



Sensitive/Pre-Decisional

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

January 4, 2011

INFORMATION MEMORANDUM FOR SECRETARY GEITHNER

FROM: Jeffrey A. Goldstein
Undersecretary for Domestic Finance

SUBJECT: Housing Finance Reform Plan

The accompanying document contains staff's proposed transition plan and descriptions of three end states as discussed in the December 23 meeting. It also highlights other key policy items that require decisions before the whitepaper release.

We look forward to discussing this proposal at your convenience.

Attachment(s)

Tab 1: GSE Transition Plan and End State Framework

TRANSITION PLAN

Transition will take place gradually over a multi-year phase-in period and be managed in a way so to (i) preserve the current economic recovery, (ii) avoid further dislocation in the housing markets, (iii) protect taxpayers, (iv) attract private capital, and (v) ensure the GSEs honor their obligations. A clear transition path with a well-defined end state will be important to communicate to the market and to all constituencies.

1. End activities the GSEs should never have been doing in the first place.

Wind down non-core GSE activities, specifically the retained portfolio (currently underway):

- As part of the PSPAs, the GSEs have already begun to reduce the size of their retained portfolios by at least 10% per year. We would continue at this pace and look for additional opportunities to accelerate reductions, particularly through disposition of non-performing loans.
- Consider managing certain assets of FNM and FRE jointly (REO, etc) to realize economies of scale and outsource any non-core activities.

2. End the preferential capital standards and pricing the GSEs have relied on at taxpayer expense.

Establish new capital standards for new guarantees made by GSEs and the mortgage finance market:

- The Administration will work with the FHFA and the Fed to establish improved capital requirements that reflect differential risk-weightings across LTV and risk profiles, consistent with Basel III. Based on current estimates, this would increase required capital to 300 - 400 bps. Previously, the GSEs were required to hold 45 bps of capital against guaranteed mortgages.
- Within six months of the whitepaper release, FHFA could publish new capital standards with clarity of long-term pricing implications (implying 50-75 bps in higher rates) under conservatorship.

Phase in guarantee pricing to reflect higher capital standards:

- Also within six months, FHFA could put forth a pricing phase-in schedule to reflect the higher capital requirements/implied pricing. This could follow a linear path of 10-15 bps per year. FHFA could indicate the specific conditions where the phase-in could be faster or slower.
 - Different mechanisms/triggers for pricing increases should be considered to account for housing market conditions (such as HPI indices, home sales, primary/secondary spread, etc).
- Over the past two years, the GSEs have implemented loan-level pricing adjustments (LLPAs) based on LTV and FICO scores. These pricing adjustments would continue and should further allow pricing to adjust for differences between states to capture differences in market conditions.

3. Create an atmosphere to attract private capital, while ensuring safety and soundness of the financial system.

Return FHA to traditional role as targeted provider of affordable housing credit:

- Lower loan level limits and increase pricing to decrease FHA's market share of new mortgages. This process should be phased in under similar timelines to the increased GSE pricing.

Continue to implement reforms under Dodd-Frank (ongoing):

- Reforms under Title IX and XIV, including risk retention, transparency, and credit rating agency changes, help create a more stable and efficient private securitization and mortgage market.
- FSOC processes and SIFI designation increase overall supervision of bank and non-bank actors.
- The CFPB brings added oversight and important consumer protection standards to the entire mortgage origination process.

Strengthen underwriting standards and reduce credit risk in system:

- QRM under D-F 941 will exempt high quality underwritten mortgages with lower LTV and debt to income ratios from risk retention (e.g., agencies have proposed 80% LTV for new purchases).

- Higher capital requirements including Basel III standards and explicit loan level pricing adjustments set by private sector will increase costs for higher LTV mortgages.
- Qualified Mortgage under CFPB will set a minimum ability to pay standards for all mortgages underwritten in system.
- The conforming credit box for GSE mortgages will be tightened over time to max cap of 90% LTV over time.

4. Affirm our current obligations.

The remaining PSPA capacity must be managed so that market participants are assured GSE obligations will be met, regardless of the outlook for legislation. (This must be clear in the whitepaper and communicated to the market).

