



# GSE Reform: Consumer Costs in a Reformed System

In evaluating any proposal for GSE reform, three major objectives must be balanced: protecting taxpayers, attracting capital to Guarantors, and ensuring consumers and borrowers have access to affordable financing. MBA's proposal carefully considers each of these priorities, and achieves such a balance. This paper expands upon the discussion of consumer costs in MBA's proposal.

MBA understands that certain stakeholders are primarily concerned with the impact of housing finance reform on consumer costs. This analysis reviews the different components of reform that may impact consumer costs, and concludes that costs under the MBA proposal are likely to be quite similar to those seen in the mortgage market today. Whether costs are modestly higher or lower will depend on how the different components noted here are determined through the political process, but stakeholders concerned with consumer costs should not forget that a more stable system, as envisioned in MBA's proposal, has benefits for consumers, as it ensures that borrowers can get loans even during downturns and periods of market disruption.

The difficulty in arriving at a precise estimate with respect to consumer cost is that several components of housing finance reform actively under debate will impact costs. Until these debates are resolved, it is impossible to be confident about the total impact on cost. Most prominently, these six factors under debate will all impact consumer costs:

- A full faith and credit guarantee behind MBS,
- Guarantor capital requirements, return targets, and pricing behavior,
- MIF premiums,
- Affordable housing fees,
- The credit box, and
- Capital requirements for MBS investors.

### **A Full Faith and Credit Guarantee Behind MBS**

While most of the other factors listed above may contribute to somewhat higher consumer costs through reform, those increases would likely be offset by a move to an explicit government guarantee of eligible MBS. A primary reason for the higher price and lower rates on Ginnie Mae securities relative to Fannie Mae and Freddie Mac MBS is the full faith and credit guarantee on Ginnies. Fannie Mae and Freddie Mac and their securities are now explicitly backed by the Treasury through the Preferred Stock Purchase Agreements (PSPAs), but even the relatively small distinction in this environment leads to a marked difference in price.



At a consumer level, this benefit from investors valuing the explicit guarantee on Ginnies can be seen in the spread between mortgage rates on conventional vs. FHA loans, which has ranged from 10 to 40 basis points in recent years as shown in Figure 1 (page 4). This spread indicates the magnitude of the potential benefit of moving to an explicit guarantee behind the MBS. The spread has varied over time due to investor perceptions regarding the relative value of the securities, a value impacted by differing prepayment speeds, default rates, trading liquidity, and other factors. The fact that the conventional conforming market is larger than the Ginnie market may indicate that a conventional MBS with an explicit guarantee could trade even better than a Ginnie MBS, leading to a further reduction in consumer costs.

**FIGURE 1: SPREAD BETWEEN CONVENTIONAL CONFORMING AND FHA 30-YEAR MORTGAGE RATE**



SOURCE: MBA's Weekly Applications Survey

While the precise impact on consumer costs from true housing finance reform may be difficult to gauge, we know that attempts to shortcut reform through recap and release would lead to much higher costs for consumers. Global investors have been clear that they have no appetite for returning to a world of implicit guarantees and the resulting instability. Consumers would be much worse off in such an unstable system.

The ultimate benefit of legislative reform to consumers is that it provides an explicit guarantee that the system will be more stable over time, and hence the mortgage market will be available to consumers, even during severe downturns — a benefit that would be worth the tradeoff of modestly higher costs should these be required. Figure 2 shows the spread between 30-year mortgage rates and 10-year Treasury rates. What jumps off the page is that this spread nearly doubled during the crisis. This is the instability that the MBA proposal seeks to solve for through a combination of sufficient private capital and an appropriately priced government backstop.

**FIGURE 2: SPREAD BETWEEN CONVENTIONAL CONFORMING 30-YEAR MORTGAGE RATE AND 10-YEAR TREASURY RATE**



SOURCE: Federal Reserve and MBA

### Capital Requirements, Return Targets, and Pricing Behavior

MBA's proposal recommends that Guarantor capital requirements be much more rigorous than the requirements that were applied to Fannie Mae and Freddie Mac pre-crisis, which were proven to be much too low. Our proposal advocates a level of capital that would be sufficient to survive a severe stress level of losses, and also be devised to be consistent with required capital for other institutions like banks who are major investors in mortgages. With such a capital requirement, we would expect consumer costs to be comparable to what we see in the market today, but higher than those in the woefully undercapitalized pre-crisis GSE system. Some proposals have argued for a much higher level of capitalization, which would directly lead to higher consumer costs, while others have argued for much lower standards, which would lead to a much less stable system. The lower costs would be illusory, as they could not be maintained over time.



