

RISKSPAN ANALYSIS

February 2011; Volume 11, Issue 2

www.RiskSpan.com
www.twitter.com/RiskSpan

Review of Housing Reform

The Administration's White Paper on reforming the broken housing market raised the decibel level from both political parties, while some key industry stakeholders—like the National Association of Realtors®—immediately mounted an aggressive campaign to maintain federal involvement. In the context of a fragile housing market and surging visible and shadow REO inventory, meaningful reform is mired in challenges. We expect a fiery debate this spring, as the federal budget deficit garners national attention and expectations brew in the Republican House.

OUR TAKE

Given the Administration has ceded the housing debate to Congress, we expect a wind down of the GSEs, a return to mission at FHA, less regulatory reform than anticipated when the Dodd-Frank legislation was signed, and a growing need for modeling and analytical tools built to assist the return of private capital to the secondary mortgage market.

WIND DOWN OF FANNIE AND FREDDIE

Despite non-commitment to a long-term solution, a number of notable changes are urged. The Paper recommends four levers to gradually reduce government support of mortgage finance:

1. **Increase guarantee fees** to effect equal footing of GSEs with private financial institutions in credit risk pricing;
2. **Increase down payment requirements** up to at least 10 percent for any loans guaranteed by the GSEs;
3. **Reduce conforming loan limits** to retreat subsidization of housing;
4. **Encourage GSEs to pursue private credit-loss protection** to mobilize private capital ahead of the wind down.

The Congress is poised to allow the temporary loan limit in high-cost areas to expire in October 2011, and to take further steps consistent with the Republican pledge to eliminate Fannie Mae and Freddie Mac on a timeline that carefully offsets the risk of a housing double dip.

FEDERAL HOUSING ADMINISTRATION (FHA)

The Administration seeks to synchronize FHA program changes with the GSE wind down to prevent FHA absorption of the loans. It proposes further loan limit reductions in addition to the one to take place by October

2011, as well as annual mortgage insurance premium increases in addition to the 25-basis-point increase detailed in the President's 2012 Budget. In testimony before a subcommittee of the House following the release of the Paper, FHA Commissioner Stevens remarked, "Perhaps no element is more crucial to [the housing finance] system's recovery than facilitating a more responsible return of private capital - and FHA is already taking significant action to help capital return to the market."

FEDERAL HOME LOAN BANKS (FHLBs)

Close scrutiny should be given to the recommendation to limit the level of advances made by the FHLBs, potentially affecting credit access for larger financial institutions. Furthermore, a recommendation is made to reduce FHLB MBS portfolios to restore greater liquidity.

MORTGAGE INTEREST DEDUCTION

In seeking to reduce the role of government in subsidizing the housing efforts of the GSEs, the Paper makes mention of the mortgage interest deduction as a tax credit that has contributed to the distortion of the opportunity cost of investment, though no action is expressly advised.

QRM AND RISK RETENTION

The TBA market will be fundamentally shaped by the definition of a Qualified Residential Mortgage (QRM). The Paper offers no guidance on QRMs beyond that they will "meet high underwriting standards."

The breadth of the QRM definition will determine what is securitized moving forward. If QRMs are defined by a strict LTV ratio, rates will rise, and a greater proportion of loans could be held as whole loans or not originated till credit analytics improve in the private market. Non-QRMs may be subject to 5 percent credit risk retention by the securitizer. The form of risk retention is TBD—it may be either "vertical," with the securitizer retaining a pro-rata interest in each tranche, or "horizontal," with the securitizer retaining the first-loss interest. The rules are scheduled to be released by April 2011 and effective in 2012. Drafts of the regulation are expected to be released before finalization.

RiskSpan is now streaming critical developments in housing policy on Twitter at www.twitter.com/riskspan. Become a follower and keep your business ahead.