAINED CAPITAL

The Treasury Department (Treasury) and the FHFA should amend the Preferred Stock Purchase Agreements (PSPAs) to suspend dividend payments to Treasury on a non-accrual basis during the suspension period. Additionally, such amendments should allow each GSE to retain capital on their balance sheets above the current applicable limit of $3 billion, provided that doing so (i) is not a prelude to releasing the GSEs from conservatorship absent legislation to resolve serious charter flaws, and (ii) would not represent a compromise of taxpayer claims.[4] Dividend payments would be replaced by reinstatement of a periodic commitment fee that would continue to compensate Treasury for the hundreds of billions of taxpayer dollars that backstop the GSEs' debt and MBS guarantees. The suspension would remain in effect until the FHFA determines

[4] If the Department of Justice determines that a proposed substitution of a Periodic Commitment Fee for the existing Net Worth Sweep dividend provision would be a compromise of claims under 31 U.S.C. § 3711(a)(2) and 31 CFR 902.2, then the proposal cannot proceed without the written approval of the Attorney General or his delegate.

that the GSEs are compliant with the final capital rule or until Congress enacts housing finance reform legislation, whichever comes first.

The rationale for this recommendation is four-fold:

1. Regardless of the specific forms a reformed secondary market system might take, all require credit enhancers to raise substantial amounts of private capital to be placed at risk in front of any government guarantee.

2. Eliminating the GSE dividends as a source of funding for other government programs would remove a reason to extend the status quo indefinitely.

3. Stronger GSE balance sheets would protect two affordable housing programs that they fund through an assessment on their new business each year. Under current law, the FHFA can suspend these assessments if collecting them would jeopardize either GSE's financial stability.

4. Building up the GSEs' equity cushions would reduce the likelihood of future draws against Treasury's capital backstop and the attendant political risks of one-off congressional intervention that such events can entail.

COMPLETE THE WORK ON THE UNIFORM MORTGAGE-BACKED SECURITY

The FHFA should finish the work on the uniform mortgage-backed security (UMBS) that will unify the previously separate MBS of Fannie and Freddie. Experience with the UMBS will then guide whether the GSEs' or Ginnie Mae's securitization platform should serve as the plumbing of the future system.

A common MBS for all guarantors is critical to allow for future entry, competition, and maximum liquidity. Without a uniform security, MBS issued by new guarantors would be less liquid than the incumbent firms' securities and trade at a discount to Fannie Mae MBS (as has been the case for Freddie Mac).

This disparity would make it difficult for new guarantors to compete for business. A key indicator of the long-term success of the uniform security will be for investors to perceive that mortgages in MBS from various issuers prepay at similar speeds through economic cycles; otherwise, there could be pricing differences across guarantors (as has been the case between Fannie and Freddie MBS), which would reduce the value of the UMBS.

Ginnie Mae provides an alternative on which to base a common security if investors in the UMBS see enough differences between MBS issued by Fannie and Freddie that the liquidity advantages of the uniform security are not realized. Ginnie Mae technology today allows multiple issuers to deliver into an MBS that has the same pool number and CUSIP number. SIFMA already requires that all Ginnie Mae "to-be-announced" (TBA) trades use the multiple issuer pool. If an issuer wants to issue a generic Ginnie Mae security that is not a multiple issuer pool for that month, the MBS is not eligible for TBA delivery. The Ginnie Mae program allows investors to buy a share of the whole market, a feature that minimizes how much one issuer can affect the prepayment speeds of an MBS pool.

NEW STEPS TO IMPROVE THE SYSTEM

IMPLEMENT TRANSPARENCY ON GSE PRICING

The FHFA should provide full information on the cross-subsidies built into GSE all-in guarantee pricing to allow for a reasoned policy discussion over the future role of the GSEs, including their footprints and product mix and the mechanisms by which the future system will serve low-income borrowers. The FHFA has disclosed neither the underlying data and assumptions nor the analytic constructs used to determine loan-level capital economic allocations, levels of under- and over-charging of loans in various risk buckets. One estimate of the extent of cross-subsidy in the current system is around $4 billion a year.[5] Another form of cross-subsidy arises out of differential mark-ups or "Loan Level Pricing Adjustments" across loan products. For example, investor loans are priced to generate surpluses significantly beyond their forecasted losses and contribute revenues beyond their share of overall business to help reduce costs for higher-risk home loans. GSE financial performance thus depends not only on overall business volume, but also on product mix and the composition of loan purchases across risk buckets. A granular understanding of current GSE pricing is needed to inform future reforms.

