INDUSTRY PERSPECTIVES

Dear FSOC:

Can We Finally Have a Housing Finance System That Is Stable as Well as Affordable?

SEPTEMBER 2020 | DON LAYTON

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September 2020

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The Financial Stability Oversight Council (FSOC) announced in mid-July it would do a review of the secondary mortgage market.

It's about time.

For many decades, housing finance policy – going back to the early days of the Great Depression – has been focused on making mortgages available and affordable to support and expand homeownership. In the past decade, housing finance policy discussions have also been heavily focused on whether the two government-sponsored enterprises (GSEs), i.e. Freddie Mac and Fannie Mae, should continue in their current form or something different on their path to exiting conservatorship. *Unfortunately, the stability of the housing finance system never quite seems to make it to the policymaker front burner – despite its having been at the heart of the two largest financial crises in the entire seventy-five years of the post-World War II era up until the pandemic hit!* Even in the pandemic, the mortgage market has shown, once again but on a less dramatic scale, how prone it is to instability.

This disconnect – the housing finance system has caused of the two largest systemic risk financial crises since World War II, but policymakers have never prioritized comprehensively improving its stability – is explained by two things. First, financial stability – meaning the ability of major parts of the financial system to resist stresses and shocks enough to avoid falling into crisis, or to resist transmitting and amplifying stresses from other parts of the financial system – has been a priority focus of financial regulation only in the decade-plus since the 2008 Financial Crisis. Second, no regulator has supervisory authority over the entire housing finance system; amazingly, some key parts of it aren't even subject to any conventional safety-and-soundness regulation at all.[1] So, no one has been or is really in charge.[2]

FSOC is thus the perfect place for such a stability review. As per its name, it is a committee (or council), with its membership being the heads of all the federal financial regulators, chaired by the secretary of the treasury. It was created by the Dodd-Frank Act in 2010 and is, as per the Treasury

[1] The Federal Housing Finance Agency (FHFA) regulates only the GSEs and the Federal Home Loan Banks; the Federal Reserve and the OCC (Office of the Comptroller of the Currency) regulate banks and thrifts, which do play a major role in mortgages, if not a dominant one; and state insurance commissions regulate mortgage insurers. Non-bank mortgage companies have no obvious regulation in terms of safety and soundness. (Note that the Consumer Finance Protection Bureau (CFPB) does regulate many of these listed firms, but only with respect to consumer protection issues.) Also worthy of note is how direct government units involved in housing finance – FHA, VA and Ginnie Mae – do not have separate regulation by an independent organization, which is possibly a fundamental weakness in the design of housing finance.

[2] A possible third reason related to me by some long-time Washington insiders is that the topic is so convoluted and so politically sensitive that policymakers just shy away from it, not wanting to become enmeshed in such a politically difficult and time-consuming activity.

website, “charged with identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States’ financial system.” Thus, it is designed to focus specifically on financial stability, and it can bring the resources of *all* the financial regulators to comprehensively examine a stability issue.

The FSOC review was announced as being limited to the secondary mortgage market, which I interpret to mean that it is focused on the activities and issues of mortgage-backed securities (MBS)… and everyone and everything involved with them. [3] That would include looking, in whole or in part, at the two GSEs, the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), Ginnie Mae, the hundreds of servicers of their MBS, all the participants in the private-label securitization (PLS) market, and the mortgage insurers (which are fundamentally only utilized for loans that go into GSE-issued MBS). It would also include the MBS markets in general, and might even include the originators of mortgages that end up in MBS and also MBS-specialized institutional investors.

In essence, FSOC will be attempting to answer the question: what can regulators do better to reasonably reduce weaknesses in the financial stability of the secondary mortgage market? That is a narrow but extremely important issue, and it is high time it was tackled head on.[4]

To aid this process, I have below suggested key topics and questions to be included on the agenda for such a review.

A Brief History of Post-War Financial Crises

The country’s financial system since 1945 has had three periods of significant instability, and housing finance was at the heart of two of them, along with playing a significant secondary role in the third (which is ongoing today). Understanding housing finance’s role in these crises is key to seeing why the FSOC review is so important.

