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FHFA's Administrative Reform of Fannie Mae, Freddie Mac, and the Housing Finance System

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May 23, 2016

Congressional Research Service
7-5700
www.crs.gov
R44506

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

Housing finance reform remains one of the major unresolved issues stemming from the financial crisis. Congress has held hearings and marked up bills related to reform, but so far only modest structural changes have been enacted. The Federal Housing Finance Agency (FHFA) has used its regulatory authority to enact certain policy changes.

FHFA is the regulator and conservator of Fannie Mae and Freddie Mac, two government-sponsored enterprises (GSEs) that play a significant role in the housing finance system. FHFA has leveraged the authority that it has over the GSEs and their market dominance to implement changes to the housing finance system that could shape the future course of the system.

The FHFA-directed restructuring of the system focuses on three main policy questions:

1. Who will bear credit risk in the future?
2. How will mortgage-backed securities (MBS) be issued? and
3. What will the MBS look like once issued?

The **Credit Risk Transactions** (CRT) are FHFA's efforts to modify who bears credit risk. The GSEs guarantee that investors in their MBS will receive timely payment of principal and interest. In doing so, the GSEs absorb the credit risk—the risk that a borrower would not make the required mortgage payment. Because of the contractual agreements that the Department of the Treasury has entered into with the GSEs in which Treasury has agreed to provide them with financial support, taxpayers are potentially exposed to the GSEs' credit risk. To reduce this risk, FHFA has directed the GSEs to transfer credit risk to other private investors. Congress is interested in several aspects of risk sharing, including the methods through which risk is being shared, how much risk is being shared, the effect of sharing risk on credit availability, and how effective the transactions are at protecting the taxpayer.

The **Common Securitization Platform** (CSP) is FHFA's attempt to improve the way in which MBS are issued. Fannie Mae and Freddie Mac each have their own securitization method (i.e., the process of transforming a pool of mortgages into MBS), but FHFA determined that their technology associated with creating and issuing MBS are outdated. Rather than invest in updating two systems, FHFA directed the GSEs to create one platform for securitizing mortgages. Congress is interested in multiple aspects of the CSP, including whether other private companies will be able to access it as well as the CSP's future ownership structure.

The **Single Security** is FHFA's initiative to alter the type of MBS that would be issued in the future. Currently, each GSE issues its own, distinct MBS. Fannie MBS and Freddie MBS are different securities governed by different legal contracts and trade at different prices. The Single Security would be a single MBS that the GSEs could issue through the CSP and would be traded in a single market. FHFA argues that the Single Security would enhance the liquidity of the MBS market—the ease with which MBS can be bought and sold—and remove the subsidy that Freddie Mac currently offers to keep its MBS competitive. Congress is interested in whether the Single Security will be effective in promoting liquidity in the MBS market and in what affect the Single Security will have on competition between the GSEs.

These three topics, although important, are just a subset of the many issues facing Congress as it considers broader reform of the housing finance system. Because FHFA's actions touch on the key issues of reform and, in some cases, are incorporated into legislative reform proposals, many in Congress have followed FHFA's actions closely. In addition, the Senate Banking Committee has reported the Financial Regulatory Improvement Act of 2015 (S. 1484), legislation that would codify FHFA's actions in some cases and would modify FHFA's actions in others.

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Introduction

In the years since the 2007-2009 financial crisis, Congress has passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203; Dodd-Frank Act), and financial regulators have made significant progress in implementing the legislation. The Dodd-Frank Act is a broad regulatory reform law that touches on many different aspects of the financial system. Housing finance reform, however, remains one of the major unresolved issues stemming from the financial crisis. Fannie Mae and Freddie Mac, two government-sponsored enterprises (GSEs) that have funded more than half of all mortgages originated in recent years, remain in a state of limbo since the crisis rocked the system and left an uncertain future in its wake.[1] Because of their prominent role in the housing finance system, the future of the system in many ways depends on the future of the GSEs.

Congress has debated housing finance reform at length and legislation making modest changes to the system has been enacted.[2] The Federal Housing Finance Agency (FHFA), the regulator and conservator for the GSEs, has used its regulatory authority to lay the foundation for the future housing finance system.

The FHFA-directed restructuring of the system focuses on three main policy questions:

1. Who will bear credit risk in the future?
2. How will mortgage-backed securities (MBS) be issued? and
3. What will the MBS look like once issued?

FHFA argues that the actions it is taking in answering these three questions do not lock the system into following a single track but "support various future paths under housing finance reform."[3] Some in Congress, however, have raised concerns about whether FHFA's steps would sufficiently move the system beyond "the duopolistic tendencies of the past."[4] The Financial Regulatory Improvement Act (S. 1484), which was reported by the Senate Committee on Banking, Housing, and Urban Affairs, would codify the actions taken by FHFA in some cases and alter FHFA's actions in others.[5]

This report explains how FHFA has answered each of the three questions that are currently shaping the policy debate and analyzes issues that are of interest to Congress for each of the three topics. But, first, this report explains the GSEs' conservatorship and their role in the housing finance system.

[1] The government–sponsored enterprises' (GSEs') status has been described as being in limbo by multiple people. For one example, see quote from Sen. Mark Warner in Sen. Bob Corker, "Corker, Warner, Vitter, Warren Reintroduce 'Jumpstart GSE Reform Act'," press release, September 16, 2015, at http://www.corker.senate.gov/public/index.cfm/2015/9/corker-warner-vitter-warren-reintroduce-jumpstart-gse-reform-act.