[5] Parrott, Jim, Michael Stegman, Phillip Swagel, and Mark Zandi, "Access and Affordability in the New Housing Finance System," Urban Institute, February 2018, https://www.urban.org/sites/default/files/publication/96461/access_and_affordability_in_the_new_housing_finance_system_2.pdf.

PROVIDE MORE RISK-BASED PRICING OF GUARANTEE FEES, WITH EXPLICIT SUBSIDIES FOR AFFORDABLE HOUSING

Risk-based pricing, along with explicit subsidies for affordable housing, will allow for greater and more effective assistance to families who need help to become homeowners. Under the current system, low-risk borrowers pay higher guarantee fees to provide a cross-subsidy for higher-risk borrowers. Ultimately this leads to adverse selection for the GSEs, as low-risk borrowers find better deals in loans that end up in private-label securitizations (PLS) or on balance sheets.

The current situation in which high-quality mortgages get better execution through PLS indicates that the cross-subsidy could push up guarantee fees for low-risk loans beyond a tipping point.

While cross-subsidies within GSE pricing are by far the largest source of affordable housing funding, they are poorly targeted because subsidies are allocated on the basis of risk rather than need—currently, 23 percent of GSE mortgages that are subsidized within the two firms' pricing structures do not go to low-income families.[6] This means that low-risk, low-income families with higher credit scores pay more for their loans in order to subsidize higher-income borrowers with lower scores.

EVALUATE AND IMPROVE THE EFFECTIVENESS OF AFFORDABLE HOUSING MEASURES

The FHFA should evaluate and refine the GSEs' affordable housing activities. Using initial data collected by Treasury and the non-profit National Low Income Housing Coalition, a recent Milken Institute assessment found that early allocations from the GSEs' affordable housing assessment to the Housing Trust Fund and Capital Magnet Fund provided resources to intended activities.[7] As more dollars are deployed, the FHFA would do well to deepen the understanding of the effectiveness of these programs.

While the affordable mortgage purchase requirements have the longest history, the evidence is uncertain that they expand lending to creditworthy low-income borrowers over and above the benefits of their securitization activities for the mortgage market as a whole. The FHFA should use its wealth of available data and its deep analytical expertise to assess the effectiveness of the affordable housing goals regime.

The GSEs are only one year into execution of their initial three-year duty to serve underserved markets plans, which is too early to determine how well they are working.

[6] Parrott, Jim, Michael Stegman, Phillip Swagel, and Mark Zandi, "Access and Affordability in the New Housing Finance System," Urban Institute, February 2018, https://www.urban.org/sites/default/files/publication/96461/access_and_affordability_in_the_new_housing_finance_system_2.pdf.

[7] Stegman, Michael and Phillip Swagel, "An Affordable Housing Fee in the Context of GSE Reform," Milken Institute, June 2018, https://www.milkeninstitute.org/publications/view/916.

However, there are aspects of the current rule, such as the inclusion of financing for renewable energy improvements, that reduce their effectiveness in delivering more affordable housing to underserved markets.

More data-driven analysis of each of these affordable housing regimes would be useful to inform the next legislative debate. At the same time, the FHFA should ensure that any refinements made in conservatorship do not reduce the scope or amount of support for affordable housing. Changes should include improved targeting so that subsidies go to prudent low-income families rather than to imprudent higher-income families. This would not mean a reduction of effort or resources for affordable housing—instead, the eventual outcome of housing finance reform should be to increase these resources.

IMPROVE THE TARGETING OF GSE MULTIFAMILY HOUSING ACTIVITIES

The FHFA should recalibrate current volume caps and exemptions to reduce the GSEs' dominance in the multifamily financing market and to better support the production and preservation of low- and moderate-income developments. The GSEs use their taxpayer-advantaged costs of capital to underprice private sources of multifamily financing for market-rate properties. While the FHFA's rationale for allowing exemptions from the volume cap is to encourage more GSE lending for affordable housing, allowed exemptions have grown to the point of diminishing effectiveness and could be crowding out private sector activity.

EXPAND THE FUNCTIONALITY OF THE COMMON SECURITIZATION PLATFORM (CSP) AND OPEN ACCESS TO KEY GSE TECHNOLOGIES

The functionality of the CSP should be expanded to facilitate future entry by new participants that can connect to the CSP on an equal footing with Fannie and Freddie in government-guaranteed securitizations. Additionally, it should support non-agency, non-government-guaranteed securitization.[8]

[8] In this paper, "agency" pertains to either or both GSEs, and "non-agency" pertains to non-GSE and non-government mortgage programs.