- Ensure \$275 billion of funding capacity available after 2012 is not used to pay dividends. This may require converting preferred stock into common or cutting or deferring payment of the dividend (under legal review).
- Potentially accelerate recognition of losses prior to 2012 (there is currently a \$180 billion difference between the GAAP and Fair Value balance sheets of the GSEs).

Additional transition steps which could be taken if migrating to a FDIC reinsurance model:

Restructure GSEs into three pieces (this step could be taken in the first year):

- Credit Enhancement/Mortgage Guarantor entity could be sold/disposed to the private market as new “going-concern” entities or in parts.
- Securitization/reinsurance utility (GNMA-like) backed by PSPA support for guarantee that could be ultimately either be transferred to GNMA or wound-down.
- “Bad Bank” consisting of retained portfolio, legacy guarantee liabilities and 3rd party debt that would also be backed by PSPAs and run down slowly to maximize taxpayer recovery.

Crowd-in private capital (these actions could start over the next 1-2 years as guarantee fees increase):

- FHFA could require higher down payment at borrower level or increase level of credit enhancement at loan level, such as increasing amount of PMI.
- Syndicating pool level risk to markets through cat bonds, CMOs or other method. Higher guarantee fees will increase ability to sell risk back to the market.
- *Consideration: crowding in private capital reduces pace and effectiveness of taxpayer recoupment.*

Note on the impact of higher capital standards/role of QRM. Higher capital requirements will generally result in lower market shares for the GSEs and any successor entities. Banks will likely originate and hold higher share of ARMs. QRMs and jumbo mortgages would make up the bulk of private securitizations away from GSEs. As guarantee fees increase, investors may determine that the value of the liquidity and credit protection provided by the GSEs is too expensive, and an unguaranteed capital market or portfolio execution is more attractive. The QRM will also provide a basis of standardization. Under the Agencies’ current proposal, approximately 30-40% of current GSE volumes (or 20-25% of total market) would qualify as QRMs (with historical credit loss of <5bps). In times of stress, when liquidity value increases, GSE execution would become more attractive.

END STATE OPTIONS

Option 1: Privatization of GSEs

- After becoming adequately capitalized during the Transition, the GSEs would exit conservatorship as private companies. (Treasury converting its preferred into common equity to be sold to the public over time (under legal review); the GSE's existing common shareholders being substantially diluted). The companies continue to guarantee a large share of mortgages, with PMI companies and homeowners taking the first loss risk as they have done traditionally.
- This is essentially the path laid out under HERA and the Paulson Treasury when the GSEs were put into conservatorship in September 2008. This would not require legislation, but is subject to decisions made by FHFA as conservator in consultation w/ Treasury.
- Dodd-Frank strengthens this option through the ability to designate the GSEs as SIFIs, and thereby subject them to more rigorous prudential standards and Fed supervision. GSEs/successor entities would maintain higher capital requirements and investment restrictions as envisioned in Transition.
- Key criticisms of this system (which are partially mitigated through provisions in Dodd-Frank):
 - Creates another set of private financial firms that are too big to fail.
 - Does not represent fundamental reform and does not "end GSEs." Replicates the pre-crisis system of "heads I win/tails you lose" mentality of private shareholders.
 - Inadequate taxpayer protections and abuse of the perception of government support.

Transition

- After GSEs reach private market pricing standards, they would be allowed to recapitalize until sufficient earnings are retained to exit conservatorship (subject to FHFA).
 - Cut in dividend or conversion of preferred into common would facilitate process (under legal review).
 - Accelerating losses before 2012 would also help strengthen the GSEs' balance sheets.

