By Paul T. Bossidy

How to Denationalize Housing Finance and Bring Private Investors Back

For all intents and purposes, the housing finance industry has effectively been nationalized. Today, the government—through Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA)—accounts for 95 percent of all newly originated residential mortgages. And since Christmas Eve 2009, we, as taxpayers, have for the first time explicitly guaranteed, without limit, Fannie's and Freddie's housing debt—more than $8 trillion in direct and guaranteed obligations.

This is not to suggest that a dramatic intervention wasn't necessary on a short-term basis. Had Congress and the Treasury not pumped liquidity back into the market, it is highly likely that the mortgage industry as we know it would be gone and the real estate market, instead of being depressed, would be in free fall.

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The question now facing Washington and our industry is: How do we denationalize? And what's the fastest, safest way to do it?

Although the Federal Reserve has already signaled that it will stop buying mortgage-backed securities (MBS) this spring, unless private capital comes back into the market, there is a very real possibility that the demand for Fannie and Freddie paper will again drop precipitously. Certainly interest rates will jump, thus further tamping down the still-anemic housing recovery.

Bringing back private capital will require a consistent government strategy to gradually wind down its massive participation in both the MBS and origination segments of the business. It will also require short-term strategic investments in certain tranches on new securities to spur private demand (more about this later).

Moving in the right direction

There are reasons to be optimistic that this can work. Last year at this time, there was a great deal of skepticism about whether the federal government would lose money on its Troubled Asset Relief Program (TARP) loans to the nation's biggest banks. But a year later, three of the four largest lenders in the nation—Bank of America, Charlotte, North Carolina; JPMorgan Chase, New York; and Wells Fargo & Co., San Francisco—have weaned themselves entirely off taxpayer support.

While more than three-quarters of the 69 smaller banks that also received TARP funds have yet to leave the federal dole, the success of the biggest banks in bidding TARP *adieu* has led some to believe that we are approaching the end to the federal bailout era.

While banks have been able to again tap private capital and raise money in the public debt and securities markets, private investors are still on the sidelines when it comes to housing. This is hardly surprising, given the losses that they incurred as the system broke down and then seized up. In 2006, private investors owned more than two-thirds of all mortgage securities (agency, too). Since then, they have lost billions of dollars on their investments, many of which were initially highly rated.

Private capital is also boycotting the origination side of the business: Liquidity is still scarce at the prime jumbo end of the market and lenders are still struggling to find warehouse lines.

Similarly, private mortgage insurers, which should be an important part of the real estate recovery, are capital-constrained thanks to record claims and their inability to raise new capital by issuing debt or securities. Meanwhile, would-be mortgage insurance (MI) investors are watching the MIs' market penetration plummet, as the government-backed FHA has grown from roughly 3 percent to 4 percent of the market to more than 30 percent in less than a year.

Loan originators have made significant progress over the past couple of years in upgrading their underwriting practices. The new business that is being written and insured is very high-quality and should, given the low rates and the state of housing-price appreciation, stay on the books for some time. Eventually, this will tempt investors to reconsider the private market, particularly when they consider the yields that are available elsewhere.

Speeding up the process

What could our industry and Washington do to speed up this process? They could finalize new rules to:

■ *Fix what undermined the system in the first place—the misalignment of compensation and incentives.* Too often in the past, mortgage brokers and commissioned loan officers had profit incentives that were in conflict

with the interests of lenders, investors and borrowers. Greater clarity about compensation standards relating to ongoing performance will enable all interested parties to better align incentives and work in the same direction. Although the new Real Estate Settlement Procedures Act (RESPA) disclosure requirements are currently creating compliance concerns, over time they will be seen as a step in the right direction.

■ *Help the buyer beware.* Obviously, there must be transparency at all levels. In the past, investors found it nearly impossible to access loan-level data on the mortgages they were investing in, usually receiving such information only after the fact. To their credit, Congress and regulators are addressing these issues in proposed legislation and policies. Industry and investors are engaged in serious efforts to dramatically improve investor transparency, as reflected in the efforts of the New York–based American Securitization Forum's (ASF's) Project Restart, as well as the credit-rating agencies' rollout of dramatically new standards and disclosure for the underwriting of mortgage-backed securities.

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An example of the new standards for transparency can be found in a deal that came to market at the end of 2009. The new issue rated by New York–based Moody's Investors Service raised $300 million that will be used as a mortgage lending warehouse facility. In its published analysis, Moody's described in some detail the due diligence conducted in connection with the transaction and its findings. This level of transparency simply didn't exist in the MBS deals of old.

■ *Encourage simplicity.* Too many private-label MBS contracts in the past were hundreds of pages long, differed from deal to deal and lost sight of the big picture. The complexity of the mortgage packages themselves made analysis difficult. When foreclosures began to mount, it became much more difficult to model cash flows. Simplicity and standardization, including the standardization of representations and warranties, will help MBS investors make more informed decisions.

Priming the market

While these structural changes will go a long way toward reassuring investors, they probably won't be enough. Because the Fed owns the market now, it has an opportunity to show how a new system can and should work. Rather than indefinitely providing a full guarantee to 95 percent of all mortgages, which is simply not sustainable, it could apply some of that funding to create a glide path to a better public/private balance. How? Here's my suggestion.

With these and other new protections in place or coming soon, the government should open the Term Asset-Backed Securities Loan Facility (TALF) program to create a new kind of MBS. Think of it as a program to stimulate investment.

Under TALF, investors would receive low-cost loans from the government in order to buy qualified bundles of loans. As an added incentive, the government should agree to take a first-loss position on the lowest-rated tranche in a security. Yes, this is still propping up the market, but at a much lower level: *x* percent versus its current 100 percent backing. This enhancement to TALF wouldn't have to be permanent; it could be phased out once the MBS market is functioning again.

With a new set of rules and a new financial instrument backed partially by the federal government, private investors would be drawn back into the market. This would spread risk across the system and put taxpayers on firmer footing. In my opinion, then, and only then, will we be able to say goodbye to the bailout era.

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