NEW STEPS TO IMPROVE THE SYSTEM

Given that the private firm Common Securitization Solutions (CSS)—which created and administers the CSP—is a joint venture of the GSEs, CSS should eventually be spun off as an independent entity to serve as a market utility.[9] The FHFA should utilize the period of conservatorship to evaluate the details of expanding the CSP's functionality, and publish a transparent analysis of their findings.

[9] Note that this action and certain others that could be considered—e.g., expanding voting rights to new non-GSE CSS board members—might need to be dealt with outside of conservatorship. We recommend a legal analysis in conjunction with the evolution of CSS to accommodate future housing finance system end-games.

The operational, technological, and economic hurdles of building a bespoke attachment to the CSP are substantial and act as a barrier to entry and competition. The FHFA should analyze and seek to alleviate these challenges. As an alternative, it is possible that technology under the auspices of Ginnie Mae could provide an efficient path for new participants to connect to the CSP. For example, the current CSP structure relies on Fannie and Freddie's computing facilities for a large part of the agency MBS bond administration calculations. Ginnie Mae's platform can perform these functions in the same manner as Fannie and Freddie. Conceptually, Ginnie Mae could attach to the CSP and new entrants could report the data underlying these calculations directly into Ginnie Mae. Leveraging the existing Ginnie Mae platform in this manner would eliminate the need for bespoke attachments by new entrants. We recommend that the FHFA, Ginnie Mae, and CSS collaborate to evaluate this potential pathway so that their findings can inform the development of end-state housing finance reform.

Other barriers to entry involve GSE data, tools, and technologies that make competition by new entrants on an equal footing with the GSEs impractical. Among other things, the GSEs enjoy exclusive access to and control over:

- ***Data*** – The breadth and depth of the GSE data trove, developed over decades in a protected environment, is unmatched across the housing finance landscape.

• ***The Uniform Data Collateral Portal (UCDP)*** – The UCDP, through which lenders submit appraisal reports for conventional mortgages delivered to Fannie and Freddie, provides the GSEs with a wealth of appraisal data and information that is similarly unmatched.

• ***Collateral evaluation tools –*** The GSEs have been able to use their expansive data on home values to build models to evaluate the accuracy of appraisals. Appraisals are perhaps the most subjective component of the loan underwriting process and pose significant risk to lenders and guarantors. These collateral evaluation tools have streamlined the origination process for lenders who sell their loans to the GSE while reducing risk.

• ***Automated Underwriting Systems (AUS)*** – The GSEs' AUS constitute an industry standard as they are used to underwrite almost half of all loans. But only Fannie and Freddie know the programming and algorithms embedded in their respective systems. Nevertheless, because the GSEs' AUS are such known and ubiquitous tools, no other automated underwriting system (at least in the short- and mid-term) will be as broadly accepted in the secondary market. In fact, the GSEs' AUS effectively have the stamp of law to determine qualified mortgage (QM) eligibility under the temporary GSE QM "patch" (the Patch).[10] No other system enjoys this status.

The FHFA should analyze: (i) increasing transparency into GSE data, the UCDP, GSE collateral evaluation tools, the GSEs' AUS, and other GSE technologies, and (ii) allowing new participants equal access to these items. The goal is to evaluate whether such transparency and access will help to lower barriers to competition and contribute to the safety and soundness of various end-state housing finance models.

[10] Under the Patch, subject to certain restrictions on loan features and points, any loan that is eligible for sale to either GSE is automatically defined as a qualified mortgage loan. Therefore, a conforming balance loan that is approved under either GSE AUS is a QM loan, even though the GSEs, rather than the CFPB, control the applicable underwriting standards and related algorithms. 12 CFR § 1026.43(e)(4).

The FHFA should also investigate the possibility of expanding the CSP to non-agency PLS without a government backstop. This would fulfill the initial vision for the CSP, although we see PLS using a separate channel or platform within the CSP.[11]

CREATE A TRANSPARENT PROCESS TO EVALUATE, APPROVE, AND MONITOR GSE PILOT PROGRAMS

Innovation has improved the safety and effectiveness of the housing finance system in conservatorship; additional pilot projects could facilitate further innovation. At the same time, pilots should be undertaken with a clearly-defined rationale and goals to avoid "mission creep," by which the GSEs increase taxpayer risk or crowd out private sector activity. In considering GSE pilot programs, the FHFA should adhere to the following three principles: (i) innovations should not increase the GSE risk profile across economic cycles, (ii) pilots should avoid supplanting private sector efforts with government-backed activity, and (iii) the FHFA should recognize that changes in GSE structure, product mix, and cost structure affect other government housing finance programs such as the Federal Housing Administration (FHA).