[2] An example of legislative action related to the GSEs is the Equity in Government Compensation Act of 2015 (P.L. 114-93), which restricts the compensation that can be paid to the chief executive officers (CEOs) of the GSEs.

[3] Federal Housing Finance Agency (FHFA), *An Update on the Common Securitization Platform*, September 15, 2015, p. 4, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[4] Letter from Sens. Corker, Warner, and Crapo, et al. to Mel Watt, director of FHFA, March 17, 2015, at http://www.corker.senate.gov/public/_cache/files/221a4274-f6fd-432d-b03b-949cc055498e/Senate%20CSP%20Letter%2003172015.pdf.

[5] S. 1484, the Financial Regulatory Improvement Act of 2015, is a broad bill that covers many different parts of the financial system. Title VII of the bill addresses the housing finance system.

The GSEs and Conservatorship

As GSEs, Fannie Mae and Freddie Mac are private corporations with federal charters that contain special privileges, such as being exempt from certain state and local taxes,[6] and special responsibilities to support affordable housing for low- and moderate-income households.

The GSEs do not originate mortgages. Instead they have two main lines of business. First, through their credit guarantee businesses, the GSEs purchase *conforming mortgages*—mortgages that meet certain eligibility criteria based on size and creditworthiness—and pool the mortgages into MBS. The MBS are sold to investors with the GSEs guaranteeing that investors will receive timely payment of principal and interest on their MBS even if a borrower with a mortgage that is part of the MBS becomes delinquent. The GSE guarantee transfers the *credit risk*—the risk that a borrower would not repay the loan on time—from the investors to the GSE. To compensate the GSEs for their guarantee, the GSEs receive a guarantee fee from the lender (who may pass the cost on to the borrower).

In the second main line of business, their portfolio investment business, the GSEs hold mortgages and MBS (including GSE MBS, Ginnie Mae MBS,[7] and MBS sold by other private entities) as investments in their portfolios. The GSEs profit from the difference between the low rates at which they can borrow money to buy mortgage-related assets (their close relationship to the government allows the GSEs to borrow at lower rates than other market participants) and the higher rates at which they receive revenues from those assets.

In September 2008, the GSEs agreed to be placed into conservatorship with FHFA because of extensive financial losses and concerns about their ability to provide support to the housing finance system during the economic downturn. As conservator, FHFA has the powers of the management, board, and shareholders of the GSEs[8] and works to "help restore confidence in Fannie Mae and Freddie Mac, enhance their capacity to fulfill their mission, and mitigate the systemic risk that contributed directly to instability in financial markets."[9] When the GSEs entered into conservatorship, they also entered into an agreement with the Department of the Treasury in which Treasury would provide financial support to the GSEs through the Senior Preferred Stock Purchase Agreements.[10] Since entering into conservatorship, the GSEs have received $187.4 billion in assistance to avoid triggering mandatory liquidation, which remains outstanding today, and have paid dividends of more than $240 billion to Treasury. Currently, all profits accrue to the taxpayers, and all risks are borne by the taxpayers. More than seven years into the conservatorship, the GSEs have operated under government control for longer than most expected.[11]

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[6] CRS Legal Sidebar WSLG114, Taxing Fannie Mae and Freddie Mac: Does an Exemption from "All Taxation" only Apply to Some Taxes?, by Erika K. Lunder.

[7] Ginnie Mae is a government agency in the Department of Housing and Urban Development that guarantees mortgage-backed securities (MBS) issued by private entities but made up of mortgages guaranteed by the federal government.

[8] P.L. 110-289, Sec. 1145.

[9] FHFA, "Conservatorship," at http://www.fhfa.gov/Conservatorship.

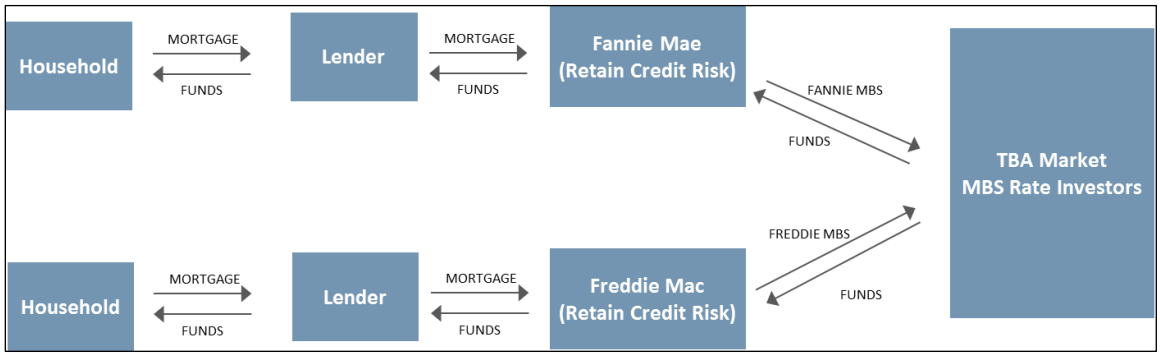
[10] The Secretary of the Treasury was given authority to lend or to invest in the GSEs by P.L. 110-289, Sec. 1117.

