

GSE Reform - The Future of Mortgage Finance

Introduction

GSE reform might be better described as the development of a new United States Mortgage Funding System (USMFS). In this article a mortgage origination and sales process is suggested derived from business and structural elements of Government Sponsored Entities (GSEs), Federal Home Loan Banks, banking, banking regulation, and mortgage securitization. No question the GSE's, certain FHLB's, banks, and securitizations have had problems not inherent in faulty purpose but rather due to poor rules, compliance, excessive credit and/or financial leverage, and/or poor management oversight.

Mortgage industry participants include issuers, GSEs, mortgage insurers, Broker/Dealers, regulators, ratings agencies, and investors. . The USMFS model is a combination public and private participation, "old school" logic ("skin in the game"), accepted guidelines and operations (GSE Seller/Servicing standards), and "new school" investment vehicles and risk management practices.

Table 1 details the mortgage process from borrower loan commitment to loan servicing, the suggested roles of mortgage industry participants, and clarifying commentary (hopefully).

Framing the Issues: Things we can change, things we cannot

Industry participants, industry rules, and industry processes (and some industry myths) will need to modify their roles/makeup to create a more efficient mortgage origination and servicing system. Here is a summary of issues that probably cannot change and some that will need to be modified or rethought:

- Fixed Rate Loans will remain the standard. It would be nice to adopt the variable rate note as the predominant interest payment, but the United States borrower is comfortable with fixed rate loans. This unfortunately adds significant interest rate risk to the system increasing the cost of mortgage lending.

- GSE/US Mortgage Entity financing is a necessity for an annual \$1.5-\$4.0 trillion dollar market; privatizing financing is unlikely given the magnitude of lending and the "callable" interest rate risk of fixed rate loans. "Callable" agency debt is the only acceptable financing for a mortgage with "callable" risks.

- Investors, Rating Agencies, Regulators, and Underwriters do not have adequate time to evaluate a heterogeneous pool of mortgages. The due diligence process must have some agreed upon central depository of loan data and legal documentation (such as Reg. ABII). The representations and warranties from issuer to investor must be specific, an arbitration process created, and the servicer responsibility to issuer and investor detailed. The due diligence process must be much longer. Loans that become delinquent will not make pools, ownership documents and assignment must be collected and chain to title perfected.

- We have to maintain a "guarantee" of ultimate payment by the government as no private counterparty can provide that. So the notion that the tax payer will never have to "bail out" the system is probably not reality, however the GSE/Mortgage Entity (USME) can collect higher credit enhancement fees dictated by the private market pricing.

