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STEPS TOWARD REFORMING U.S. HOUSING FINANCE

To Our Clients and Friends:

This fall, the U.S. financial agencies have taken initial, but substantial, steps towards reforming the U.S. housing finance system. In September, the U.S. Department of the Treasury (Treasury) published a detailed proposal (Housing Reform Plan), which included a call to tackle the last unfinished piece of regulatory business stemming from the Financial Crisis, the conservatorships of the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).[1] The Housing Reform Plan set forth 49 specific legislative and administrative reform measures and is thus the most ambitious financial proposal put forth since the enactment of the Dodd-Frank Act. In addition, Treasury and the Federal Housing Finance Agency (FHFA), the regulator and conservator of Fannie Mae and Freddie Mac (GSEs), amended the Preferred Stock Purchase Agreements (PSPAs) with the GSEs to permit the GSEs to retain up to $45 billion in capital.[2] And, on October 28th, the FHFA published its 2019 Strategic Plan for the GSE conservatorships and an accompanying Scorecard.[3]

Although the prospects of legislative housing finance reform are slim given the current political environment and the upcoming 2020 election, these actions are nonetheless significant. Both GSEs have been in conservatorship for over eleven years, and government control was never intended to be permanent. Even if legislative action may be stymied until after November 2020, the Housing Reform Plan establishes an overall framework that can influence future legislative action, and other actions toward reform may be taken – as they have begun to be – as an administrative matter.

I. The Housing Finance System: Conservatorships of the GSEs

Privatized in 1970 and 1989, respectively, Fannie Mae and Freddie Mac work in conjunction with regulatory agencies like the FHFA, Federal Housing Administration (FHA) and the Department of Housing and Urban Development to provide the structural support necessary for the current housing market to function. For example, the GSEs own or guarantee approximately 44% of all outstanding single-family mortgage debt, and the FHA is responsible for more than 10% of mortgage originations.

Early in the Financial Crisis, the U.S. government put the GSEs into conservatorship as a result of their excessive risk taking in the years leading up to the Crisis. As part of this process, the FHFA, the GSEs' regulator and conservator, entered into the PSPAs with Treasury. The PSPAs provided the Treasury with a cash-sweep right that required the GSEs to dividend to the government all net income above a miniscule capital reserve amount. Since entering into the PSPAs, the GSEs have returned to profitability, and they have paid over $300 billion to the Treasury. At the same time, however, the PSPAs have prevented them from maintaining sufficient capital to operate independently of government support. This has required the FHFA conservatorship to continue year after year.

II. Overview of the Housing Reform Plan

A principal goal of the Housing Finance Plan is to reduce the amount of U.S. government support for the U.S. housing finance system. It sets forth 18 legislative and 31 administrative measures focused on preparing the regulators and GSEs for a transition out of conservatorship and establishing a legislative framework to ensure that such a transition is orderly. Although congressional action is necessary for a permanent solution, the Housing Reform Plan notes that "reform should not and need not wait on Congress" and thus makes significant administrative recommendations as well.

The Housing Reform Plan framework is organized into 12 distinct goals, each comprising several legislative and administrative recommendations:

1. *Clarifying Exiting Government Support*: Recognizing the need for reduced taxpayer exposure, the Housing Reform Plan sets forth four legislative and five administrative recommendations directed at providing an explicit, paid-for federal guarantee of certain mortgage-backed securities (MBS) by the Government National Mortgage Association.

2. *Support of Single-Family Mortgage Lending*: In an effort to refocus GSE activities on providing stability to the lending markets, the Housing Reform Plan sets forth one legislative and two *administrative* recommendations directed at limiting the scope of GSE single-family mortgage activities to securitizing government-guaranteed MBS and taking a first-loss position on those MBS ahead of the government guarantee.

3. *Support of Multifamily Mortgage Lending*: Citing recent regulatory shortcomings with respect to GSE multifamily mortgage loan acquisitions, the Housing Reform plan sets forth two legislative and one *administrative* recommendation directed at limiting the scope of GSE multifamily mortgage activities to a specified affordability mission.

4. *Additional Support for Affordable Housing*: Concerned with the GSEs' divergence from statutorily defined affordability goals and the associated lack of transparency with respect to underwriting criteria, the Housing Reform Plan sets forth one legislative and three administrative recommendations directed at increasing efficiencies related to affordable housing.

5. *Ending Conservatorships*: Setting the stage for legislative action, the Housing Reform Plan recommends *three* administrative actions aimed at ending the GSE conservatorships.