TAILOR THE GSE FOOTPRINT

The FHFA should gradually restrict or eliminate specific product types currently offered by the GSEs that are adequately served by the private sector in good times and bad. As an example, there is no need for Fannie Mae and Freddie Mac to be involved with cash-out refinances and second home financing. Americans own their home equity and are free to borrow against it, and qualified borrowers are free to buy second homes. The private sector can provide loan products for these purposes, subject to applicable guardrails and consumer protections. There is no need for a government guarantee with the concomitant taxpayer risk for an activity that does not further the societal goal of affordable homeownership.

[11] "A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending," Federal Housing Finance Agency: 13-14, February 21, 2012, https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf; "Building a New Infrastructure for the Secondary Mortgage Market," Federal Housing Finance Agency, October 4, 2012, https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/FHFA_Securitization_White_Paper_N508L.pdf. StrategicPlanConservatorships_508.pdf; "Building a New Infrastructure for the Secondary Mortgage Market," Federal Housing Finance Agency, October 4, 2012, https://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/FHFA_Securitization_White_Paper_N508L.pdf.

One variant that could be considered, however, is to allow GSE involvement with cash-out refinances that are qualified for 401(k)-type purposes. Ensuring and tracking this would pose operational challenges, but we believe it is possible—after all, retirement saving plans operate this same way. We recommend that the new FHFA director evaluate GSE vs. non-agency cash-out refinance offerings to determine appropriate GSE cash-out refinance qualifications and purposes. Short of this, however, we recommend leaving this type of financing to the private sector.

Additionally, the Federal Housing Administration, the Department of Veterans Affairs (VA), and other government mortgage programs allow for cash-out refinancing. We recommend that these entities place similar restrictions on cash-out refinances.

Any loan that no longer fits within GSE or government mortgage program eligibility guidelines will find a home either on a balance sheet or in a PLS but only to the extent the pricing and liquidity in these alternatives support the origination of the loan. Therefore, moves to restrict agency-eligible product types should be made gradually to give the non-agency primary and secondary markets time to adjust for greater market share.

We do not recommend reducing the conforming loan limit—at least not at this time. The proposed changes to guarantee fees with risk-based pricing and to the product mix with the move of cash-out refinances and second homes out of the GSEs present enough change to be absorbed over the next few years. However, we do recommend that FHFA conduct an evaluation of conforming loan limits in light of median home prices, median income, and borrower cost-burden, and provide an explicit justification for any future increase in limits.

We also recommend, to the extent permitted by law, that the FHFA consider reducing conforming loan limits when housing prices fall rather than freezing them until prices rebound, which is the current practice.[12] A system that only allows loan limits to rise over time inevitably expands the GSEs' market power at the expense of the private sector. Making reductions optional rather than mandatory would allow the FHFA to weigh the need for increased government support of the housing market in times of crisis.

IMPROVE THE FUNCTIONALITY OF BUT MAINTAIN THE CONSUMER PROTECTIONS EMBEDDED IN THE ATR/QM RULE

The consumer protections embedded in the ability-to-repay and qualified mortgage rule (ATR/QM rule) should be preserved as a centerpiece of post-financial crisis mortgage reforms, as this instills a critical layer of safety and soundness across the primary and secondary markets. The Consumer Financial Protection Bureau (CFPB) will soon distribute the results of its statutorily mandated five-year lookback on these rules. Whether apart from or in connection with this exercise, the CFPB should take the following incremental steps to strengthen these rules in the context of the housing finance landscape.

1. ***Incremental expansion/modification of Appendix Q***[13] – The CFPB should incorporate by reference into Appendix Q methods or tools to verify income, assets, or employment used or permitted in agency or government mortgage program originations, assuming such loans continue to qualify automatically for QM status.[14] However, before doing so, the CFPB should make certain that the selection of any such method or tool does not enable, constitute, or result in "cherry-picking," or selecting a favorable method or tool that only works properly in combination with other unselected methods or tools. Such cherry-picking could result in deficient underwriting that increases the danger to systemic safety and soundness. Any applicable regulatory or legislative action should be drafted in a manner that prevents this unsound practice.

[12] Note that the Housing and Economic Recovery Act of 2008 sets forth rules regarding changes to conforming loan limits.