Option 2: FHA-only option: Wind Down of the GSEs (FHA-only option)

- The GSEs' new business would be gradually limited by FHFA so that eventually they no longer guaranteed mortgages. In the absence of large mortgage guarantors, private securitization, covered bonds, and bank balance sheets would support mortgage financing.
- As in the first option, FHA would become the only provider of explicit government supported mortgage guarantees. FHA would be limited to targeted segments of the population, so that market share in normal times would be less than 10%.
- The bank-centric model reduces distortion in the allocation of credit and preference for housing. However, this model benefits larger institutions that have better access to funding and the capacity to hold fully diversified portfolios of residential mortgage risk. This could lead to increased concentration in the banking sector and higher costs for borrowers served by smaller institutions.
 - Many countries rely more heavily on their banking systems to provide mortgage credit, but often still have other strong forms of government involvement and support.
 - To counteract the tendency for banks to become larger, we would have to effectively apply Dodd-Frank provisions, including SIFI surcharge, increased prudential regulation, concentration limits, etc, to limit taxpayer losses in future housing crises.
- FHLBs would be an even more important source of funding, which would require greater FHLB reform to reduce subsidy and the risk that the FHLBs become the next FNM/FRE.

- In the absence of GSEs, provision of mortgage credit in a crisis could be accomplished in several ways:
 - Allow FHA to expand dramatically
 - Allow FHLBs' advances to expand (if they became restricted) to become a liquidity provider
 - Legislate ability for the Fed to purchase QRM (Fed is currently unable to buy PLS)
- Key criticisms of this system:
 - Reduced prevalence of 30yr fixed rate mortgages and predominance of 3yr and 5yr hybrids.
 - Markets would be subject to greater swings in spreads and liquidity and credit pricing would be more pro-cyclical.
 - Loss of funding from certain GSE investors (particularly overseas) could increase mortgage rates beyond the anticipated rate implied by higher capital standards alone.

Transition

- After GSEs reach private market pricing in transition, full wind down would be achieved by gradually lowering conforming loan limits until zero. GSEs' charters would be abolished through legislation. Legislation or FHFA directive could initiate wind down.

Option 3 - Federal Home Insurance Corporation (FHIC) Catastrophic Risk Model

Government Guarantee/Single Securitization Utility - FHIC

- Single, government-backed FDIC-like securitization/reinsurance utility
 - Serve as platform to support standardization, liquidity, efficiency and transparency
 - Divisions for Securitization, Insurance and Supervision/Oversight
 - All non-private label loans, including FHA and VA and "conforming loans," will be eligible to be wrapped through utility. Legacy GSE MBS would be wrapped by this entity as well.
- Actuarially priced reinsurance for tail risk (based on Treasury borrowing cost) will be available in both normal times and times of stress, and effectively serve as catastrophic risk insurance.
- Securities deliverable into a single pool, further benefiting liquidity and efficiency and maintaining TBA market. Existing FNM/FRE securities would become eligible, interchangeable collateral.
- Taxpayer Protection: Reserve fund with additional auto-recoupment mechanism for any unexpected losses (similar function to the deposit insurance fund (DIF) utilized by FDIC).

First-Loss Providers (FLPs) / Private Mortgage Guarantors

- Mortgage credit risk would be taken by the private sector through bank-like capitalized and regulated First-Loss Providers (FLPs). Similar to option 1, FLPs would hold ~300 of capital and charge 70-100bps for guarantee, and might insure only moderate risk mortgages if QRM market develops.
- Existing PMIs, new firms or other financial institution subsidiaries could apply to become an eligible FLP; parts of FNM and FRE could be converted/sold to become FLPs.
- Risk based pricing on a loan level explicitly allowed, including adjustments for credit risks such as LTV and DTI levels as well as geographic considerations (including accounting for a market which may be overheating/riskier or which has weaker enforcement laws).
- *Open item on how to permit both regulated credit guarantees and b-tranche funding.*

Regulation

- Approved FLPs would be eligible "retainers" for risk retention for non-QRM loans.
- FLPs will be approved and supervised by FHIC as prudential regulator and through counterparty risk management regime. Portion of FHFA which supervises GSEs could be merged into FHIC.

Taxpayer recoupment

Recovery of PSPA investments need to be balanced against objectives in all three options and methods to maximize recovery will vary depending on the future end state. Potential recoupment mechanisms include:

- Higher net income on new originations at the GSEs as a result of higher guarantee fees.
- Disposition of non-core assets, such as multifamily, shared services, etc.
- Sale of the GSEs or parts of the GSE's core guarantee activities to the private market.
- Residual fee – RefCorp-like solution of a [10] basis point tax on future mortgage securitizations or originations (may be challenging to institute a fee at origination vs. through a securitization utility).

