

Transition Options - Potential Near and Medium Term Transition Steps

End State Objectives:

- Government to provide net worth support to government-owned Securitization Utility so as to provide liquidity, standardization, efficiency, and FDIC-like tail risk insurance to residential mortgage backed security market
 - Explicit guarantee by government-owned Securitization Utility of securities to end investor
 - The utility to be subject to national [FHFA] regulatory oversight
- The first loss and most of the credit risk shall be taken by the private sector through well-capitalized First-Loss Providers (FLPs)
 - FLPs will be subject to rigorous counterparty assessments from the securitization utility and also will be subject strong prudential regulation [FHFA]
- Securitization Utility and FLPs to be subject to same capital (Basel III) and supervision standards as banking sector, so as to create level playing field and minimize distortion
- Strong regulation/governance
- Increased transparency and better availability of data

Legal Constraints:

- FHFA mandate is to “conserve assets” while the GSES are in conservatorship
- Treasury has to approve any asset sales and other actions out of the ordinary course
- Existing legislation, HERA, FLS1992 Act, [FIRREA], [FHLB Act], and other non-GSE specific legislation
- Incremental amounts available under the PSPAs after 2012 limited to \$275 billion
- More work remains to evaluate constraints to Treasury and FHFA action. Follow-up document to come

Potential actions which could be taken in the short and intermediate terms ¹:

1. **Clear plan for ending FNM and FRE in their current form: Corporate Reorganization**
 - GSEs could be restructured into three distinct corporate entities, a credit enhancement/mortgage insurance entity, a securitization utility, and a “bad bank”
 - Even before new corporate entities are established, the GSEs can start engaging in internal cost accounting and management organizational changes
 - Consider additional asset sales of non-core businesses and outsourcing non-core functions to third-party contractors
 - Management retention to ensure that human capital does not flee the GSEs
 - Clear communication with management about the transition path
 - Structuring of appropriate retention packages
 - *Note: A complete reorganization may require FHFA to trigger receivership*

¹ Note – these actions are for brainstorming purposes only and are subject to legal review. FHFA as conservator would need to determine what was most appropriate for their mandate as prudential regulator and conservator of the GSEs while in conservatorship.

a. Credit Enhancement/Mortgage Insurance Entity

i. Timeline

1. [Within 6 months] – FHFA lays out detailed restructuring plan
2. [1 year] - Human capital and physical infrastructure from FNM and FRE's credit analysis teams contributed to newly formed subsidiary ("GMIE")
3. [3-5 years] - GMIE is either sold to private MI or taken public
 - a. Once sold, these businesses will become fully private, receiving no government support and would not be attached to the existing charters
 - b. GMIE(s) will be subject to ongoing regulation by [FHFA]
 - c. Proceeds from the sale of this business will be returned to the taxpayer and help the process of recouping losses
 - d. Potentially maintain some level of legacy debt/obligation/tax to repay assistance which was provided by the taxpayer

- ii. Consider transforming multifamily businesses into dedicated multifamily guarantors that could also be privatized as separate entities

b. Securitization Utility will be a separate division, clean of all legacy assets and liabilities of the old FNM and FRE

- i. Will retain keep-wells from the old FNM/FRE (or other form of support from the Treasury) to ensure that investors will be made whole on the securities that they purchase

- ii. Retains the charters from the old corporate entities

iii. Timeline

1. [6 months] – FHFA lays out detailed restructuring plan
2. [1 year] - Human capital and physical infrastructure from FNM and FRE's securitization teams contributed to newly formed subsidiary
3. [1.5 years] – FNM wraps all of FRE's securities to increase liquidity in the market and begin migration to a single security and TBA market
4. Post-legislation: FNM and FRE securitization utilities will be merged with GNMA

c. "Bad bank" consisting of retained portfolio, legacy guaranty liabilities and 3rd party debt (equivalent of discontinued ops from accounting and management function)

- i. Bad bank will continue as a division of the securitization utility, so as to retain support of PSPAs

ii. Timeline

1. [3 months] – Operational plan of how to split up legacy assets
2. [within 1 year] – clear timetable established for rundown and establish method for disposition
 - a. Option 1: legacy assets remain in FNM and FRE corporate shell and employees are given retention packages to manage the unwind
 - b. Option 2: Private money manager (e.g. PPIP-like manager) is contracted out to manage the assets and oversee the unwind