[13] "Appendix Q to Part 1026 – Standards for Determining Monthly Debt and Income," CFPB, Accessed on December 27, 2018, https://www.consumerfinance.gov/policy-compliance/rulemaking/regulations/1026/Q/.

[14] Warner and Round's Senate Bill 3401 in the 115th Congress had a similar intent, allowing the use of such methods for income verification of self-employed borrowers.

The CFPB should also evaluate and implement a number of technical fixes that industry stakeholders have proposed since the ATR/QM rule development. Many suggestions would not adversely impact borrowers and, in fact, may actually help borrowers who were shut out from access to affordable, sustainable credit by the rule's initial formulation. These include proposed adjustments to documentation for self-employed borrowers, seasonal employment, non-traditional sources of income and assets, and numerous other topics.

2. *Technological innovation* – The CFPB can encourage technological innovation by evaluating proprietary underwriting tools and methodologies created by financial technology platforms, and employing on a case-by-case basis no-action letters that would allow new systems to be tested in a sandbox.[15] The tension here is that to the extent a CFPB no-action letter does not definitively shield the tool or methodology from regulatory liability, primary and secondary market users are less likely to adopt or give full credit to the tool or methodology. However, definitively shielding the tool or methodology from regulatory action puts borrowers at risk should the tool or methodology prove to violate consumers' rights. The CFPB must solve for this conundrum before entering into any no-action letters.

On December 13, 2018, the CFPB published a proposed rule in the Federal Register that would revise its 2016 final policy on issuing no-action letters and create a new "Product Sandbox."[16] This undertaking will allow the CFPB to evaluate comments and address this conundrum. We recommend that the CFPB keep the following points in mind as it crafts a final rule:

- Protections from regulatory action should not preclude all private rights of action through the courts or actions by other governmental entities with standing.

[15] To date, the CFPB has issued one no-action letter. This no-action letter states, in relevant part, that it is not a "grant of any exception, waiver, safe harbor, or similar treatment respecting the statutes and rules identified in the Request,...[nor] viewed as an interpretation, waiver, safe harbor, or the like, nor should it be viewed as binding on the Bureau." Furthermore, the CFPB states that, "This No-Action Letter is not issued by or on behalf of any other government agency or any other person, and is not intended to be honored or deferred to in any way by any court or any other government agency or person."

[16] "Policy on No-Action Letters and the BCFP Product Sandbox," Federal Register, December 13, 2018, https://www.federalregister.gov/documents/2018/12/13/2018-26873/policy-on-no-action-letters-and-the-bcfp-product-sandbox; "Policy on No-Action Letters: Information Collection," CFPB, 2016, Accessed on December 27, 2018, https://files.consumerfinance.gov/f/201602_cfpb_no-action-letter-policy.pdf. The proposed rule would revise the final policy to state that the CFPB intends that a no-action letter "will include a statement that, subject to good faith, substantial compliance with the terms and conditions of the letter, and in the exercise of its discretion, the Bureau will not make supervisory findings or bring a supervisory or enforcement action against the recipient's offering or providing the described aspects of the product or service under (a) its authority to prevent unfair, deceptive, or abusive acts or practices; or (b) any other identified statutory or regulatory authority within the Bureau's jurisdiction."

- Ongoing, diligent CFPB oversight of sandbox results should help to identify consumer protection law violations promptly, which would help mitigate damage to borrowers and to the lenders charged with remedying such violations.

- Distinctions in enforcement and penalties between (i) willful misconduct or gross negligence and (ii) good-faith errors could help reduce the chill on participation in the sandbox program without sacrificing consumer protection.

3. ***Temporary GSE Patch extension –*** The CFPB should extend the Patch for the duration of the conservatorship, which will likely extend beyond 2021.[17] However, this should only be done if the FHFA commits to evaluating, prior to rollout, any change in the eligibility requirements, credit policies, or underwriting standards of either GSE. This is particularly important with respect to changes that would not comport with Appendix Q. Under the Patch, there are no guidelines limiting the extent to which the GSEs can expand their respective credit boxes, and any such expansion still qualifies for QM status. As the GSEs' regulator, the FHFA should ensure that the GSEs adhere to prudent eligibility standards, credit policies, and underwriting standards.

4. ***Expand the 43 percent debt-to-income ratio (DTI) limit under the ATR/QM rule to 45 percent DTI and establish a residual income test*** – Expanding the DTI limit in Appendix Q from 43 percent to 45 percent will help to move some market share in higher DTI loans from the GSEs and FHA back to the non-agency market. The following table illustrates the number of purchase loans covered by the Patch having DTIs above 43 percent—what we define as higher DTI loans—and the subset of these loans having DTIs up to and including 45 percent.

