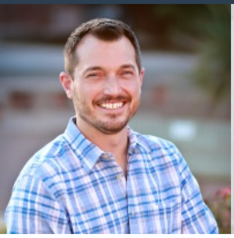

The Arizona Loan Baron

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A Message from The Arizona Loan Baron:

"This is an important issue."

NAR's Proposal to Restructure Fannie/Freddie

The second proposal for reform of the housing finance system in a week was just introduced by the National Association of Realtors® (NAR). Their "vision" for reform is **centered on Fannie Mae and Freddie Mac** (the GSEs). The future of the two companies, in federal conservatorship since 2008, barely got a mention in the outline for reform legislation released a few days ago by Mike Crapo (R-ID), chair of the Senate Bankin Committee.

NAR unveiled its proposal, developed in collaboration with Susan Wachter, the Albert Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania, and Richard Cooperstein, head of Risk Management at Andrew Davidson and Company, Inc., before a sold-out forum audience of 400 on Thursday.

The proposal says the GSEs do much more than buy mortgages, package them into securities, and sell them to investors with a guarantee. They also set, monitor, and enforce standards for mortgage origination, credit, servicing, and prepayment in the $5 trillion conventional mortgage market. They provide the infrastructure and scale required in the investment markets for interest rate and credit risk and **facilitate more competition than would exist without them.**

NAR's take on why the GSEs foundered was insufficient capital, guarantee fees that were too low, inadequate regulatory oversight, and ruinous competition from unregulated providers (subprime lenders.) The GSE could chase the market because **their returns and mission were not regulated.** "They could not capture the benefits of setting good credit standards."

The nation needs a liquid mortgage market that is efficient and stress resilient to meet the home financing needs of middle America and provide access for underserved communities. Today the taxpayer is exposed to loses because of the lack of private capital, but the need for continuing federal support is also apparent.

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	7.08%	-0.05	0.00
15 Yr. Fixed	6.45%	-0.02	0.00
30 Yr. FHA	6.55%	-0.05	0.00
30 Yr. Jumbo	7.25%	-0.04	0.00
5/1 ARM	7.07%	-0.03	0.00
Freddie Mac			
30 Yr. Fixed	6.86%	-0.01	0.00
15 Yr. Fixed	6.16%	+0.03	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	7.03%	+0.09	0.62
15 Yr. Fixed	6.56%	+0.09	0.54
30 Yr. FHA	6.90%	+0.11	0.95
30 Yr. Jumbo	7.11%	-0.01	0.50
5/1 ARM	6.38%	+0.11	0.54

Rates as of: 7/3

Recent Housing Data

		Value	Change
Mortgage Apps	Jun 12	208.5	+15.58%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%

		Value	Change
Builder Confidence	Mar	51	+6.25%

NAR proposes the GSEs be structured again as government-chartered utilities, but this time with improved accountability and regulatory oversight. This structure would strengthen adherence to mission and regulates returns to leverage the discipline of private capital while limiting the profit motive.

Today's GSEs have a stronger regulator in the Federal Housing Finance Agency (FHFA) and public oversight from Congress. They are restricted in the products they can buy, the size of the portfolio, and their ability to lobby. They also transfer most of the interest rate and credit risk on the mortgages they guarantee to the private sector. In essence, "the GSEs' operations are reformed, but their ownership structure and oversight remain to be determined."

NAR suggests re-chartering the GSEs as **Systemically Important Mortgage Market Utilities** (SIMMUs), similar to the Systemically Important Financial Market Utilities (SIFMUs) established under Dodd-Frank. Like the SIFMUs, failure of an unregulated GSE could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and threatening the stability of the U.S. financial system. SIFMUs are overseen by the Financial Stability Oversight Council (FSOC), an enhanced FHFA would oversee the SIMMUs.

This structure would support the public missions of liquidity and broad access through its board and its enhanced oversight while shareholder equity provides discipline. The public mission of the SIMMU should supersede competitive motivations and benefits of shareholders in a manner consistent with the legal construct of a Beneficial Corporation. The entities would report to Congress on the strength of the business and performance against their public mission on a regular basis, but they would not be able to lobby and would **fund their operations outside the government appropriations process** through fees as the GSEs. Their returns would be regulated.