In addition to the level of capital, the return targets for the Guarantors are a critical variable that impact costs. Historically, given their unassailable duopoly position in the guarantee business, and a regulatory framework that did not permit oversight of returns, the GSEs achieved above-market levels of returns. MBA's proposal will lead to a more competitive secondary market with the potential for new entrants if returns are above market over a sustained period of time, or if the stable returns under utility-style regulation are deemed attractive by certain investors.

Under the utility framework, MBA envisions that the regulator will monitor the market to ensure adequate but not excessive returns, measured on a through-the-cycle basis. This more competitive and more transparent approach to pricing, along with a cultural shift from the GSE growth stock model to a Guarantor focused on steady, utility-like returns, should also lead to less pressure on consumer costs. Furthermore, by ensuring a level playing field for lenders of all sizes and business models, MBA's proposal would support a vibrantly competitive and dynamic primary market which will deliver mortgages at competitive rates to consumers.

## MIF Premiums

Several proposals under consideration would move the system from one that included implicit guarantees that supported the GSEs to explicit guarantees behind just the MBS, not the Guarantors. Under the MBA proposal, this explicit guarantee would be paid for through premiums that would build up over time in a Mortgage Insurance Fund (MIF). As substantial private capital would stand in front of the MIF, it would only be covering catastrophic risk. This risk would be difficult to price precisely, as truly catastrophic financial market events are quite rare and difficult to predict. MBA's view is that MIF premiums should be set at a reasonable level, and the MIF should be allowed to build up over time to a level consistent to cover crises similar in magnitude to what we have seen historically. If these premiums are set too low, there is an increased risk that the MIF would run dry during a crisis, and taxpayer support would be needed. (MBA's proposal would adjust premiums on a go forward basis in such an event to pay back taxpayers and replenish the MIF, similar to the FDIC's Deposit Insurance Fund.) If MIF premiums are set too high, the MIF would grow quickly, but it would needlessly add to consumer costs.



### Affordable Housing Fees

Roughly one-third of existing-home sales today go to first-time homebuyers, down from a historical average closer to 40%. For first-time buyers and others on the margin, higher costs or more stringent standards can mean being shut out of the market altogether. Efforts to extend affordability and access to underserved borrowers are one of the items that FHFA or its successor would closely monitor in the system we envision.

MBA's proposal supports charging a fee on MBS to raise funds to support affordable housing initiatives. However, debate is ongoing regarding the size of this fee. Understanding that affordable housing needs in the country, for both owners and renters, are large and growing, setting this fee too high could be counterproductive as it would directly lead to higher costs and loss of access for consumers who may just barely qualify in the conventional market. It will be important for policymakers to carefully balance the costs and benefits when setting this fee.

### The Credit Box

Higher risk loans have higher expected losses. Subject to a QM-like standard that would set eligibility for securitization through the Guarantors, these entities would set underwriting criteria and make pricing decisions consistent with prudent risk management. If the eligibility standard is set very conservatively, for example, if it were consistent with the QM parameters absent the benefits of the patch, mortgage credit risk would be quite low, and consumer costs may be lower than in the current market. However, access to credit would be unacceptably low in the eyes of many stakeholders. On the other hand, if there were no eligibility standard, and we returned to a market where the GSEs set their own credit standards, with the taxpayers on the hook for any misjudgments, we could be back to a world of negative amortization, interest only, and subprime, which could lead to higher costs for consumers. Getting the balance right, such that the Guarantor credit box represents the provision of sustainable credit to qualified borrowers without being unduly restrictive, will be a challenging but worthy goal of reform.