By way of background, financial regulators today often categorize risks into several key categories: interest rate risk,[5] credit risk, operating risk and sometimes a few others. Using this same taxonomy, the accounts of financial crises below show how housing finance has serially failed: the first

[3] I would have preferred the review to include the primary mortgage market as well (e.g. banks originating mortgages to hold on their balance sheet) but the limitation to the secondary market is not in my view strategically crippling to FSOC’s effort, as it plays such a dominant role in housing finance (i.e. accounting for about two-thirds to three-quarters of all mortgages).

[4] I would not expect FSOC to stray into more political or policy issues, like how to restructure the GSEs or anything like that. That’s just not what FSOC does.

[5] Sometimes this will be described as “market risk,” which is a broader category that includes interest rate risk.

crisis was one of interest rate risk being systemically mishandled, the second crisis showed credit risk being systemically mishandled, and the third – today's pandemic crisis – shows the mortgage system's operating risk being systemically weak.

The S&L Crisis

The first post-World War II financial crisis was the S&L Crisis of 1989 (also known as the Thrift Crisis), which officially cost the US government – meaning taxpayers – $132 billion to clean up ($276 billion in today's dollars). The root cause of the crisis was that the S&Ls, which dominated housing finance in the immediate post-War era, funded their thirty-year fixed-rate, free-prepayment mortgages – known, with all its features, as the American mortgage, which was and still is by far the most common type of home loan[6] – with a pool of savings deposits that could be withdrawn on no or little notice, producing an interest rate and liquidity mismatch of stellar proportions.[7] Then, when inflation in the 1970s skyrocketed and interest rates followed, the thrifts suffered massive loss of their deposits – given federal deposit interest rate ceilings then in existence, consumers withdrew their deposits to get much higher market rates elsewhere. The thrifts then had to scramble to replace those deposits with funds that, unsurprisingly, cost a lot more than the yield on their mortgages. The thrift industry collapsed as a result, causing the first significant financial crisis since World War II, which had ended over forty years earlier.[8]

Also, it was exacerbated by the S&L regulator at the time, the Federal Home Loan Bank Board, requiring inordinately low levels of capital, which reflected decades of lobbying by housing interest groups focused on making mortgage credit as inexpensive as possible.[9]

[6] The American mortgage has a fixed rate, a thirty-year maturity, is fully self-amortizing, can be prepaid in whole or part at any time for any reason with no penalty, and can have its rate locked up several months prior to take-down to provide certainty of the financing cost of a not-yet-finalized home purchase.

[7] Rates had been very low and stable in the period following World War II (which included government control of rates during the Korean War), and so apparently no one thought much about their someday becoming high and unstable, as they did beginning in the 1970s.

[8] Some of the thrifts, to help recoup their losses, were allowed by their regulator (the Federal Home Loan Bank Board) to go into risky activities; the results were often poor, sometimes spectacularly so. In total, more than one thousand S&Ls (i.e., a third of the industry) disappeared between 1986 and 1995, and their share of mortgage originations declined from 53% in 1975 to 30% in 1990 (and some more afterwards). See https://www.investopedia.com/terms/s/sl-crisis.asp.

[9] Many of the resulting losses ended up being absorbed by the taxpayer as the S&Ls were the beneficiaries of deposit insurance via a government corporation, the FSLIC (Federal Savings & Loan Insurance Corporation), which was later combined with its better-known counterpart, the FDIC (Federal Deposit Insurance Corporation).

The 2008 Financial Crisis

The role of the thrift industry then dramatically declined, with its share of mortgages going down by about half. The differential, about one in four mortgages, then largely moved to government-supported securitization channels, specifically the two GSEs Freddie Mac and Fannie Mae, which until then had been comparatively modest in size, along with Ginnie Mae.[10] (The two GSEs are stockholder-owned, federally-chartered corporations, whereas Ginnie Mae is fully on the books of the government, part of the Department of Housing and Urban Development). This securitization process produces "agency MBS" (i.e., mortgage-backed securities), in which the investors do not take on the underlying mortgage credit risk, which is instead either guaranteed by the GSEs[11] or insured via Ginnie Mae (deploying the full faith and credit of the US government) against credit-related losses.[12] This structure, in which the MBS investor is taking on only interest rate and liquidity risk, is a key to the low cost of most mortgages along with the many borrower-friendly features of the American mortgage.