6. *Capital and Liquidity Requirements*: Recognizing the shortcomings of previous GSE capital and liquidity *regulation*, the Housing Reform Plan sets forth one legislative and four administrative recommendations directed at restricting regulatory discretion in establishing such requirements and increasing transparency when promulgating them.

7. *Resolution Framework*: Similar to the resolution planning requirements for large banks, the Housing Reform Plan sets forth one legislative and one administrative recommendation

directed at ensuring that GSEs maintain loss-absorbing instruments (*e.g.*, long-term debt convertible into equity) sufficient to facilitate timely resolution.

8. *Retained Mortgage Portfolios*: In an effort to scale down the size of the GSEs, the Housing Reform Plan sets forth one legislative and one administrative recommendation directed at curtailing the *investment* activities of GSEs in mortgage-related assets, in another effort to focus GSE activities on securitizing federally-guaranteed MBS.

9. *Credit Underwriting Parameters*: In light of past less-than-sound underwriting practices, the Housing Reform *Plan* sets forth one legislative and one administrative recommendation directed at restricting the underwriting criteria for MBS eligible for a government guarantee.

10. *Leveling the Playing Field*: Revisiting past attempts to encourage private market participants in the housing *finance* system, the Housing Reform Plan sets forth one legislative and eight administrative recommendations directed at limiting the current competitive advantages of GSEs.

11. *Competitive Secondary Market*: To ensure more competition than is the case currently, the Housing Reform Plan sets forth three legislative recommendations directed at establishing a system for chartering private market actors to compete with the GSEs.

12. *Competitive Primary Market*: To ensure a robust primary market, the Housing Reform Plan sets forth two legislative and two administrative recommendations requiring GSEs and guarantors to provide cash *windows* for small lenders and restrict volume-based pricing.

III. Legislative Proposals

The legislation proposed by the Housing Reform Plan would be revolutionary in the same manner as the Dodd-Frank Act. Although perhaps not as substantial as the final version of Dodd-Frank, any such legislation would do away with the GSE framework that has developed since the creation of Fannie Mae in 1938, seek to create more competition, and reduce overall government support.

1. *An Explicit Federal Guarantee, but More Limited*: Treasury supports legislation to create an explicit, paid-for guarantee backed by the full faith and credit of the U.S. government. Somewhat surprising for a conservative Republican Administration, this support reflects the reality that after decades of GSE growth, failing to continue some form of government guarantee would be hugely disruptive. The Housing Reform Plan, however, states that any such guarantee should be limited to a subset of MBS, "qualifying MBS." It therefore calls on Congress and regulators to reexamine the products that may qualify for a guarantee.

2. *Open Chartering Process for GSE Competitors*: The Housing Reform Plan recommends legislation that would authorize the chartering of new private actors to compete with GSEs in securitizing MBS and providing first-loss protection. Treasury reasons that leveling the playing field would diversify the secondary markets and encourage greater competition among market participants.

3. *Capital and Liquidity Requirements for Market Participants*: The Housing Reform Plan recommends that the FHFA should require capital sufficient to withstand a severe economic downturn, and require shareholders and unsecured creditors, rather than taxpayers, to bear losses on insolvency. To foster a level playing field, the Housing Reform Plan recommends that similar credit risks should generally bear similar credit-risk capital charges and that the FHFA should establish a simple, transparent, leverage restriction to act as a credible supplementary measure to risk-based capital requirements. Enhanced liquidity requirements would also be mandated.

4. Limitation *of Activities of Market Participants Benefiting from a Federal Guarantee*: The Housing Reform Plan would seek to limit the scope of GSE and newly chartered competitor activities, by requiring them to be effectively monoline businesses focused on the business of securitizing guaranteed MBS. Treasury suggests that such a limitation could be "statutorily defined to include credit enhancing the mortgage collateral securing Government-guaranteed MBS and ancillary activities such as operating a cash window, loss mitigation on mortgage loans, and holding and disposing of property acquired in connection with collecting on mortgage loans." These restrictions, however, would not necessarily extend to affiliate businesses.

5. *Creation of a Federal Mortgage Insurance Fund*: Although private companies would collect their own fees as compensation for taking the first-loss position on the mortgage collateral supporting the MBS, the Administration recommends that any legislation ensure that these actors compensate taxpayers for default risk by authorizing the FHFA to charge fees for government guarantees of qualifying MBS. Such fees would be used to create a mortgage insurance fund that would fund government-guarantee obligations. In the event that such funds are inadequate, the Housing Reform Plan suggests that legislation provide the FHFA with authority to recapitalize the fund through industry assessments.