[17] The Patch expires on the date the GSEs exit federal conservatorship or receivership or on January 10, 2021, whichever occurs first.

Table 1: Higher DTI Purchase Loans Covered by the Patch

Year	# Purchase Loans: > 43% DTI	% Purchase Loans: 43% < DTI ≤ 45%	# Purchase Loans: 43% < DTI ≤ 45%
2016	380,000	70%	266,000
2017	500,000	58%	400,000
2018 (through May)	528,000	42%	221,760

Source: Urban Institute Housing Finance Policy Center (numbers and percentages are approximate).

GSE data has shown positive performance of these loans in the post-crisis years. However, we must also consider stress scenarios. In this regard, we believe residual income, net of taxes, is an important factor to consider for higher DTI loans.

Residual income tests help lenders evaluate the amount of income a borrower would have left after paying monthly housing and other costs that factor into the DTI calculation. The higher the DTI the greater the risk that the borrower will be cost-burdened and less able to handle an adverse life event or economic downturn.[18] Ensuring adequate residual income affords a measure of protection against the extension of unsustainable credit, which benefits both borrowers and the housing finance system.[19]

The CFPB recognized the importance of residual income by providing in the ATR/QM rule that for higher priced QM loans, a borrower could challenge a QM presumption by claiming the lender left the borrower with insufficient residual income with which to meet his or her living expenses.[20] In practice, non-agency higher priced QM and expanded credit non-QM lenders include residual income tests in their guidelines. Among agency and government mortgage programs, only the VA employs a residual income test, although some lenders choose to place residual income overlays on originations in these channels.[21]

[18] The Department of Housing and Urban Development (HUD) defines "cost-burdened" as paying more than 30 percent of income for housing: see https://www.hud.gov/program_offices/comm_planning/affordablehousing/. See also https://www.census.gov/housing/census/publications/who-can-afford.pdf and https://nlihc.org/issues/hacb.

[19] See https://www.housingwire.com/articles/30672-adding-this-one-test-could-cut-fha-default-rates-in-half, https://www.nytimes.com/2014/07/27/realestate/improving-default-rates-on-fha-loans.html, and https://www.scotsmanguide.com/News/2014/11/Residual-income-test-gains-support--but-HUD-sticking-with-DTI/.

[20] 12 CFR §1026.43(e)(1)(ii)(B). See also https://files.consumerfinance.gov/f/201301_cfpb_ability-to-repay-summary.pdf.

[21] See https://www.benefits.va.gov/WARMS/docs/admin26/pamphlet/pam26_7/ch04.doc. Note that the VA minimum residual incomes "[…]are a guide. They should not automatically trigger approval or rejection of a loan. Instead…residual income [should be considered] in conjunction with all other credit factors." (Id.) The FHA used a residual income test in the past, but now only considers residual income as an elective compensating factor at DTIs that exceed DTI limits. See https://www.hud.gov/sites/documents/FY16_SFHB_MOD4_UNDER.PDF. As a general matter, all residual income tests remain subject to lender-permitted exceptions as the tests are not currently prescribed by law.

We recommend that the CFPB, through a rule-making with input from housing finance stakeholders, develop residual income standards to establish guardrails that shield vulnerable borrowers from taking out unsustainable loans, without unduly restricting credit or opening the door to biases.[22] The standards should be data-based, feasible, and flexible enough to consider complex factors like cost of living, household size, disparities in personal needs and spending, and legitimate compensating factors. The CFPB should also evaluate ways that technology can safely enhance residual income calculations.

Furthermore, because the potential consequences of excessive cost-burden are borrower- and not channel-based, the CFPB residual income standards should apply to all higher DTI loans across non-agency, agency, and government mortgage programs alike. The CFPB has authority to embed residual income requirements in Appendix Q and likely has authority to incorporate them into the GSE patch.[23]

5. *Clarification of ATR liability for non-QM loans* – The CFPB must address the enforcement uncertainty caused by the current construction of the ATR/QM rule with respect to non-QM loans. There are few if any guidelines around what constitutes ATR for legal purposes apart from meeting eight prescribed underwriting factors.[24] Under the current rule, two identical borrowers who lodge an ATR claim in foreclosure defense can face two opposite rulings based on the same set of facts and circumstances. Non-agency secondary market participants charge for this uncertainty through methods like price discounts and greater credit enhancement (despite the lack of ATR claims to date, which is likely a by-product of a strong economy, low unemployment, low delinquencies, and expanded loss mitigation efforts).

