News Bulletin

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The Obama Administration's Housing Finance Reform Proposal: Opportunity for the Private Markets

The Proposal

Ending months of suspense, on February 11, 2011, the Department of the Treasury and the Department of Housing and Urban Development issued a report to Congress unveiling the Obama Administration's plans for the two giant, government-sponsored secondary mortgage market entities (the "GSEs"), Fannie Mae and Freddie Mac, and for the future of the U.S. housing finance system generally (the "Proposal").

Action to reform the housing and mortgage finance markets cannot come too soon. Despite a widespread political and public consensus that the GSEs, currently bankrupt wards of the State, have grown far too large in size and influence—a sentiment reinforced by a taxpayer bailout of at least $135 billion to date—the GSEs occupy an ever increasing share of the residential mortgage market. More than 90% of all new U.S. residential mortgage originations are purchased, guaranteed, or insured by the federal government, with the GSEs alone purchasing at least 70% of residential originations. Turning the fully laden GSE ship in mid-course is one of the most daunting tasks currently facing the government, but is considered by many to be an essential stepping stone to restoring a healthy housing market in the aftermath of the financial crisis.

Three-Part Approach

The Proposal first sets forth a three-part plan for restructuring the U.S. housing finance system, employing measures that can be accomplished under current law or with relatively straightforward legislation that will not require the resolution of the looming philosophical debate over the extent to which the federal government should guarantee investors against losses on mortgage loans made to U.S. homeowners.

The first element of the plan is to reduce government support for housing finance in general, including the gradual but deliberate wind-down of Fannie Mae and Freddie Mac over a period of years. This will be accomplished by a number of means, including increasing the GSEs' guarantee fees charged to sellers of loans sold to the GSEs; allowing the GSEs' "loan limits" to decline in accordance with current law from a maximum of $729,750 in most markets to $625,000, and thereafter possibly further; gradually increasing minimum required borrower down payments to at least 10%; encouraging the GSEs to pursue additional credit-loss protection from private insurers and other capital providers; and winding down the GSEs' investment portfolios at an annual pace of at least 10%.

The second element of the plan is to remedy "fundamental flaws" in the mortgage finance market identified by the Administration as significant contributors to the financial crisis, by reforming loan origination and securitization practices as already provided for by the Dodd-Frank Act, and by reforming mortgage servicing and foreclosure processes, as has been widely debated in recent weeks but, as of this writing, not yet formalized into a regulatory or statutory proposal. The third element of the plan is to better target the government's support for affordable housing by reforming and strengthening the Federal Housing Administration (the "FHA"), rebalancing national housing policy to provide additional support for rental properties, and ensuring that housing capital reaches non-mainstream communities, including rural areas, economically distressed regions, and low-income communities.

Long-Term Structural Options

The Proposal then sets forth three "options for the long-term structure of housing finance." Embedded within these three options is the core of the unresolved fundamental American philosophical and political debate regarding the appropriate role of the government in supporting housing, ranging from an extremely limited guarantee and insurance program focused on only the more needy elements of society, extending to the provision of a federal guarantee that would ultimately backstop the entire U.S. securitized mortgage market. In "Option 1," the government's role in insuring or guaranteeing mortgage loans would be strictly limited to targeted disadvantaged groups currently served by the FHA, the Department of Agriculture, and the Department of Veterans Affairs. At the other end of the spectrum, in "Option 3," the government would provide catastrophic reinsurance to holders of mortgage-backed securities ("MBS") meeting specified qualifications, which would buttress a first protection level of private mortgage insurance—in effect insuring the entire private MBS market, and thereby arguably reinstating an aspect of the GSEs' role highly criticized for fostering "moral hazard." An intermediate "Option 2" would provide for limited insurance or guarantees to be provided by the government that would normally operate at a minimal level, but would be ramped up to provide support for housing finance during periods of economic stress.

Take-Aways

Emphasis on Private Market Solutions. Although the Proposal sidesteps taking a position on the fundamental question regarding the appropriate level of government support ultimately to be provided to the housing finance market, the Proposal adopts a stance in favor of private market solutions that many have found surprising coming from a purportedly liberal Democratic Administration. Stated objectives of the Proposal are to "pave the way for a robust private mortgage market" and to induce the return of private capital to the mortgage market. By throwing its support behind a private market solution and showing a reticence to use housing and mortgage policy as a means of promoting social policy goals, the Obama Administration has in effect established the Democratic boundary of the housing debate with Republicans. The starting line drawn by the Obama Administration may alienate the more liberal wing of the Democratic Party, who might prefer to see housing policy used to achieve redistributive and other liberal social goals. However, most observers believe that the line drawn by the Administration will stick, with the result that private enterprise can expect to take up the lion's share of the mortgage and housing finance effort going forward. Even the most "liberal" of the three long-term government guarantee options — the provision of catastrophic mortgage reinsurance — postulates a first line of defense composed of a vast network of private mortgage insurance. This positioning should reassure entrepreneurs and investors considering participating in the next round of growth of the U.S. housing markets that they can stake out a position in the new market without fear of being marginalized by gargantuan governmental or quasi-governmental entities similar to Fannie Mae and Freddie Mac.

Bye-Bye American Dream. Another striking feature of the Proposal is the degree to which it explicitly retreats from the American Dream of home ownership as a national policy goal. The Proposal quite clearly supplants this long-standing pillar of American housing policy with a goal of affordable, livable shelter for all Americans. The Proposal recognizes that home ownership is not appropriate for all Americans, and that it should not be subsidized or inordinately favored. The Proposal thus emphasizes the need for other forms of housing, including multifamily rental options. The term "affordability," often used in the past as a proxy for the ability of an American family to purchase a home, has been redefined by the Administration to refer to the ability of an American family to afford a livable residence, whether purchased or rented.

Endorsement of Securitization. The Proposal explicitly recognizes that securitization is a necessary means of bringing capital to the U.S. housing markets, and thereby represents a major step in dispelling the demonization of securitization that followed the onset of the financial crisis. To be sure, the Proposal calls for substantial reforms to the securitization process, including foreclosure and servicing reforms, but the Administration acknowledges that ultimately securitization must play a significant role in the recovery of the U.S. housing markets.

A Long Road Ahead. Although the Proposal is a major step forward in restructuring the nation's housing finance system, the completion of the restructuring is many years away. Winding down Fannie Mae and Freddie Mac and dispersing their immense portfolios without major disruptions to the housing and mortgage markets will likely take from five to ten years once a plan is agreed upon. Moreover, as evidenced by the fact that the Administration has not taken a position on the fundamental philosophical and political question on the degree to which the government should stand behind the mortgage and finance markets, reaching a political census on a definitive plan to restructure the housing finance system itself is probably several years away. Although Senate and House Committees have already begun to consider the Proposal in earnest, many seasoned observers of the political process doubt that a consensus can be reached before Congress tables controversial topics next summer in anticipation of the 2012 Presidential election, and believe that it is unrealistic to expect final housing finance legislation to be enacted before 2013.

Recognizing that the total re-engineering of the U.S. housing finance system is a journey of a thousand miles, the Administration has finally taken the all-important first step. The world will watch as the rest of the journey unfolds.

Contacts

Kenneth E. Kohler
(213) 892-5815
kkohler@mofo.com

Melissa D. Beck
(212) 336-4319
mbeck@mofo.com

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Jerry R. Marlatt
(212) 468-8024
jmarlatt@mofo.com

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