These recommendations are laid out only as a framework, with the critical details to be left to congressional action. As such, their immediate effect will most likely be to frame one side of the debate over housing finance reform before the 2020 election.

IV. Administrative Proposals

The focus of the Housing Reform Plan's administrative proposals is to set the stage for the transition of the GSEs out of conservatorship. In particular, nearly one-third of the contemplated administrative reforms relate to amendment of the PSPAs. These proposed amendments would largely serve to:

1. *Reduce Non-Mission Oriented Activities*: As noted above, one of the key themes to the Housing Reform Plan is to realign GSE activities by scaling back permissible activities. It therefore calls for the FHFA to amend the PSPAs to (i) reaffirm commitments to support single-family and multi-family MBS, (ii) limit federal support of each GSE's multifamily business to its underlying affordability mission, and (iii) reduce the cap on GSE investments in mortgage-

related assets, setting a different cap for each GSE, and restrict retained mortgage portfolios to solely supporting the business of securitizing MBS.

2. *Begin the Recapitalization Process*: Pending congressional action, the Housing Reform Plan recommends adding the following provisions to the PSPAs: (i) the establishment and periodic payment of commitment fees by the GSEs to the federal government to be used as part of the mortgage insurance fund contemplated under the legislative proposals, (ii) establishing a pre-capitalization plan that will allow GSEs to retain additional earnings, and (iii) requiring GSEs to maintain long-term debt convertible into equity and other loss-absorbing instruments to further reduce taxpayer risks.

3. *Support the Primary Market*: To better encourage primary market competition, the Housing Reform Plan calls for an amendment to the PSPAs to require GSEs to provide cash windows for small lenders and restrictions on volume-based pricing.

The Housing Reform Plan also calls for interim preliminary rulemaking measures in anticipation of congressional action. Treasury recommends that the FHFA begin the process of considering, among other things: (i) post-conservatorship GSE capital and liquidity requirements, (ii) operational and competitive issues relating to the private guarantor model, (iii) permissibility of new activities and products, (iv) clarification to supervisory roles between regulators, and (v) effects on secondary and primary markets.

V. FHFA Actions

The FHFA, as the GSE's regulator and conservator, has begun to take some actions recommended by the Housing Reform Plan. First, in late September, it entered into PSPA amendments that permit the GSEs to retain additional capital – $25 billion for Fannie Mae, $20 billion for Freddie Mac. (Because, prior to the amendments, GSE leverage was approximately 1000-1, there is still a long way to go before the GSEs can become self-supporting; most large U.S. banks have at least 10-1 leverage.)

Second, on October 28, the FHFA issued its Strategic Plan and Scorecard. The Strategic Plan has three central goals for the near term – increasing competition, increasing FHFA authority, and making changes to the ways the GSEs operate. The Scorecard is the FHFA's means of assessing the GSEs' alignment with these overriding principles. It has three sections that are intended to ensure that the GSEs:

1. Focus on their core mission responsibilities to foster "Competitive, Liquid, Efficient, and Resilient" (CLEAR) national housing finance markets that support sustainable home ownership and affordable rental housing;

2. Operate in a safe and sound manner in conservatorship; and

3. Prepare for their eventual exit from government control.

The Scorecard is therefore evidence of active FHFA monitoring to advance the principles of the Housing Reform Plan in the coming year.

VI. The Future

The Strategic Plan's statement that "restor[ing] the GSEs to their proper role as fully-private, well-capitalized, and well-regulated financial institutions . . . will take time and a great deal of effort" is likely an understatement. Although the Housing Reform Plan is ambitious in approach, the practical realities of implementing it must be seriously considered. Some considerations that we believe could hinder comprehensive reform, absent a new political impetus, are:

The Upcoming Presidential Election and Extent of Political Will

With the upcoming presidential election, legislative action is almost certain not to occur until after November 2020. Although few would disagree with the need for reform, political paralysis has only grown in Washington, and reform is not a hot button issue that is likely to get substantial airtime in the coming year. Sensing this, Senator Michael Crapo – the Senate Banking Committee Chairman who was able to craft some bipartisan financial legislation notwithstanding the current political atmosphere – stated in the Senate Banking Committee hearing on the Housing Finance Plan that "it's time for the Administration to act and to start building the foundation in taking the necessary steps it can take in order to address this issue and actually help Congress get to a comprehensive solution."[4]

Fractured Constituencies

As with any legislation having the potential to upend existing financial interests, a shift from government-favored enterprises to a free market, more level playing field will affect many interests that are reliant on the regulatory status quo. Because the beneficiaries of the current regulatory regime will be competing with private market actors standing to benefit from reform, there is a risk that congressional constituencies may fracture rather than coalesce behind a single, comprehensive framework.