[22] We also recommend cooperation from agency, government, and private sector entities in providing anonymized data for the CFPB’s analysis.

[23] Because the agencies overseeing government mortgage programs are granted their QM authority statutorily, it is more likely that these programs would require agency action or legislation to implement CFPB-developed standards.

[24] 12 CFR §1026.43(c).

The cost of this uncertainty is ultimately borne by non-QM borrowers. This reduces the number of non-QM loans simply by cost and affordability alone. Creating greater clarity around ATR enforcement would help to reduce this uncertainty and responsibly remove hurdles to non-QM lending.

REFORM CREDIT RISK TRANSFER (CRT) TRANSACTIONS

The FHFA should direct the GSEs to strengthen CRT transaction-related due diligence review and exceptions to underwriting guidelines so that CRT and PLS transactions are generally equivalent in terms of scope, substance, and disclosure.[25] CRT transactions are effectively no different than PLS in terms of investor exposure to credit losses on the underlying assets. That means understanding the underlying assets is critical to making an informed investment decision. However, there are certain review and disclosure requirements and practices in post-crisis PLS that do not apply to CRT transactions or, if applicable, are far less robust in CRT transactions relative to PLS. Therefore, even though CRT investors are exposed to losses on loans, they are given much less information about diligence and underwriting exceptions on the underlying assets. The FHFA should direct the GSEs to eliminate these differences, keeping in mind that the reasons underlying certain securities law exemptions for traditional agency MBS issuance are not appropriate for CRT transactions.

With the GSEs in conservatorship and well along a path to becoming distributors of mortgage credit risk, there is broad bipartisan agreement that CRT transactions should continue to be a cornerstone of a safe, sustainable housing finance system. The FHFA, in coordination with the GSEs, should continue to evolve CRT mechanisms and market. A natural next step would be to have more front-end risk sharing, including expansion into deeper loan-level mortgage insurance.

[25] Given the size of the CRT transactions, we anticipate the need for due diligence sampling. Sampling is acceptable, as long as the sample is selected properly, appropriate disclosure is provided to investors, and the GSEs utilize their robust enforcement framework to identify, pursue, and enforce breaches within the underlying reference pools.

PROVIDE GINNIE MAE AND FHA WITH RESOURCES TO IMPROVE TECHNOLOGY AND OPERATIONS

Ginnie Mae and FHA should each have the necessary funding and operational flexibility to run their programs effectively. FHA needs additional funding to assure it has a stable IT platform that can be used to manage lenders and the credit risk in its portfolio effectively. While Ginnie Mae funding is adequate to maintain and operate a state-of-the-art bond administration platform, it lacks adequate resources to hire needed staff to protect the government guarantee and to replace higher cost contractors when appropriate with government employees. Indeed, there is a striking contrast between the resource constraints at Ginnie Mae and FHA and the GSEs' abilities to hire professional staff at competitive pay levels and to invest in state-of-the-art infrastructure. Providing more resources and flexibility for Ginnie Mae and FHA would improve the ability of the overall housing finance system to serve the American people.

STRENGTHEN COORDINATION AMONG COMPONENTS OF THE HOUSING FINANCE ECOSYSTEM

The FHFA can strengthen coordination across government-supported lending channels by making better use of a little-known and under-utilized consultative entity that Congress created when it created the agency in 2008.[26] The statutory mandate of the Federal Housing Finance Oversight Board (FHFOB)—consisting of the Secretaries of the Treasury and HUD, the Chairman of the Securities Exchange Commission, and the FHFA director serving as chair—is to advise the director on matters pertaining to the safety and soundness and performance of the GSEs (and Federal Home Loan Banks), provide feedback on the performance of the FHFA, and on "*such other matters relating to the Agency and its fulfillment of its mission, as the Board determines appropriate.*"[27] It is this latter charge that should be used to speak to the implications of the FHFA's actions as conservator and regulator on other components of the housing finance ecosystem. While a more active and resourceful FHFOB can raise coordinating challenges, as an advisor to the

[26] 12 U.S. Code § 4513a - Federal Housing Finance Oversight Board.

[27] Id.

FHFA director it cannot ensure they are dealt with before the fact or unwind unintended effects of the FHFA's decisions.

Broader and better coordinating efforts are necessary because the GSEs are part of a housing finance ecosystem. This means that changes in one part of the system affect other parts, which can lead to capital arbitrage, venue shopping, and destabilizing influences on the FHA book of business that stricter risk-based pricing would cause by virtue of lowering borrowing costs for higher credit-quality borrowers.