This structure did reasonably solve the problem of properly managing the interest rate and liquidity risks of the American mortgage, which the thrifts had not done properly (and, with the benefit of hindsight, really were not structured to do). Agency MBS investors – broadly diversified, global and sophisticated in hedging prepayment and other risks, and dealing with a liquid security rather than an illiquid loan – are clearly much stronger hands in taking on these risks than the thrifts had been. I recall in the early 2000s many people involved in the industry being very proud of the result, bragging how the US housing finance system was the best in the world.

But they had missed the toxic byproduct of solving the "thrift problem." Previously, thousands of thrifts had been making their own decentralized credit decisions for the loans they held on their individual balance sheets; now, under the new agency securitization-dominated business model, credit risk was concentrated in extreme amounts on the books of just two companies, the GSEs.[13] This

[10] Ginnie Mae is a securitization utility employed by various government mortgage lending agencies, in particular the Federal Housing Agency (FHA) and the Department of Veterans Affairs (VA).

[11] Until September 2008, the GSE guarantee was considered to be near-Treasury equivalent in strength, as investors believed the government would rescue debtholders of the GSEs rather than allow a default. This was known as the "implied guarantee," and it turned out to be an accurate assumption. Since September 2008, a formal support agreement has existed.

[12] Ginnie Mae-issued MBS carries insurance, backed by the full faith and credit of the US government, on the credit risk of the underlying mortgages, but technically Ginnie Mae itself does not provide the insurance; instead, it is provided by the underlying lending agencies of the government (e.g., FHA) that utilize Ginnie Mae as a securitization utility.

[13] The concentrated credit risk was also on the books of FHA and VA. However, as they are direct on-budget units of the US government, their losses just disappear into the federal budget with no systemic repercussions (other than possibly political ones).

concentration of risk became an accident waiting to happen, as it did when the housing bubble burst, becoming a major component of the Financial Crisis of 2008.

More specifically, the two GSEs combined had at that time about $4.25 trillion of mortgage credit risk, about 40% of the national total. And in the real world of Washington, just as had been true for the S&Ls back in 1989, over the years the GSEs and housing interest groups had collaborated to lobby for capital requirements against that risk that were low even by the relatively lax financial institution capital standards of that time.

Between the deteriorating credit quality on $4.25 trillion of mortgages and the low capital requirement, the markets began to lose confidence in the MBS and unsecured debt of the two GSEs during the growing market distress in 2008 – despite the implied government guarantee supporting it. This exacerbated the already crumbling confidence in and among all large financial institutions at that time, which in turn caused more problems as investors globally fled for safety. The result was that, among other large government actions taken during September 2008, the two GSEs were taken over by the government via the legal form of conservatorship, under which they remain to this day, and the implied guarantee was replaced with a formal support agreement to regain market confidence. The official cost of the rescue is usually calculated at about $190 billion.[14]

Additionally, other parts of the housing finance system also became weak enough to feed into the fear behind the flight to safety of the crisis. The private-label securitization (PLS) market completely collapsed, with major losses (including by the GSEs, which held large amounts of PLS securities).[15] All seven mortgage insurance firms used by the GSEs either failed (i.e., went into regulator-supervised run-off and liquidation); dropped to a deep junk (i.e., below-investment grade) credit rating, which ended in a sub-rosa government bailout; or were otherwise indirectly bailed out with government funds.[16] Even the Federal Home Loan Banks, also with large investment losses in PLS securities, required a special arrangement by Treasury to shore up confidence in them.

The common theme among most such situations was concentration of risk, just as found at the GSEs. In fact, by the design of the government, most housing finance takes places through monoline (or

[14] This is the amount of funds drawn down from Treasury at its peak to cover GSE losses. It does not net out amounts later paid back, which could be considered to have paid it fully back over the succeeding years. The calculation also does not account for broader damage to the economy – it is a relatively narrow and technical definition.

[15] The PLS market has never significantly recovered from this collapse, which revealed very deep flaws in its business model, including conflicts of interest, wholly inadequate investor protections, etc.