[11] For example, the FHFA Office of Inspector General has described the GSEs' conservatorships as being of "unprecedented length." FHFA Office of Inspector General, *FHFA's Conservatorships of Fannie Mae and Freddie Mac: A Long and Complicated Journey*, March 25, 2015, p. 6, at http://fhfaoig.gov/Content/Files/WPR-2015-002_0.pdf.

FHFA Reforms

The next three sections of this report explain three of the major steps that FHFA is taking as conservator to reform the housing finance system. As described later in the report, some of these steps have been completed whereas others are still in progress. FHFA argues that the actions it is taking "fulfill the legal requirements Congress assigned FHFA as conservator and also prepare the foundation for a new, stronger housing finance system in the future."[12] **Figures 1** and **2** below illustrate how the reforms will modify the system. Under the pre-FHFA reform system shown in **Figure 1**, Fannie Mae and Freddie Mac guarantee their MBS and, in doing so, absorb the credit risk. They use their own technology system to securitize the mortgages and create their MBS. Each also issued their own MBS to investors.

Figure 1. Pre-FHFA Reforms



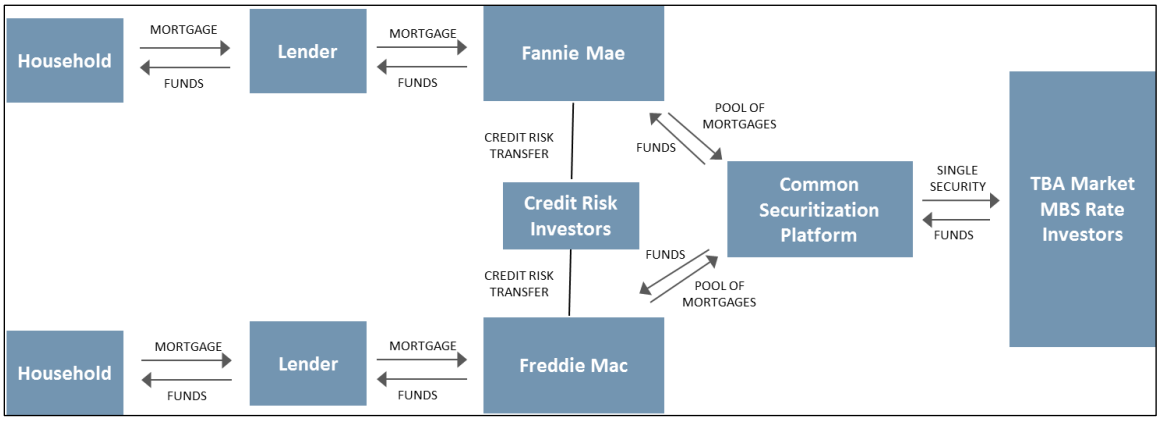
Source: Created by the Congressional Research Service (CRS).

Note: The To Be Announced (TBA) Market is a market in which Fannie Mae, Freddie Mac, and Ginnie Mae MBS are bought and sold.

As mentioned above, some of FHFA's reforms are still being implemented. Once those reforms are implemented, as illustrated in **Figure 2**, the GSEs will engage in *credit risk transfers* to share credit risk with private investors on some of their pools of mortgages. The GSEs would aggregate the mortgages but then securitize them through the *Common Securitization Platform* that they would both use. Rather than issue separate Fannie MBS and Freddie MBS, the GSEs would issue a *Single Security*.

[12] FHFA, *A Strategic Plan for Enterprise Conservatorships: The Next Chapter in a Story that Needs an Ending*, February 21, 2012, p. 3, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/20120221_StrategicPlanConservatorships_508.pdf.

Figure 2. FHFA Reforms Implemented



Source: Created by CRS.

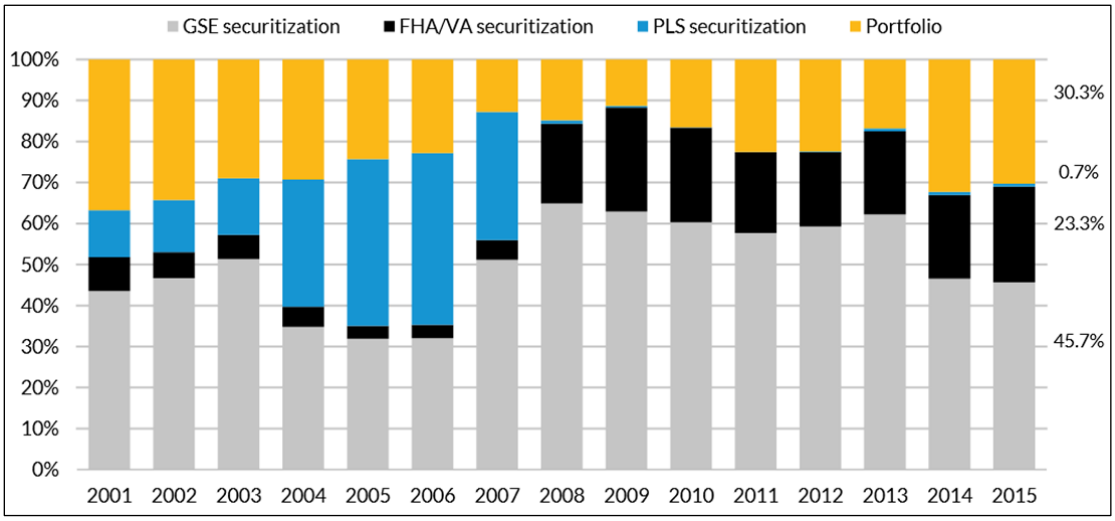
Note: The TBA Market is a market in which Fannie Mae, Freddie Mac, and Ginnie Mae MBS are bought and sold.