TABLE 1 - The Mortgage Market - A New Process

<i>Mortgage Loan Process</i>	<i>USMFS</i>	<i>Days</i>
Loan Commitment	The GSE/US Mortgage Entity provides "best efforts" commitments to prospective lenders eliminating the "pipeline" risk of the lender backed by the issuance of callable debt. The "best efforts" commitment would extend to the sale of the security 180 days in the future. This will require that the participation structure to be presented is accepted and a "forward" market for RMBS is created. The lender/issuer has all the interest rate and credit risk associated with its retained participation.	15
Underwriting	The GSE/US Mortgage Entity's seller/service guide is broadly accepted by investors and will continue be the guidelines for mortgage origination and servicing. The guidelines should be reviewed periodically by an industry group with representatives from the GSE's, investors, ratings agencies, and underwriters. IF THE LOAN DOESN'T FOLLOW COMMON SENSE UNDERWRITING SUCH AS SUFFICIENT DOWN PAYMENTS, GOOD PAY HISTORY, AND VERIFICATION OF ASSETS AND INCOME NO DUE DILIGENCE PROCESS NOR SECURITY STRUCTURE CAN CURE A SUBSTANDARD LOAN. Loan limits should be lowered to \$500,000 for agency.	35
Mortgage Insurance	The Mortgage Insurer would continue to provide the same coverages.	na
Funding	The funding process would remain unchanged. A simultaneous transfer takes place from lender to borrower to seller. The "best efforts" commitment becomes a "mandatory" commitment at this point; any non-delivery due to delinquency and/or improper documentation is borne by the lender/issuer.	10
Due Diligence	The period of loan level review has never been adequate. The result being mortgage insurer, wrap provider, investor, and GSE repurchase requests, loss note affidavits..etc. Ratings agencies, investors, issuers, accountants (via Rag AB2, 17-g5, FDIC Fair Harbour) agree on loan level disclosure (and agency MBS data), representations and warranties; all investors are given a much longer due diligence period say 120 days for review. An arbitration process is created but the standard is "pure" fraud given the discovery/due diligence process has been lengthen.	150
Primary and Secondary Marketing	A monthly auction would be held (much like treasuries) of various participation structures, an example is presented in the Table 2. The TBA market would have a new specific pool delivery (ultimately "the" TBA delivery) from "contributed senior participations for mortgage note rates. Credit enhancement, servicing fees, and excess fees would be in the form of a participation as well and be held by the lender/issuer or GSE/US Mortgage Entity. The credit participation would be sold by the GSE/US Mortgage Entity via street underwriters. This credit market would value the risk for the sovereign, allow it to sell the risk, and price the risk in the future. THE GOVERNMENT WILL STILL REMAIN THE FINAL GUARANTOR BUT WILL BE PAID MORE FOR THE RISK AND SELL SOME OF CREDIT EXPOSURE.	45
Servicing/Trustee	A pure division of the servicer's responsibilities for the lender/issuer versus the investor (led by the trustee) would be best but unrealistic. Investors, trustees, accountants, rating agencies..etc need to decide on due diligence standards, arbitration, and representation within servicer operations. The originator having additional skin in the game should serve to mitigate some of the inherent conflicts in deciding on corporate and investor best interests.	na

-Mortgage insurance needs to be retained as it is widely accepted and provides loan by loan credit enhancement. In the future as the formation of private credit enhancement matures it may not be necessary.

-Issuer “skin in the game” is a must but cannot eliminate gain on sale treatment for securitizers. Loan servicer “agent” relationship to both issuer and investors must be defined (creating separation) to avoid a conflict of interest that denies a ownership transfer. Fixed rate loans are normally not held by banks due to asset/liability mismatch, so securitization vehicles that results in gain on sale (not financing) are necessary to attract the capital necessary to meet the demands of the largest bond market in the world.

United States Mortgage Financing System (USMFS)

The reader should refer to Table 1 for more information on market participants and their changing role in a new mortgage process. The major third party responsibilities and structural changes are described in this section.

The USMFS, as we call it, would have a central GSE/US Mortgage Entity (USME), which might be any combination of FNMA, FHMLC, GNMA, and the Federal Home Loan Banks. The entity would provide financing and product/underwriting guidelines to the market, be guarantor of debt issuance, however the pricing and transfer of credit risk is determined/facilitated by the private market. The cost of credit (which has never been “market” priced) will be higher resulting in higher mortgage rates but manageable versus a complete private system of financing, heterogeneous investor guidelines, and private market credit enhancement. The USME will no longer purchase and hold a portfolio of securities; its only assets will be securities (senior or subordinate) that have not been sold into the private market. The USME will continue to issue callable debt although the duration may be different to match the proposed terms of the participation security suggested (see Table 2). Detractors questioning the increased interest rate and funding risk of this proposal may want to consider the risks currently embedded in treasury “unhedged” issuance for other public policy needs, its support of quasi private companies FNMA and FHLMC, and the fact that the Federal Reserve currently holds \$1.25 trillion RMBS securities resulting from market support action.

In this proposal the government is paid more for the credit risk and has a pricing/transfer (sales) mechanism for credit risk. This transfer (sales) mechanism is provided by underwriters that raise capital for the world’s largest bond markets. Regulation related to capital and leverage requirements, counterparty risk and clearing mechanisms, limits on “short” positions to the underlying notional outstandings of the RMBS securities will need to be in place.