[16] Three failed and went into liquidation, three were bailed out sub-rosa after dropping to deep junk credit rating levels, and one was bailed out by its parent, but as that parent was AIG – which itself had been bailed out – it was using government capital (i.e., taxpayer funds) to do so.

near-monoline) firms – that is, financial institutions which have all their eggs in the housing and real estate basket. Given the increase in our understanding of and focus on systemic risk which occurred post-2008, this type of risk concentration is now understood to be very poor financial system design: it works fine in good times, but exacerbates stresses in bad.

And, in a limited replay of the S&L Crisis, hundreds of thrifts failed (along with many smaller commercial banks which were heavily concentrated in real estate-related lending), as they were near-monolines, required to have at least 80% of their balance sheet in real estate-related assets.

Of course, the weaknesses described above throughout so many housing finance institutions were matched by other weaknesses in most parts of the American, and indeed global, banking and financial system. It is arguable whether housing finance firms were more or less flawed than all the others. But what is not arguable is that the after-crisis efforts to strengthen the US financial system – exemplified by the Dodd-Frank Act – significantly bypassed specialty housing finance institutions; consequently, strengthening them remains, twelve years later, the largest piece of unfinished business from 2008.[17] The GSEs' continuing to be in conservatorship is most representative of this, but the unfinished business includes many other aspects of the housing finance system as well, including a still-heavy dependence upon monoline institutions with extreme concentrations of mortgage risk.

The Pandemic, Forbearance, and Non-Bank Servicers

When the pandemic arose early this year, it generated a financial crisis in which housing was finally *not* at the center of the problem (as it had been in the two episodes recounted above); in fact, house prices have actually been rising during it. But the pandemic had the potential to collapse a major component of the housing finance system nevertheless. This time around the issue was not interest rate risk or credit risk, but operating risk, reflecting a toxic incompatibility between the forbearance program passed in the CARES Act and the inner workings of the government-supported securitization process. This situation is a reminder of the extreme complexity of the country's housing finance system, and of how hard it can be to predict what will (and what won't) work properly in a period of dislocation and stress.

[17] Such specialty housing finance institutions would include the GSEs, mortgage insurers, the FHLBs, non-bank originators and servicers, and of course the government mortgage operations housed in the FHA, VA, and Ginnie Mae. Though it did not focus on these institutions, Dodd-Frank nevertheless included some very relevant and important mortgage-related reforms: the creation of the Consumer Finance Protection Bureau (CFPB) and the concept of the Qualified Mortgage (QM) are probably the most important. The SEC also instituted many reforms related to PLS markets.

Given the design of using government-supported securitization via the GSEs and Ginnie Mae to avoid the interest rate and liquidity risk problems of the thrifts, as described above, there arose a major industry to "service" the mortgages on their behalf.[18] In routine times, this servicing is fairly mundane – collecting monthly payments which are then remitted to the underlying mortgage lender (and if that is a GSE or Ginnie Mae, the payments will in turn be passed to the proper MBS investors), paying property taxes which have been escrowed from monthly payments, etc. In times of stress, however, servicers have very significant and complex obligations to deal with defaulted mortgages.

Banks (including thrifts) often service the loans they hold and also those they originate to sell, although as post-2008 costs to do so are much higher than previously, those without the large scale needed to produce acceptable unit costs will today often outsource the function to specialty servicing firms.[19] The "originate to distribute" non-bank mortgage firms that arose after the S&L Crisis, and which send their originated loans to the GSEs and Ginnie Mae, often service their own loans. Servicers also represent a real mix of types of companies, ranging from small to large. Some do only servicing, others are involved in several aspects of housing finance, and others are part of large and diversified financial institutions; some even specialize only in servicing distressed mortgages.