The utilities would continue to set standards for residential mortgages and to transfer most of their risks to private capital markets; interest and prepayment risk through the To-Be-Announced (TBA) market and credit risk through existing credit risk transfer (CRT) and related credit risk programs. MBS would carry an explicit, paid-for, catastrophic guarantee provided by the U.S. government to enhance liquidity and support the TBA and CRT markets and long-term financing in turn.

The entities would retain enough risk to align incentives and enough capital to protect taxpayers from losses in all but the most extreme circumstances. This capital requirement reflects their role as insurance utilities and includes product, counter-party, and balance sheet risks, along with their countercyclical obligations.

NAR suggests a 5 percent claims-paying ability, from guarantee fees, capital, and risk transfer, would be enough to survive a 2007 type crisis. Under extreme stress, the U.S. Treasury backstop would provide additional liquidity.

The entities would only guarantee mortgages that comply with the **Qualified Mortgage standard of the Ability-to-Repay Rule (**ATR). They would require 20 percent borrower equity or credit enhancement from private insurance. The entities would continue to enforce capital and operational standards for servicers and credit counterparties that protect taxpayers while achieving the public mission. They would also provide and maintain the infrastructure for securitization and credit risk sharing with private markets.

Additionally, the proposal says there must be access for small lenders, clear and fair pricing and support for 30-year fixed-rate mortgages. The entities must make significant investments in data and research and programs to expand access to mortgages including first-time homebuyers and targeted populations. The Duty to Serve mandates, and contributions to the Capital Magnet Fund and Housing Trust Funds would continue.

Government programs may support a similar mission, but without reliance on private capital. Proposals that would eliminate or shrink the GSEs would reduce liquidity in the market and cause government programs to expand, increasing risk to tax payers. Both efficiency and equity goals are accomplished through the SIMMUs-financial market utilities that receive regulated returns and execute the government's mission for housing finance.

Transition to any type of important financial market must not cause disruption. Mortgage markets are currently functioning smoothly so the final model and the transition process must be telegraphed to the markets. The advantage of their proposal NAR says, is that it builds on two existing entities and their infrastructure, **retaining many of the reforms already made.** Congressional action would be needed to re-charter the GSEs into SIMMUs.

The SIMMUs would continue to maintain and develop the infrastructure of the conventional mortgage market, and the regulator would oversee the issuance of required stock analogous to an Initial Public Offering. It is estimated that $100-$200 billion (2 to 3 percent) of equity capital would be needed to back the SIMMUs, supplementing the existing guarantee fees and risk sharing structures for a 4 to 5 percent claims paying ability. Experts say this could be achieved through two or three offerings so the new SIMMUs could be up and running within two years, well-capitalized, with a stronger regulator and clearer public mission.

Pricing of the guarantee fee is critical to accomplish the mission and to attract private investors but raises a number of important questions. What is the right guarantee fee that fairly prices risk and protects taxpayers? How much should the utilities charge to raise and maintain equity and sell risk into the market? Will the market be disrupted in achieving a market rate?

For an extended period before the financial crisis, the GSEs had 0.45 percent statutory capital for credit risk and 2.50 percent for portfolio assets, charged about 20 basis points (bps) guarantee fees, and generated high returns on their highly-levered balance sheet. During the crisis the GSEs cost the taxpayers nearly $200 billion, or about 4 percent of $5 trillion notional balance mortgages, a loss nearly ten times their required capital. Since then, about $2.5 trillion of notional balance CRT has been issued, transferring risk and providing extensive discovery on the price of risk and implied capital required for GSE credit risk. From 2011 to 2014, guarantee fees were **raised in a series of steps to roughly 55 bps.**

NAR says its proposal uses conservative estimates and comes to about the same fee level. Part of that fee would be used to purchase risk-based catastrophic protection similar to deposit insurance from the U.S. Treasury.