Risk-Sharing Transactions[13]

After the bursting of the housing bubble, private capital pulled back from the market and was less willing to be exposed to credit risk. Because of high delinquency rates and the losses absorbed by many investors, their response was not surprising. During periods when private capital retreated, the government historically has ensured that mortgage credit continues to flow by playing a counter-cyclical role and increasing its exposure to credit risk during downturns. As shown in **Figure 3**, the federal government played a more significant role in the mortgage market after 2008 through the GSEs, the Federal Housing Administration (FHA), and the Department of Veterans Affairs (VA). By contrast, private capital decreased in aggregate, with private-label securitizations (PLS; mortgage-backed securities that do not have a Fannie Mae, Freddie Mac, or Ginnie Mae guarantee) nearly disappearing and loans held in banks' portfolios increasing but not enough to offset the drop in PLS volume.

[13] This section focuses on risk sharing for single-family mortgages, but the GSEs have engaged in risk sharing as part of their multifamily business as well.

Figure 3. Mortgage Categories



Source: The Urban Institute, Housing Finance Policy Center, *Housing Finance At A Glance: A Monthly Chartbook April 2016*, April 2016, p. 8, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000755-Housing-Finance-at-a-Glance-A-Monthly-Chartbook-April-2016.pdf.

Notes: The figure shows the proportion of annual funding by origination source. Note that not all mortgages that were securitized in a given year were actually originated in that year. "PLS securitization" refers to private-label securities that are mortgage-backed securities (MBS) issued by private companies and not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae. "Portfolio" refers to mortgages retained in a bank's portfolio.

When the GSEs increased their support to the market, they also increased their exposure to different financial risks, in particular credit risk. Credit risk is the focus of the risk-sharing transactions, but it is only one of many different types of risks to which the GSEs are exposed.[14] The other major type of risk associated with MBS is interest rate risk—the risk that changes in interest rates could affect the price of MBS. When a GSE sells its MBS, it retains the credit risk (because it offers a guarantee on the MBS) but it transfers the interest rate risk to the investor.[15] Because the GSEs are exposed to significant amounts of credit risk, credit risk is the focus of the risk-sharing transactions.

Normally, credit risk would be borne by Fannie's and Freddie's shareholders, but as a result of the financial agreements that Treasury entered into with the GSEs, the more risk that the GSEs are exposed to, the more risk taxpayers are exposed to. Risk sharing is one of the ways in which FHFA is attracting private capital back into the market and reducing taxpayers' risk exposure. In a risk-sharing transaction, the GSEs continue to guarantee their MBS, but they transfer some of the credit risk to other private market entities to offset some of the GSEs' risk. The private entity absorbs the credit risk (and possible losses should they occur) but is compensated for doing so. When risk is transferred to other investors, taxpayers are exposed to less credit risk but also forgo some of the dividends that would otherwise be transferred to Treasury.

[14] For examples of risks the GSEs face, see Fannie Mae, *Form 10-K, 2015*, p. 48, at http://fanniemae.com/resources/file/ir/pdf/quarterly-annual-results/2015/10k_2015.pdf.

[15] The GSEs can manage the interest rate risk for MBS and mortgages retained in their portfolios through derivatives and other means of hedging (i.e., actions intended to potentially offset risk)

The House of Representatives and Senate Explained

Congressional Procedure

A Practical Guide to the Legislative Process in the U.S. Congress

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Foreword by Alan S. Frumin

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Amount of Risk Shared

The GSEs shared credit risk before the crisis, such as by requiring borrowers to have a down payment or mortgage insurance, but did not share enough risk to avoid large losses. FHFA is attempting to expand the methods and quantity of risk sharing.

The GSEs do not target all of the mortgages that they acquire for risk-sharing deals but only include those that would result in deals that are economical (for example, some mortgages have little credit risk or are non-standard, making it difficult for the GSEs to sell the credit risk on those mortgages).[16] Of the approximately 60% of mortgages acquired by the GSEs that meet the criteria[17] for risk sharing, FHFA has announced that for 2016 it will target the "transfer of credit risk on at least 90 percent of the unpaid principal balance of newly acquired single-family mortgages,"[18] meaning that approximately half of the mortgages purchased by the GSEs are included in risk-sharing deals.

Since the first transactions in 2013, risk sharing has become an increasingly large part of the GSEs' business activities. One of the ways that the GSEs report how much risk sharing they have done is based on the unpaid principal balance of mortgages that have been included in risk-sharing deals. Using this metric, the GSEs engaged in combined risk-sharing transactions of $75.9 billion in 2013, $344.8 billion in 2014, and $417.1 billion in 2015.[19]

The GSEs do not share all of the credit risk for the mortgages included in risk-sharing deals. Instead, only some of the credit risk for the pool of mortgages is included in a risk-sharing transaction. The GSEs transfer *expected* and *unexpected* credit risks but do not include *catastrophic* credit risk. Expected credit risk is "credit loss projected to occur if housing market conditions proceed according to a stable long-term trend," and unexpected credit risk is "loss to the Enterprise over and above expected losses should there be a stressful, yet plausible, macroeconomic event."[20] Catastrophic credit risk yields potential losses "beyond unexpected loss and would be deemed highly unlikely to ever occur, allowing that there is not a bright line marking transition from unexpected to catastrophic loss."[21] Of the $417.1 billion of unpaid principal balance that was included in credit risk transfers in 2015, the combined value of the risk that was actually transferred was $16.8 billion (approximately 4% of the unpaid principal balance).