That CARES Act forbearance program allows any borrower of a government-supported mortgage (i.e., those securitized via the GSEs and Ginnie Mae, about 65% of all mortgages outstanding) to defer mortgage payments for up to six months, extendible for a second six months; no documentation is required to prove hardship (i.e., it's an honor system approach).[20] The problem is that the investors in the MBS of the agencies have been promised they will get their interest and principal payments on time, regardless of whether the borrower keeps making payments or not, as part of insulating the investors from credit risk, which is instead taken on by the GSEs, FHA, and VA. This means some organization has to provide a cashflow bridge – to keep payments going to MBS investors while the borrower doesn't provide the cash to do so – until a troubled mortgage is finally "resolved" (i.e., until it is once again being paid on time or until it has gone through foreclosure or some foreclosure alternative). We're talking about potentially many billions of dollars (estimates vary widely) of cash need which could last a year or more.

[18] Historically, most lending thrifts and banks had serviced their own mortgages.

[19] Many of the reforms after the Financial Crisis justifiably raised the cost of servicing.

[20] The forbearance program in the CARES Act is patterned after one adopted by the GSEs to deal with natural disasters (e.g., hurricanes). It was already being utilized by the GSEs by policy when the CARES Act turned it into law.

I will now focus primarily on Ginnie Mae – for simplicity, I will use Ginnie Mae to designate the FHA and VA as well, as the three are so intertwined. Ginnie Mae accounts for about 20% of all mortgages outstanding today, and the cashflow bridge is particularly burdensome since Ginnie Mae has no "balance sheet" or ability to routinely finance that bridge period (i.e., to cover the cash payments that need to be made to the investors until the loan is resolved).[21] Furthermore, if the borrower is not paying local property taxes or homeowner's insurance, then the property is in additional jeopardy, so more cash is required to cover those expenses during the forbearance period.

If one digs deep into the details of how this all works, one finds that Ginnie Mae documentation puts the servicer on the hook for all that cash requirement during the bridge period, which could last several years. In other words, the MBS investor's cashflow is protected by Ginnie Mae, but Ginnie Mae itself then foists the cashflow bridge burden of providing that protection onto the servicers of the loans behind its MBS issuances; the FHA and VA will make good on their mortgage insurance only at the very far end of this process, when the loan is finally resolved one way or another. If those servicers required to provide the cashflow bridge are well capitalized banks with access to liquidity from the Federal Reserve, then the unexpectedly large cash burden because of the widespread forbearance program can probably be absorbed by them without inordinate stress. But there has been a trend in recent years for servicing volume to shift away from banks and towards non-bank servicers.[22] And those non-bank servicers do not obviously have the financial capacity to absorb the cash burden during the cashflow bridge period. So, they came under great stress fairly quickly after the pandemic arrived.

Thankfully, the cash burden for these lenders has so far turned out to be less than originally expected: the rate of overall (i.e., not just Ginnie Mae) forbearances peaked at between 8.5% to 9% (as estimated by the Mortgage Bankers Association and others), nowhere near as high as feared, as many were forecasting rates as high as 20% to 25%. Additionally, non-bank servicers that are also in the mortgage origination business (which is most of them) have had their own cash reserves bolstered by the profits from an amazingly hot (i.e., record volume) refinancing market, due to the lowest mortgage rates in history. Lastly, lenders to non-bank mortgage companies, after concerns they might cut and run, have instead stepped up and increased volumes, providing another source of cash. To date, then, the

[21] The GSEs, which *do* have balance sheets, largely take over the cashflow bridging obligation four months after forbearance non-payment is initiated on an underlying loan.

[22] The reasons for this shift are complex, but perhaps the largest one is that the government assessed large operating-mistake damage claims against banks, especially the largest ones, at a triple-damages rate using somewhat obscure legislation that applies to Ginnie Mae mortgages but not GSE ones. There were also accusations that some of these claims were politically driven headline-hunting that focused on the largest banks. Not unreasonably, many banks, especially the larger ones, decided to avoid such a situation lest it happen again.

non-bank servicers have generally been able to finance the bridge period; however, as the pandemic is still enough of a problem that it is unclear if things will get better or worse going forward, this risk could still become destabilizing on a large scale at a later date.