Table 2 presents a participation structure not unlike that initially developed by the GSE in the 1950s. A participation would be held by the issuer (far more understandable than the “vertical slice” of bonds proposed in recent legislation) that would represent servicing compensation and “skin in the game”. The USME would take its credit enhancement in the form of loan participation and “excess” servicing fees in combination to produce the “tightest WAC” bond for new TBA delivery. The bond market will have to acquiesce to a new delivery profile, but shaking up the “street status quo” is worth a better performing bond and eliminating a lender loan and servicing asset with significant interest rate risk. In Table 2 depicts monthly deliveries in five different participation buckets each having different product types and degrees of credit risk.

The period of underwriting, due diligence, and secondary marketing will be significantly longer. The current 60-90 period will be extended to 180-210 days to accomplish these tasks. Delinquent and

defaulted loans will not be accepted (hopefully no sale compensation will be paid until delivery), complete transfer of ownership documentation with all assignments made to the trust with no exceptions, a agreed upon data and legal doc repository will be decided (much like that to be agreed in Reg. ABII), and investors will have an appropriate time to evaluate loan pools. The market has suffered greatly now that worse than expected performance has met a due diligence period that was never long enough. These changes should eliminate some systematic fraud, align better the motivations of issuer and

TABLE 2 - USMFP Participation Deliveries					
Monthly GSE/USMFP Mortgage Deliveries					
Class A Participation - 15 Year Fixed Agency/Non-Agency (1% Issuer Retention/Credit Enhancement)					
Class B Participation - 30 Year Fixed Agency/Non-Agency (2% Issuer Retention/CE)					
Class C Participation - Hybrid ARM Agency/Non-Agency (3% Issuer Retention/CE)					
Class D Participation - Other Prime Residential Agency/Non-Agency, GNMA 15 Year (5% Issuer Retention/CE)					
Class E Participation - GNMA 30 Year, Second Liens, Affordable Housing (10% Issuer Retention/CE)					
Class B Participation - 30 Year Fixed Agency/Non-Agency (2% Issuer Retention/CE)					
GSE/US Entity Requires 1.5 points in Credit Enhancement (Determined by the Market)					
Delivery Example - 25 bps in yield = 1 point in price/credit enhancement					
TBA Delivery to 4.5% Coupon					
Mortgage Note Rate:	4.500%	4.625%	4.750%	4.875%	Comment
Senior Security - Participation %	96.500%	97.000%	97.500%	98.000%	Percentage of Note Rate Allocated to TBA or Senior Security
GSE/US Mortgage Participation %	1.500%	1.000%	0.500%	0.000%	Credit Enhancement Held by GSE/US Entity - Participation
GSE/US Mortgage Excess %	0.000%	0.125%	0.250%	0.375%	Credit Enhancement Held by GSE/US Entity - Excess Fees
Issuer Held Participation %	2.000%	2.000%	2.000%	2.000%	Issuer's "Skin in the game & servicing compensation"
Security Profile (assumes even note rate distribution)					
Weighted Average Note Rate	4.688%				"Tight WAC" bond delivery into 4.5% coupon
GSE Participation CE	0.750%				Held by GSE/US Mortgage Entity or sold to private investor
GSE Excess CE	0.188%				Held by GSE/US Mortgage Entity or sold to private investor

investor and hopefully eliminate future conflict with regard to repurchases.

Representations and warranties will to be understandable, acceptable, and reasonable given how the market functions. The servicer's role must be defined for both investor/trustee and issuer and an arbitration process created for file discovery and accordingly less fragmented resolution.

Summary

The mortgage market's unprecedented downturn has limited the availability of credit to the market and adversely affected housing. Many of the ideas associated with the suggested USMFS may be considered provocative (or maybe unrealistic) yet the market has to be changed in terms of risk management, pricing, and responsibilities of the actors. I would even suggest, to the anger of some, that individual investors purchasing mortgage securities have the same public policy driven tax-exempt status afforded municipal issuances. The issues are many, the market large, and the participant's roles and wants conflicting. Hopefully this suggested framework, improved/changed via the efforts of the many talented professionals in the industry, can be helpful in restoring investor confidence and bring capital back to the housing market.