For a perspective on historical losses, FHFA reports that mortgages purchased by Freddie Mac in 2007 (the year that experienced the highest losses when the housing bubble burst) have resulted

[16] Some mortgages may not be economical for credit-risk transfer deals, such as certain loans with loan-to-value ratios below 60%, because those loans contain little credit risk. See FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 7, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[17] For risk sharing, FHFA has targeted "non-HARP, fixed-rate mortgages greater than 20 years, and loan-to-value ratios above 60%." FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[18] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[19] FHFA, *2015 Scorecard Progress Report*, March 2016, p. 17, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Progress-Report-2015-Scorecard.pdf.

[20] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 3, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[21] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 3, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

in a 3.47% loss rate as of mid-2015.[22] Most other years experienced losses of less than 1%. The 4% of credit risk that was shared by the GSEs on their 2015 risk-sharing deals, therefore, is comparable to the amount of the losses for the GSEs' worst years.

In summary, approximately half of the mortgages that the GSEs purchase are included in risk-sharing deals. Of the amount included in risk-sharing deals, the GSEs sell 4% of the credit risk, which is approximately the same amount of losses that they experienced on their deals during the worst years of the financial crisis.

Risk-Sharing Methods

The GSEs have employed several different methods of sharing risk with private entities.

GSE Debt Issuance. Debt issuance has been the most commonly used risk-sharing structure employed by the GSEs. Under the debt issuance model, the GSE sells debt to investors and the GSE receives payment upfront at the time of the sale. The debt repayment is tied to the performance of a reference pool of mortgages, in which the investor earns a higher return if the mortgages perform well and a lower return should they perform poorly. The GSE is not selling the mortgage or stream of payments from the mortgages to the investors, but ties the payments for the investors to the performance of the reference pool. As described by FHFA, the GSEs "pay interest to investors on a monthly basis and allocate principal to investors based on the repayment and credit performance of the loans in the underlying reference pool. Investors ultimately receive a return of their principal, less any covered credit losses."[23]

Freddie Mac's debt issuance deals are called Structured Agency Credit Risk (STACR) and Fannie Mae's are called Connect Avenue Securities (CAS). Through these deals, the GSEs transfer some of the credit risk to the purchasers of the securities. How much risk is transferred and which risk is transferred varies from deal to deal. Different tranches or pieces of debt are often issued for a given deal that corresponds to a different loss position with each piece having a different thickness (meaning the amount of loss that is absorbed). For example, with a pool of $100 million of mortgages, an investor could agree to bear 90 cents for each dollar of loss up to $5 million in losses while the GSE would absorb 10 cents of loss on each dollar of loss for the first $5 million and then all of the losses after that.[24]

FHFA has stated that its "longer term goal for the STACR and CAS products is for the [GSEs] to transition from a debt issuance structure to credit-linked notes (CLNs)."[25] Under the debt issuance model, STACR and CAS are debt issued by the GSEs. A CLN would have a similar structure—the notes would be tied to the performance of a pool of mortgages—but the notes would be issued by a trust instead of the GSE. When an investor buys debt from a GSE, the investor is exposed to counterparty risk, the risk that the GSE may not satisfy its end of the deal because of factors unrelated to the deal. By issuing the notes through a trust, the investors would have less

[22] Approximately 19% of mortgage debt from the 2007 mortgages remained outstanding as of mid-2015 so it is possible that that loss rate could change. FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 13, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[23] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 15, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[24] For an example of an actual deal structure, see Freddie Mac, *Structure Agency Credit Risk ("STACR") Debt Notes, 2016-HQA1 Roadshow*, at http://www.freddiemac.com/creditriskofferings/docs/investor_presentation.pdf.

[25] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 16, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

counterparty risk because the trust holds cash or other safe investments and does not engage in other activities that could cause it to fail to make its required payments. (The reduced counterparty risk of the trust may be less of a concern while the GSEs are in conservatorship but could matter more depending on how the future system is structured.) FHFA notes that while the reduced counterparty risk is a benefit of CLNs for investors, there may be downsides as well, such as certain tax issues that have not been resolved.[26]

Insurance Transfers. Under the insurance risk transfer model, Fannie Mae or Freddie Mac transfers credit risk to (in most cases) reinsurance companies on a pool of mortgages that the GSE owns. Reinsurance companies are insurance companies that offer insurance to other insurance companies. The GSE (which is receiving its guarantee fee for assuming the credit risk on the mortgages), pays the reinsurance companies to take on some of the credit risk. Reinsurance companies assume different types of risk from other customers and not just mortgage credit risk, meaning that they have diversified exposures so they may present "lower counterparty risk because their book of business risk should be less correlated with the [GSEs'] book of business risk."[27]

Freddie Mac's insurance transactions are called Agency Credit Insurance Structure (ACIS) and Fannie Mae's are referred to as Credit Insurance Risk Transfer (CIRT). The insurance transfers can be combined with other risk-sharing transactions. For example, Freddie Mac transfers credit risk to investors through its STACR deals and retains some of the credit risk. In some cases, Freddie Mac has then transferred through ACIS deals some of the remaining risk that it has retained to reinsurance companies.[28]