If this situation had turned out really badly, with forbearance rates of over 20% as earlier feared, a huge swath of the servicing industry would have gone into default, with major ramifications to the plumbing of mortgage finance, and possibly with very severe results all along the housing finance value chain. Likely, there would have been some sort of government rescue.[23]

Interestingly, it has in fact been known for some years that the non-bank servicers are a weakness in the current housing finance system. As conservator, the FHFA had the two GSEs put out revised minimum liquidity and capital standards in May 2015 to apply to their non-bank servicers (which would cover almost all of them); in retrospect those standards were probably not tough enough.[24] When Treasury and the FSOC started looking at the issue in the past few years, the servicing industry naturally took the posture that it did not need more regulation, that it had enough capital and liquidity to do fine.[25] Additionally, the topic of servicing is so obscure and complex and has so little political headline appeal that it was just not prioritized. The pandemic-related forbearance program made it clear that it should indeed have been prioritized.

We will not know how this threat hanging over the non-bank servicers finally turns out until the pandemic-induced downturn has run its course. It could easily settle down, or the need for cash to bridge the forbearance period could balloon under several scenarios. We probably won't fully know until sometime well into 2021. Regardless, the current situation shows once again how the housing finance system is vulnerable to collapse in stress periods – the opposite of the stability we should be looking for it to have.

A Recommended Agenda

In its announced review of the secondary mortgage market (i.e., of how it will perform during times of financial distress), the FSOC should focus on at least three major issues, as I have summarized below. I

[23] The mortgage industry, on behalf of servicers, pre-emptively began asking for a bailout in the form of a line of credit at the Federal Reserve to finance the bridging cashflow needs. Naturally, their proposal was extremely one-sided in being favorable to the servicers. Instead, Ginnie Mae and the GSEs took limited steps to reduce the cashflow bridging burden.

[24] These "eligibility standards" act as a quasi-regulatory requirement on the non-bank servicers, which otherwise are not routinely regulated for safety and soundness.

[25] It is commonplace for industries to fight against increased regulation and increased capital/liquidity requirements; in my experience, for financial institutions, it is almost universal.

have chosen “activities-based” issues rather than focusing on “types of companies,” in line with how the FSOC, responding to certain policy and political concerns, currently organizes such things. In this case, the “activities” are centered around types of risks.

#1 - Mortgage interest rate risk, especially how well agency MBS works during severe adverse stress periods.

The secondary mortgage market is very centered on utilizing agency MBS (i.e., the pass-through MBS of the two GSEs and Ginnie Mae) to take the complex interest rate risks inherent in mortgages (e.g., prepayment risks) and put these into the hands of diversified global investors. As recounted above, this tendency grew in particular after the S&Ls collapsed, with the root cause being that the thrifts did not manage this risk properly (in fact, they had not been structured to be able to manage it). So, the obvious questions to be addressed are the following:

> *How well has agency MBS performed during the 2008 Financial Crisis and the pandemic crisis presently underway?*[26] *What about investors that specialize in such MBS? And how well is the new single-security MBS faring through current market stresses?*[27]

My expectation is that FSOC will find that agency MBS has worked very well in doing its job through these two stress periods. However, there were media reports of some specialty investors[28] heavily concentrated in agency MBS reportedly coming within days of failure during the earliest weeks of the pandemic; FSOC should therefore examine whether regulated financial institutions (e.g., banks) are financing such specialty MBS investors too laxly, allowing over-leverage and inadequate liquidity. It will also be interesting to see a review of how well the single-security MBS fared versus other securities (e.g., Ginnie Mae securities) in maintaining trading liquidity.

[26] This question refers to whether agency MBS continued to trade on reasonable terms (i.e., at a reasonable bid-offer spread) and to whether its price reflected fundamental economics rather than market disruption. In the pandemic, the Federal Reserve intervention for almost all fixed-income markets clearly benefitted the MBS market as well.

[27] This single-security MBS is known as uniform MBS (UMBS) and represents a common structure between Freddie Mac and Fannie Mae MBS. It commenced recently, in June 2019, and the pandemic market is the first stress period it has faced.

[28] In particular, mortgage real estate investment trusts, known as mREITS.

#2 - Mortgage credit risk, especially how it will perform during severe adverse stress periods given the extreme risk concentrations inherent in secondary-market monoline institutions.