OTHER REFORMS

Changes/reforms to other government supported entities in the system:

Absent parallel reforms, each of FHA and the FHLBs would become relatively cheap sources of mortgage financing if GSE successors and first-loss providers are required to hold Basel III levels of capital.

FHA: Footprint should be reduced through higher pricing (as if required capital and some level of ROE) and greater restrictions on eligible borrowers (changes in loan limits and means testing). FHA max CLTV cap will be reduced to 95% (down from 97.5%). Further reforms, such as converting FHA into a government corporation to increase flexibility and independence, can be considered.

FHLB system: Taxpayer exposure and potential systemic risk should be reduced by structural reform, which could include establishing advance caps (\$5bn or < per institution), returning to single-district membership, and imposing portfolio restrictions on investment. We should consider designating the FHLBs as SIFIs. *Question for how best to address in white paper and legislation or regulation.*

Other key parts of plan:

Affordability initiatives: Affordable initiatives are paid for and delivered in a separate and transparent way. HUD and Affordable Housing Trust (AHT) and Capital Magnet Fund (CMF) are principal funding vehicles for affordable initiatives. FHA will continue to be a provider of credit to lower-income and first time home buyers. *Open question as to whether there should be a form of duty to serve or reformed goals in a future guarantee system. If no FHIC/GSE successors, how will we pay for affordable programs?*

Multifamily: Government financing and other support for multi-family will be limited to class B and C properties, small unit properties (5-49 unit properties) and certain projects which meet specific housing policy and community development goals as set by HUD. Most large scale and class A luxury properties would not be eligible. *Open question as to whether multifamily support should be part of FHIC system (i.e. through private multifamily guarantors) or only through FHA.*

National Servicing Standards: Basic servicing standards will be set through (i) D-F 941 QRM definition, (ii) global settlement process underway, (iii) CFPB, (iv) further regulatory action and (v) and specific legislative recommendation as part of reform process. We would recommend making servicing a significant part of our broader reform process and indicate that we will produce further recommendations.

Fee for Service Master Servicing Model: GSEs will migrate to a fee for service model which will change industry business model. Holder of credit risk will retain master servicing rights and contract back to sub-servicers (such as the originator, independents, special servicers, etc). Structured to reduce presence of MSRs on originators' balance sheets as well as align incentives to credit investors. FLPs would continue to follow this model in FHIC system. *Note: FHFA will be proposing this model as a near term market reform.*

Lien Priority: First lien rights and enforcement should be increased, and Garn–St. Germain, which limits the ability for a first lien to restrict subsequent second liens, should be repealed and/or modified so that second liens can only be originated either if (i) the permission of the first lien is granted or (ii) the pro forma debt is inside the original LTV or original loan value of the first lien at time of origination.

Foreclosure Laws: Establish model foreclosure rules for states. *Open item of best way to implement.*

Covered bonds: Difficult to establish a meaningful covered bond market without substantial changes to FHLB system. Legislation could be included as part of reforms to FHLBs to serve as an alternative for advances for large institutions who have sufficient access to capital markets.

Not addressed in the plan:

Tax Code/MID: We recognize that the government supports housing through the tax code, primarily through the mortgage interest tax deduction. This plan does not consider changes to the tax code, but that is an area that should be explored in subsequent discussions.

Information Memorandum Clearance Sheet

Subject: Housing Finance Reform Plan

Drafted: Capital Markets – Brian Zakutansky

Approved: Capital Markets – Jeff Foster (1/4/11) OK

Cleared: Financial Markets – Mary Miller (1/4/11) OK
Economic Policy – John Bellows (1/4/11) OK
Domestic Finance – Jeffrey Goldstein (1/4/11) OK
OGC – Peter Bieger (1/4/11) OK
Exec Sec – Sam Valverde (1/4/11) OK
OPA – Steve Adamske (1/4/11) OK
Lewis Alexander (Counselor to the Secretary) - (1/4/11) OK
Jake Siewert (Counselor to the Secretary) - (1/4/11) OK
Jim Millstein (CRO) – (1/4/11) OK