Deeper Mortgage Insurance. The GSEs could also transfer risk through deeper mortgage insurance. Mortgage insurance is an insurance policy that can be purchased by either the borrower or the lender that compensates the lender in the event that the borrower defaults. The GSEs are required by statute[29] to purchase mortgages with at least a 20% down payment or, if the mortgage has less than a 20% down payment, then the GSEs require an alternative method of protection should the borrower default. Mortgage insurance is one of the approved credit enhancement methods for mortgages with less than a 20% down payment. A mortgage insurer is required by the GSEs to absorb a specified amount of losses if the losses occur when the borrower defaults, with the amount that the insurer must absorb varying based on the down payment. The lower the down payment, the more the insurer is expected to cover.[30] If the losses on a default exceed the amount that the mortgage insurer has agreed to absorb, the GSE is liable for any excess losses.

Deeper mortgage insurance would require the mortgage insurer to agree ahead of time to cover more losses than they currently agree to cover, thereby reducing the amount of risk the GSEs are exposed to. As opposed to other options, which transfer risk after it has reached the GSEs, deeper coverage could be agreed to before a GSE purchases the mortgage. The GSEs have not performed

[26] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 17, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[27] Ibid., p. 18.

[28] See Freddie Mac, *Freddie Mac Agency Credit Insurance Structure (ACIS)*, at http://www.freddiemac.com/creditriskofferings/creditrisk_insurance.html.

[29] 12 U.S.C. §1717.

[30] For an example of how mortgage insurance requirements vary based on down payment, see Fannie Mae, *Selling Guide, B7-1-02: Mortgage Insurance Coverage Requirements*, at https://www.fanniemae.com/content/guide/selling/b7/1/02.html.

a deeper mortgage insurance transaction, but FHFA stated it intends to issue a request for input to solicit feedback on how it could be performed.[31] The specific structure of a deeper mortgage insurance transaction is therefore unknown, but the GSEs would likely charge a reduced guarantee fee for those mortgages with deeper mortgage insurance, allowing the mortgage insurer to be compensated for the additional risk it would be absorbing.

Front-End Lender Risk Sharing. Front-end lender risk sharing occurs when "an originating lender or aggregator retains a portion of the credit risk associated with the loans that they sell to" the GSEs.[32] Normally, the lender would sell the mortgages to the GSE, not retain any credit risk, and pay the required guarantee fee to the GSE for assuming the credit risk. When the lender retains some of the credit risk in a front-end lender risk-sharing transaction, the lender pays a reduced guarantee fee to the GSE because the GSE is not assuming as much credit risk as before. An example of a front-end lender risk-sharing transaction is the Madison Avenue Security that Fannie Mae and J.P. Morgan Chase were involved in.[33] In that deal, "J.P. Morgan warehoused loans made by J.P. Morgan Chase bank, then sold them in bulk into a newly issued Fannie Mae MBS, presumably for a very meaningful reduction in guarantee fees."[34]

Senior-Subordinate Securitization. In a senior-subordinate securitization, a GSE sells tranches of an MBS to investors but guarantees that only investors in the senior tranches will be repaid. Investors in the junior tranches do not have a guarantee and are exposed to credit risk.[35] As compensation, junior (subordinated) investors have the ability to earn a higher return should the underlying mortgages have lower credit losses, but could earn a lower return if the credit losses exceed expectations. The senior-subordinate structure is also used in PLS. Freddie Mac has issued senior-subordinate securitizations called Whole Loan Securities (WLS).[36]

S. 1484 and Risk-Sharing Policy Issues

Risk-sharing methods have different strengths and weaknesses. Congress may be interested in the different transaction types for how they affect the housing finance system and reduce taxpayers' risk exposure in the short-term, but also in how risk sharing could be incorporated into broader housing finance reform (how much, if any, credit risk the federal government should be exposed to is a source of contention in the reform debate). This section addresses risk-sharing issues raised by S. 1484 as well as several other policy issues that may be of interest to policymakers.[37]

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[31] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[32] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 20, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[33] Fitch Ratings, *Fitch Expects to Rate JPMMA L Street Securities 2015-CH1; Presale Issued*, September 16, 2015, at https://www.fitchratings.com/site/fitch-home/pressrelease?id=990881.

[34] The Urban Institute, Housing Finance Policy Center, *Housing Finance At A Glance: A Monthly Chartbook November 2014*, November 2014, p.3, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000020-Housing-Finance-At-A-Glance.pdf.

[35] FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 20, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

[36] Freddie Mac, *Freddie Mac Whole Loan Securities (WLS)*, at http://www.freddiemac.com/creditriskofferings//freddie_mac_whole_loan_securities.html.

[37] A December 2015 report by the Urban Institute and Moody's Analytics described several issues that policymakers may wish to consider in assessing the risk-sharing methods. See Laurie Goodman, Jim Parrott, and Mark Zandi, *Delivering on the Promise of Risk-Sharing*, December 1, 2015, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000531-Delivering-on-the-Promise-of-Risk-Sharing.pdf.

Section 706 of S. 1484 would codify existing risk-sharing practices at the GSEs and require them to move further in certain directions. It would

- direct FHFA to require the GSEs to engage in risk-sharing transactions that would transfer the first-loss position;
- require that each GSE "engage in significant and increasing risk-sharing transactions, including front-end risk sharing and risk-sharing transactions in which the first loss position is transferred," while taking into account "market conditions and the safety and soundness" of the GSEs;[38] and
- mandate annual reports from FHFA to Congress about various aspects of the risk-sharing transactions.