CONCLUSION

Broadly speaking, there are two plausible courses of action the administration can take with regard to the future role of Fannie Mae and Freddie Mac. The first is to use the administrative powers of the FHFA and Treasury to prepare the GSEs to exit conservatorship by transitioning them back to shareholder ownership and control. The policy rationale for this approach is that the decade-long conservatorship has stabilized the firms from their near-insolvency and transitioned them from primarily holders of mortgage credit risk to largely distributors of mortgage credit risk to private investors and the larger capital market through an expanding system of credit risk transfers. With their risk profiles to the taxpayer lessened, the administration can act to reduce their outsized footprints and allow them to begin to rebuild capital, making good on its commitment to initiate the end of the conservatorship on its watch.

The second broad approach to the next phase of housing finance reform is for the administration to maintain the GSE conservatorship but undertake non-legislative actions to improve the housing finance ecosystem in preparation for eventual legislative action. In this scenario, the administration would craft an end-state vision that includes the secondary market and other reforms we propose in this paper, implement this vision as far as the administrative levers at its disposal will allow, and then ask Congress to finish the job.

We support the second option because administratively ending the conservatorship would preserve the GSEs' flawed charters that privatize profits and socialize losses. Such action would keep in place a too big to fail duopoly that effectively crowds out competition and innovation that benefit homeowners and protect taxpayers. We recognize that this second approach is more difficult because it requires eventually achieving bipartisan agreement on legislation.

CONCLUSION

But continuing the conservatorship while undertaking administrative reforms is preferable to restoring a system that still has the critical flaws of the one that failed during the financial crisis. We believe the steps outlined in this paper would not only benefit the housing finance system in its own right, but also reduce the lift of the bipartisan legislation required to bring housing finance reform over the finish line.

ABOUT US

ABOUT THE AUTHORS

Eric Kaplan is the director of the housing finance program within the Milken Institute Center for Financial Markets, where he focuses on the restoration of the U.S. housing finance ecosystem to a state of sustainable health. Kaplan concentrates on the interplay between government and industry stakeholders regarding the roles of public and private capital, securitization reform, and lending and servicing practices. Kaplan's 25-year career in housing finance includes a wide range of finance, legal, and policy roles, supporting a multifaceted perspective on industry, transactional, loan-level, operational, consumer, legal, and policy related issues. Before joining the Milken Institute, Kaplan served as managing partner at Ranieri Strategies LLC, where he worked closely with founding partner and chairman, Lewis S. Ranieri, to evaluate and pursue FinTech investment opportunities, as well as on policy initiatives. Prior to that, he served as head of mortgage finance for Shellpoint Partners LLC, launching its non-agency securitization platform. Kaplan is a leading industry advocate for the creation of new and improved mortgage-backed securitization standards and origination practices to support the safe and scalable return of private capital to the U.S. housing finance ecosystem. Eric serves on the board of directors of MISMO and the Cameron Kravitt Foundation, and was an SFIG board member from 2015-2018.

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Theodore W. Tozer is a senior fellow at the Milken Institute Center for Financial Markets, where he helps lead the Milken Institute's housing finance reform work. Before joining Milken, Tozer was the president of Ginnie Mae for seven years, bringing more than 30 years of experience in the mortgage, banking, and securities industries. As president of Ginnie Mae, Tozer managed the growth of Ginnie Mae's government guarantees of mortgage-backed securities (MBS) from $900 Billion to $1.73 Trillion, and more than $460 billion in annual guarantees of MBS issuance for fiscal year 2016. Ted led the modernization of Ginnie Mae's securitization platform. He also transformed Ginnie Mae's program by leading the shift in its issuer base majority from financial institutions to independent mortgage bankers. Before joining Ginnie Mae, Tozer was senior vice president of capital markets at the National City Mortgage Company (NCM) for more than 25 years, overseeing pipeline hedging, pricing, loan sales, loan delivery, and mortgage product credit guidelines. He was instrumental in transforming NCM from an originate-and-hold lender to an originate-and-sell lender. From 2000-2004 Ted served as Chairman of the Mortgage Bankers Association (MBA) Capital Markets Committee, and as a member of the MBA Residential Board of Governors. From 2000 to 2009 Tozer served on both Fannie Mae and Freddie Mac's Lender Advisory Councils. Ted is currently a member of Fannie Mae's Affordable Housing Advisory Council.

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