In 2008, we saw how inimical to a resilient financial system it is to have extreme concentration of mortgage credit risk on the books of the stockholder-owned monolines that are at the heart of the secondary mortgage market: Freddie Mac and Fannie Mae. This instability also appeared in the collapse of the monoline mortgage insurers, and even Ginnie Mae fell under its required 2% reserve level.[29] These events from the Financial Crisis speak to several inter-related questions for FSOC:

> *Are the levels of regulatory capital required by these secondary-market institutions adequate not just for routine safety and soundness but also to meet post-2008 stress resistance criteria.[30] This question needs to be answered for the two GSEs; the FSOC should also look into how Ginnie Mae would fare against its 2% reserve requirement and how monoline mortgage insurers will be able to meet their obligations to the GSEs and enable continued high-LTV lending.[31] Even if capital requirements are adequate to meet these post-2008 criteria, to what extent does FSOC view the extreme concentration of risk as systemically problematic nonetheless?[32]*
>
> *Many of the secondary-market monolines have engaged in various forms of credit risk transfer (CRT) transactions to reduce their concentration of risk. These include GSE CRT transactions, traditional GSE mortgage insurance (MI) transactions, and the MI firms themselves using types of CRT. How does FSOC view these transactions – are they important to reduce systemic risk, or marginal? Are they designed to actually perform as promised during periods of severely adverse stress – and if not, what changes need to be made? And should FHA and VA, who insure the mortgage risk of loans securitized through Ginnie Mae, also somehow engage in CRT to reduce the likelihood of the taxpayer having to fund losses?*

This second area of focus should be one of the highest-value parts of an FSOC review, as it is at the core of one of the last unaddressed regulatory issues from the 2008 Financial Crisis: concentration of mortgage credit risk. I was personally amazed that government officials on behalf of FSOC (meaning all the financial regulators together) never showed up at any meeting of which I was a part asking how CRT

[29] One can ask the same question for institutions like banks, but as they are not secondary-market firms, I am not including them.

[30] Defined as incurring the losses of a severely adverse market scenario while still having enough remaining capital afterwards to maintain market confidence – the latter generally known as a "going concern buffer."

[31] The Federal Home Loan Banks can also be included in this, depending upon whether they are being defined as a secondary market firm or not.

[32] FSOC could even review the fundamental underwriting criteria of these many institutions to see if they are too lax or not in terms of how their originated mortgages would perform in a stress environment. However, I expect it likely FSOC would consider this outside the scope of its review.

works in routine and stress environments, at what cost, and how it reduces systemic risk. They were conspicuous by their absence, possibly reflecting distaste for getting into the highly politicized world of housing finance.[33] Nevertheless, the FSOC's credibility is needed to break through some of the usual political noise around housing finance CRT (and possibly even capital requirement) issues, helping to depoliticize the housing finance system's resiliency.

In this inquiry, I would expect that FSOC will find: (1) capital levels (including the 2% reserve for Ginnie Mae) don't uniformly meet post-2008 stress resistance criteria (i.e. be able to "survive a severely adverse scenario with enough capital to maintain the market's confidence"), and therefore need revision; (2) CRT is strategically critical to reduce systemic-sized concentrations of risk at the GSEs and MIs, especially if it can be done on an economically sensible basis, and should be pursued aggressively; and (3) that the designs of traditional MI and possibly some reinsurance-based CRT transactions are problematic in terms of whether they will perform adequately in a severely adverse scenario.[34] Hopefully, the FSOC will promulgate some standards against which regulators (including the FHFA) can measure all such transactions as being acceptable or not for use.

#3 - Will the "plumbing" operate properly (i.e., is there significant "operating risk") during times of severe adverse stress, considering both origination and servicing, and both bank and non-bank firms?

The plumbing of the housing finance system is incredibly complex, and I have found a lot of people go into MEGO ("my eyes glaze over") mode when it is being discussed. Nevertheless, it is critical that it be designed for stress-resistance. This was proven by the episode recounted above, in which the intersection of the forbearance program and how the GSEs and especially Ginnie Mae put the cashflow bridge burden onto servicers could easily have threatened a collapse of the plumbing if forbearances had actually gotten into the range of 20% or more, instead of staying under 9%.