Types of Risk Sharing and Types of Loss. The GSEs have employed several different methods of sharing risk with private entities, and those methods can be divided into two major categories, *front-end* risk sharing and *back-end* risk sharing. In a front-end transaction, the GSE and private entities agree to share risk on a pool of mortgages prior to the GSE acquiring the mortgages. Deeper Mortgage Insurance is an example of a front-end transaction because the deeper mortgage insurance is in place prior to the GSEs purchasing the mortgage. In a back-end transaction, the GSE and private entities agree to share risk on a pool of mortgages that the GSE already owns. The GSE Debt Issuance structure is back-end risk sharing; the GSEs sell off risk through STACR or CAS after they have been exposed to the credit risk.

The major difference between front-end and back-end risk sharing is whether the GSE is exposed to credit risk while temporarily warehousing mortgages (i.e., the process of accumulating enough mortgages in its portfolio to eventually pool and securitize). Front-end risk sharing transfers credit risk prior to the mortgages being in portfolio so the GSEs are not exposed to credit risk while warehousing the mortgages, whereas back-end risk sharing exposes them to credit risk while warehousing the mortgages.

In a risk-sharing deal, loss position refers to the order in which an investor is exposed to losses. Investors in the *first-loss position* bear losses due to defaults on the underlying mortgages before all others.

S. 1484 would require the GSEs to engage in more front-end risk sharing and to sell the first-loss position to private investors. As mentioned earlier, the GSEs always require some form of front-end risk sharing; the borrower must either have a 20% down payment or an alternative approved method of credit enhancement. The borrower's equity and the credit enhancements are the first layers of private capital and are in place whether the GSEs later engage in front-end or back-end risk sharing. Front-end risk sharing would involve deeper risk sharing upfront than is currently required by the down payment or alternative credit enhancement. In December 2015, FHFA stated that the GSEs and FHFA will "conduct an analysis and assessment of front-end credit risk transfer transactions."[39] In addition, the GSEs' initial risk-sharing transactions did not involve selling off the first-loss position, but more recent transactions involved the GSEs selling part of the first-loss position.

Front-end risk sharing and selling off the first-loss position could reduce the amount of risk to which the GSEs are exposed. Reducing risk, however, is just one of the goals in a risk-sharing

[38] S. 1484, Sec. 706.

[39] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

transaction. The GSEs also try to structure the deals so that the risk is transferred at the best price for the GSEs. Dictating the structure of the transaction could affect the cost of the transactions for the GSEs, and thus the amount of dividends they return to taxpayers.

Access to Credit. Policymakers may also consider how different risk-sharing methods affect consumers' access to credit, which could be affected through two different channels. First, some worry that front-end risk sharing could result in *credit overlays* (qualification standards more strict than the GSEs require) that increase prices for consumers or restrict access.[40] The GSEs set minimum standards that a mortgage must meet for the GSEs to purchase the mortgage. Those standards influence what mortgages lenders will originate. With front-end risk sharing, the mortgage insurer or lender interacts with the borrower prior to the GSE purchasing the mortgage. These private entities could play a gatekeeping role and influence credit standards, which may result in more stringent standards than the GSEs would require. Private entities may require more stringent standards than the GSEs out of fear that, if the mortgages did not meet the GSEs' standards, the entities could be required to repurchase the mortgages from the GSEs to compensate the GSEs. The GSEs could take certain steps to address concerns about the more stringent standards of front-end risk sharing, such as requiring private entities to meet similar affordable housing requirements as the GSEs or having clear standards for when a repurchase would be required.[41] Others argue, however, that front-end risk sharing can give lenders incentives to improve their efficiency and offer lower rates to borrowers in order to capture a larger share of the guarantee fee.[42] Doing so could result in expanded access to credit.

Back-end risk sharing could also affect credit availability if investors demand a higher return to compensate them for the risk. The GSEs, however, would have more control over whether the higher return would be passed on to consumers than in front-end transactions.

Second, risk-sharing methods may react differently over a credit cycle so that some options could result in greater price fluctuations than others. Some analysts argue that those risk-sharing transactions that rely on the capital markets (such as STACR and CAS deals that involve selling credit risk to investors) are likely to be more volatile than mortgage insurers or lenders because "asset managers, hedge funds, and other capital market investors are highly sensitive to risk tolerance in the financial system."[43] Capital market investors are concerned about individual deals and do not have the same fixed costs associated with long-term investing that mortgage insurers and lenders do. Mortgage insurers, some argue, "are in the long-term business of taking mortgage credit risk, so they will not raise their pricing as much in bad times or lower it as much in good times."[44] While some experts make particular arguments about how the transactions will respond to different market conditions, the risk-sharing transactions are relatively new and have not experienced a market downturn, so exactly how they will react is unknown.

Minimizing Taxpayer Risk. Risk-sharing methods have different means of protecting taxpayers and those methods may vary in their effectiveness. The GSE Debt Issuance method is said to be

[40] See Laurie Goodman, Jim Parrott, and Mark Zandi, *Delivering on the Promise of Risk-Sharing*, December 1, 2015, p. 4, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000531-Delivering-on-the-Promise-of-Risk-Sharing.pdf.

[41] Ibid.