Ideological Differences

Although members of Congress appear to agree on the need for a legislative solution, the particulars as to how to effectuate reform may suffer from the same ideological divisions that plagued GSE regulation in the years before the Financial Crisis. For example, some Democrats cite concerns over the Housing Reform Plan's impact on affordable housing, in that financial products for lower-income individuals may fall outside the scope of a more limited federal guarantee, with the potential to increase mortgage costs for those persons.[5] Conversely, many Republicans have sought to rally support around their answer to affordable housing, the reduction of state and local regulations,[6] but this view is far from universally shared. Lack of bipartisan support for some of the more basic concepts proposed by the Housing Reform Plan may indicate challenges to producing a viable bill even after 2020.

Challenges to the FHFA

As the Housing Reform Plan notes, there are substantial actions that the FHFA itself may take in moving reform forward. In September, however, the U.S. Court of Appeals for the Fifth Circuit held that the FHFA's structure – having a single director that may be removed only "for cause" – is unconstitutional,[7] and the U.S. Supreme Court has granted certiorari on a similar challenge to the

structure of the Consumer Financial Protection Bureau, with a likely decision by June 2020. How these cases will ultimately affect the ability of the FHFA to take prompt actions that fall within its regulatory authority, such as promulgating new, heightened GSE capital and liquidity requirements, is currently unclear.

Conclusion

The Housing Reform Plan is generally a positive development in articulating a coherent vision for U.S. housing finance in the 21st century. The seventy years between the creation of Fannie Mae and the onset of the Financial Crisis demonstrate that supporting private-sector mortgage finance can be both highly profitable and potentially calamitously risky. The concept of a private-sector support system backed by a paid-for, explicit government guarantee, and subject to the same strict capital and liquidity standards as the nation's largest banks, has many reasons to suggest it as a far better alternative to both the pre- and post-Financial Crisis housing finance system.

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[1] U.S. Department of the Treasury, Housing Finance Reform Plan (September 5, 2019), *available at* https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf.

[2] The PSPAs are available on the FHFA's website at: https://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx.

[3] *See* https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Releases-New-Strategic-Plan-and-Scorecard-for-Fannie-Mae-and-Freddie-Mac-.aspx.

[4] Remarks of Senator Michael Crapo, United States Senate Committee on Banking, Housing and Urban Affairs, *Housing Finance Reform: Next Steps* (Sept. 10, 2019).

[5] Senator Sherrod Brown (D-OH) argued that the Housing Reform Plan "will make mortgages more expensive and harder to get." United States Senate Committee on Banking, Housing and Urban Affairs, *Housing Finance Reform: Next Steps* (Sept. 10, 2019). Similarly, a former Obama administration housing adviser argued that "[i]nvestors will be much pickier and charge more for the loans they are willing to invest in." Andrew Ackerman and Kate Davidson, Trump Administration Aims to Privatize Fannie Mae and Freddie Mac, The Wall Street Journal (Sept. 5, 2019), *available at* https://www.wsj.com/articles/trump-administration-aims-to-privatize-fannie-mae-and-freddie-mac-11567717213.

[6] Senators Pat Toomey (R-PA) and Tom Cotton (R-AK) both spent their allotted times at the Senate Banking Committee Hearing discussing issues with state and local level regulations impeding affordable housing construction – as Senator Toomey stated, "[t]he primary driver is state and local regulations and it really does concern me the damage that's being done to our economy and to affordability and access from these barriers. It's causing a crisis in many parts of this country. We have to recognize that while the mortgage market and mortgage finance does play a role, it cannot fix this

problem by itself." Remarks of Sen. Pat Toomey, United States Senate Committee on Banking, Housing and Urban Affairs, *Housing Finance Reform: Next Steps* (Sept. 10, 2019).

[7] *See, e.g.,* https://www.reuters.com/article/otc-cfpb/5th-circuit-holds-fhfa-structure-unconstitutional-boost-for-supreme-court-challenge-to-cfpb-idUSKCN1VU2D7.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions practice group, or the following:

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