## Capital Requirements for MBS Investors

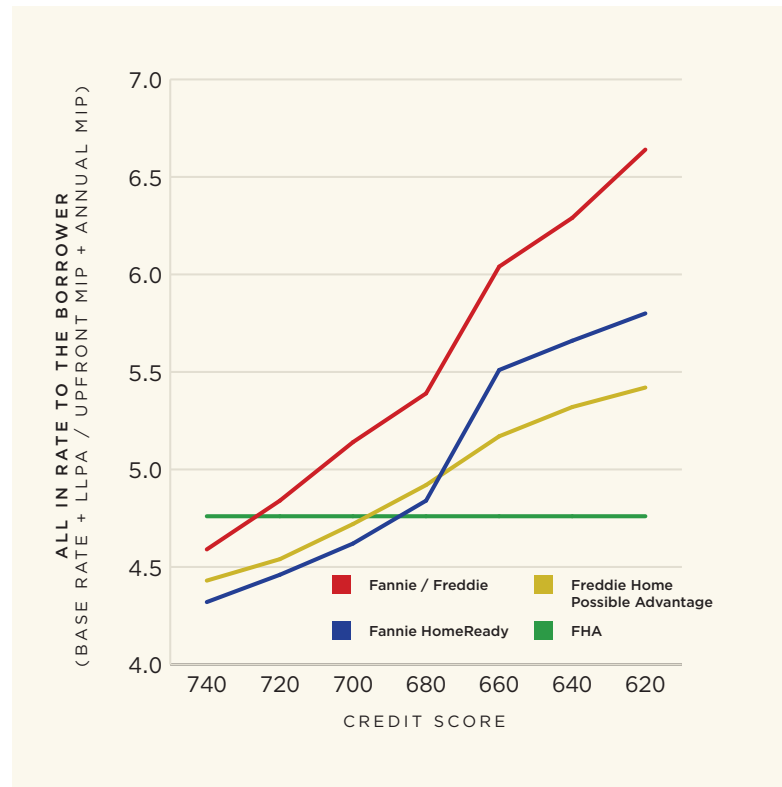
One of the factors leading to higher values on Ginnie Mae securities, and hence lower rates on FHA and VA loans included in those securities, is their bank regulatory capital treatment. This is connected to, but distinct from, the benefit of the full faith and credit backing on Ginnie Mae securities. For risk-based capital purposes, Ginnie Mae MBS receive a 0% weight, while Fannie and Freddie MBS receive a 20% weight, even with the Treasury backstop behind the companies. Moreover, Ginnie Mae MBS also are considered high quality liquid assets for the liquidity coverage ratio test, while Fannie and Freddie MBS are haircut with respect to their ability to meet this liquidity standard.

If reform follows MBA's proposal and provides an explicit guarantee behind MBS issued by Guarantors, and bank regulators change risk weights and liquidity treatment to match those for Ginnie Mae MBS today, that will be another factor leading to lower consumer costs in the new system. In fact, given the larger size of the conventional market relative to the Ginnie market, there may be even greater liquidity in the conventional market. Banks benefit by having a more liquid mortgage investment, originators benefit by having better pricing for their loans/securities, and consumers benefit from lower rates.

## Other Considerations

Beyond the impact for average pricing, changes in any of these factors could lead to differential changes in costs for stronger vs. weaker credit borrowers. However, when examining the potential impact of future pricing on different subsets of borrowers, it is critical to remember that today the GSEs are not reaching many first-time homebuyers given their current pricing structure. For many borrowers with less than perfect credit, FHA offers a competitive or lower all-in cost as shown in Figure 3. This is true even for the GSEs' affordable housing initiatives.

**FIGURE 3: COMPARISON OF FHA AND GSE PRICING BY CREDIT SCORE FOR 96.5/97 LTV LOANS (AS OF JULY 2017)**



SOURCE: MBA analysis of Fannie Mae, Freddie Mac, and FHA pricing

## Conclusion

The ultimate impact on consumer costs from housing finance reform will be a function of a large number of factors that are to be decided through the legislative debate. MBA expects that the lower costs resulting from the explicit guarantee behind the MBS will largely if not completely offset the higher costs that are a function of more rigorous capital requirements, the MIF premium, and affordable housing fees. Other factors, including the business model of the Guarantors, which will impact required returns, the credit standards for the new system, and potential changes to bank regulatory treatment of conventional MBS, will also have an impact. Balancing taxpayer protection, investor returns, and consumer costs is critical to realizing a more stable housing finance system going forward. MBA looks forward to continuing to contribute to all aspects of this debate.

**MBA**<sup>®</sup>

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