- c. Option 3 (could occur in either of above scenarios) Consider structured sale to ensure taxpayers retain some equity-like upside
- 3. [within 2 years] – Consider other block asset sales
 - a. NPLs, REO, etc.
 - b. These sales would potentially realize a loss
- 4. [within 2 years] - In order to ensure that Bad Bank is adequately capitalized for all future net worth deficiencies, consider revaluing full portfolio to disposition value – this would set the stage for faster recovery in value and could push more inventory of credit through resolution process
- d. Consolidation of other assets
 - i. Consider managing certain assets of FNM and FRE jointly (REO, etc) to realize economies of scale
 - ii. Potentially merge management of retained portfolios and bad bank assets
- e. [Accounting / Fiscal Consolidation]
 - i. Mark to market accounting
 - ii. USG accounting treatment

2. Steps to Privatize the Mortgage Market

- The Administration is committed to privatizing the mortgage market.
- Transition should be managed at a measured pace that does not disrupt the still fragile housing market recovery
- a. Capital standard changes
 - i. Work with Fed to establish new risk-weighting for mortgage assets which are consistent w/ Basel III, where higher LTV mortgages require a greater capital charge.
 - ii. Capital standards and g-fees become enforcement mechanisms for new “conforming” loan standards
 - iii. The desired end state is 300-400 basis points of capital, which implies a 70-100 basis point g-fee. This capital level will be a floor if Basel implies lower required capital levels.
- b. Pricing Changes
 - i. Slowly phase in Basel III capital requirements over a [5] year time period to the credit enhancement entities by raising G-fees to private market levels
 - 1. Consider different mechanisms/triggers for price increases to ensure that fragile housing markets are allowed to continue to heal
 - a. [No pricing/capital changes will occur before [4] consecutive quarters of national house price increases]
 - ii. Allow credit enhancement entities to implement more highly differentiated LLPAs pricing to allow true credit risk pricing – including differences between states to capture the differences in the foreclosure process across state lines.
- c. Credit Risk Syndication
 - i. Slowly lower government attachment point to bring more equity into housing finance system from private sector – either through down payment

at borrower level or other forms of credit enhancement at financing level, such as increasing amount of PMI or syndicating risk to capital markets through cat bonds, CMOs or other method

- d. Encourage Other Private Sector Participation
 - i. Establish clear guidelines and incentives for private mortgage insurers to opt into [FHFA] regulation to gain access to the securitization utility and encourage additional entities to enter the market to provide credit protection

3. Taxpayer recoupment

Potential methods for taxpayer recoupment of their investment in FNM and FRE

- a. Increase g-fee on new originations
- b. Disposition of non-core assets, such as multifamily, shared services, etc.
- c. Better than expected disposition of REO through realizing economies of scale of consolidation and NPL disposition
- d. Sale of credit enhancement entities to the private markets
- e. Residual fee – RTC like solution of a [10] basis point tax on the securitization utility

4. FHA and FHLB Reform

Reforms to ensure FHA and the FHLBs do not become the cheapest sources of funding for mortgages

- a. FHA, limit footprint through:
 - i. Pricing/required ROEs - price FHA to be competitive to private market with some level of required return or market matched pricing
 - ii. Restrict eligible borrowers (FHA credit box)
- b. FHLBs – limit level of advances which can be made available to banking sector
- c. Consider other “non-core” reforms
 - i. FHA - governance changes
 - ii. FHLBs – single district membership

5. Increase Transparency

- a. Establish central mortgage data repository where both GSEs [and other mortgages insurers] are required feed data into and all members of the private sector have access to the data – (work with OFR)

6. Servicing

- a. Establish true “master servicing” and fee for service model to help eliminate misalignment of incentives in the servicing industry and eliminate problems associated with MSRs
- b. Securitization Utilities would only wrap loans where the master servicing in a fee for service model sits with the entity that held that first loss credit risk
- c. If entire market switched to fee for service model, “fee for service securities” would become TBA eligible.

7. Consider other initiatives to reform the mortgage contract and embed best practices further into the system

- a. Standardized mortgage contracts with binding arbitration
- b. Simple terms and fact sheets for consumer protection

Key Questions/Open Items for Further Exploration:

- What should be done with the multifamily businesses of the GSEs?
- Can the dividends be adjusted such that we are not drawing to pay ourselves?
- Are there restrictions on where the charter can sit and what entities the charter will be tied to upon emergence from receivership?
- Further exploration of the opportunities for public/private partnerships to sell some of the retained portfolio assets to ensure that the taxpayers retain some equity-like upside in the deal.
- Can the commitment fee be set such that it is equal to the positive net income from the GSEs in every year in the future?
- More detailed modeling work around taxpayer recoupment
 - What is the appropriate fee the securitization utility should charge to raise money, but not price itself out of the market?
 - Over what time horizon will taxpayers be paid back?
 - RTC was set as a 30yr bond, but paid back in 20 years, which was palatable.
- Are there alternative ways to capitalize/pre-fund the newly constituted “good” entities?
- How will we ultimately merge the FNM and FRE securitization utilities into GNMA?