The FSOC should look at the "eligibility standards" for non-bank seller-services from the GSEs and Ginnie Mae and determine if they are adequate to meet post-2008 stress resistance criteria.[35] *In this complex industry, "adequacy" is not so easy to define: with hundreds of such firms, each and*

[33] I note that Treasury officials, at various times, were engaged heavily in issues of GSE CRT, capital and credit risk. Unfortunately, I also learned from FHFA sources that, for example, the Federal Reserve - the most prestigious financial regulator - was distant and showed no appetite for significant engagement.

[34] Interestingly, for banks, when I researched the issue several years ago, the OCC and Federal Reserve did not give any relief for the capital required on mortgages because they carried mortgage insurance. This was their way of implementing a view that MI would not adequately stand up during a period of severe stress.

[35] For bank seller/servicers, I am presuming existing regulatory capital and liquidity requirements are adequate to meet this standard.

every one does not need to survive unimpaired, but instead enough need to do so in order for the "system" to continue to operate without transmitting or amplifying market stresses; thus, different eligibility standards for different firms (e.g. lower for smaller firms, higher for larger ones) may in fact make sense.[36]

FSOC should also look at the "interconnectedness" mechanisms that could be problematic. One such mechanism is the cashflow bridge burden in forbearance described above. Are there other such "bombshells" buried in the detailed documents of who does what along the entire value chain of origination and servicing? (One example might be over-concentration by the industry in outsourcing to just a single vendor.)

And then there is the issue of mortgage servicing rights (MSRs), a highly unstable asset on the books of the servicers.[37] *The FSOC should definitely look at other approaches to servicer compensation to reduce the instability of MSR values, or even to eliminate the asset altogether.*[38]

The "plumbing" topic is going to be very challenging for FSOC. It has less defined criteria than do issues of interest rate risk or credit risk concentration. Even just deciding how to define "adequacy" for a whole category of firms, rather than focusing on any specific firm, is non-conventional. It is unclear if such a review would have captured the forbearance cashflow bridge problem, as it reflects such a combination of detailed obligations that no one might have caught it. One could even see FSOC just looking to push much of the mortgage plumbing back into banks so that the hard-to-predict problems of the future are in their stronger hands rather than in those of weaker non-bank institutions. (Such a shift would, of course, create a real political brouhaha, potentially forcing non-bank firms to become banks.[39])

[36] The process of moving servicing from a failed or failing servicer to a healthy one is not even close to frictionless. Thus, the servicing "system" can't stand up to a stress event unless all but a small percentage of servicers stay healthy despite the stress.

[37] MSR has one foot in the operating risk category and one foot in the interest rate risk category. I included it in the former category somewhat arbitrarily.

[38] Revising servicer compensation has long been talked about in regulatory circles; it is time it be addressed officially via FSOC.

[39] I am aware of one large specialized mortgage servicing firm, Cenlar, that actually is a bank in legal structure, specifically a federal savings bank, making it more resistant to problems than if it was constituted as a non-bank. Perhaps that could be the model of the future.

Conclusion

It is time to finish the last unfinished regulatory reform agenda from the 2008 Financial Crisis. That should be the core driving force behind the FSOC's activity-based review of the secondary market for mortgages.

This means the review should not be limited to just some narrow non-bank servicer issues. It also means that FSOC and its leadership (in particular, the secretary of the treasury) will need to have the political courage to face the powerful housing-related special interests in order to finally get a housing finance system that can be a positive strength, and not the weak link, in our national financial system.

It would also be desirable if this became a bipartisan project, a matter of "professional regulation" rather than representing an issue with political appeal to one side or the other. If the regulatory leadership represented on FSOC would lay the groundwork for such bipartisanship at the very beginning, they would help ensure that narrow special interests could be resisted later.

The agenda for the review, as I have suggested above, is wide-ranging but not just a fishing expedition. There are clear topics to focus on, which I have organized by risk type: interest rate risk, credit risk and its concentration, and lastly the risk of the "plumbing" breaking down.

Congratulations to FSOC for putting this review on its agenda. It really is needed to finally, at long last, complete the upgrade to the stability and resilience of the housing finance system based upon what we learned from the 2008 Financial Crisis and the decade-plus since.