[42] Letter from the Securities Industry and Financial Markets Association (SIFMA) to Sen. Shelby, Sen. Brown, Rep. Hensarling, and Rep. Waters, December 7, 2015.

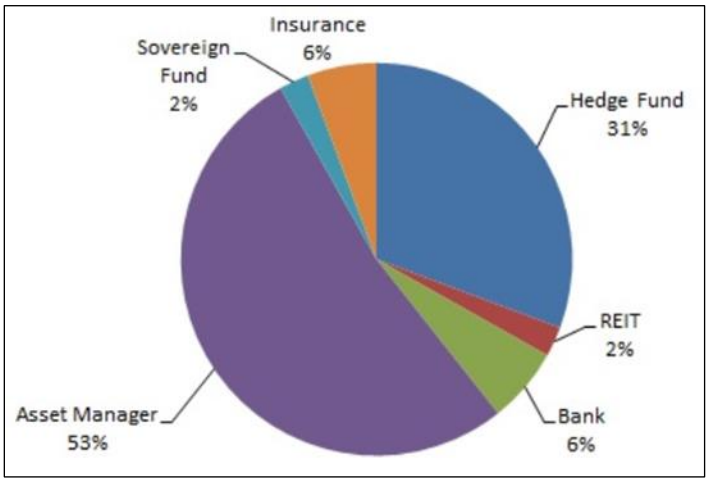
[43] See Laurie Goodman, Jim Parrott, and Mark Zandi, *Delivering on the Promise of Risk-Sharing*, December 1, 2015, p. 4, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000531-Delivering-on-the-Promise-of-Risk-Sharing.pdf.

[44] Ibid.

prefunded, meaning that the investors make up-front payments and the money is held in a trust. If the GSEs incur losses on the reference pool, then they are paid out of the trust. This model provides a high likelihood that the GSEs would be compensated as needed. Alternatively, the insurance methods and the Front-End Lender Risk-Sharing method are dependent on insurance companies or lenders making payments to the GSEs if credit losses occur. The GSEs are therefore exposed to counterparty risk under those methods. If the GSEs' counterparty (the insurance company or lender) does not have sufficient resources to repay, the GSE may not be repaid. Payments to the GSEs by other private companies are likely to be highest during a market downturn, which may also be the time when the companies would have the most difficulty in making the needed payments. The GSEs take steps to minimize counterparty risk by, for example, requiring counterparties to meet certain minimum standards for creditworthiness and by requiring counterparties to post collateral for each deal.

Broad Investor Base. FHFA has stated that one of its goals with risk-sharing transactions in 2016 is to expand the investor base for its transactions.[45] A broader base of investors—both in terms of the number of investors and the different types of investors (i.e., banks, hedge funds, insurers, and other companies)—could increase demand and reduce some of the potential volatility of risk sharing.[46] **Figure 4** shows the composition of investors in the GSEs' debt issuance transactions.

Figure 4. Investors in STACR and CAS Transactions



Source: FHFA, *Overview of Fannie Mae and Freddie Mac Credit Risk Transfer Transactions*, August 2015, p. 14, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CRT-Overview-8-21-2015.pdf.

The Securities Industry and Financial Markets Association (SIFMA), an industry group that represents many potential investors in risk-sharing deals, identified several issues that may limit potential investors' involvement. For example, real estate investment trusts (REITs)[47] are companies that are required to, among other things, have 75% of their assets and income derive from real estate and return at least 90% of their profits to shareholders as dividends.[48] Some types

[45] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[46] Laurie Goodman and Jim Parrott, *A Glimpse at the Future of Risk Sharing*, Urban Institute, February 10, 2016, p. 6, at http://www.urban.org/research/publication/glimpse-future-risk-sharing.

[47] For an overview of REITs, see CRS Report R44421, *Real Estate Investment Trusts (REITs) and the Foreign Investment in Real Property Tax Act (FIRPTA): Overview and Recent Tax Revisions*, by Jane G. Gravelle.

[48] See IRS, *Form 1120-REIT*, at https://www.irs.gov/instructions/i1120rei/ch01.html.

of credit-risk transactions do not satisfy the REIT requirements, discouraging REITs from participating.[49] Additionally, SIFMA argues that banks are discouraged from acting as market makers for credit-risk transactions—purchasing and selling the securities to help meet the demands of clients and customers—because of the higher capital requirements associated with holding the securities.[50]

Modifying specific regulations may result in an expanded investor base, but those benefits would be weighed by policymakers against the costs of modifying the regulations, namely the potentially reduced effectiveness of the requirements.

Common Securitization Platform

The Common Securitization Platform (CSP) is a technology platform being created by Fannie Mae and Freddie Mac to perform the *back-office functions* of securitization. Each GSE has its own technology systems for securitizing mortgages, but in 2012, FHFA determined that those systems were "antiquated and inflexible."[51] Rather than updating two separate systems, FHFA determined that the GSEs should jointly develop a new, common system that they could both use. The CSP is a multi-year project that FHFA does not expect to be released until the fourth quarter of 2016.[52]

Development of the CSP

The CSP is being created by Common Securitization Solutions (CSS), a company jointly owned by Fannie Mae and Freddie Mac. Each GSE appointed two members to CSS's board of managers (all four members are employees of Fannie Mae or Freddie Mac) and jointly announced a CEO.[53] The employees working at CSS to develop the CSP are employees of the GSEs, and CSS depends on the GSEs for certain office functions, including accounting and human resources.[54] FHFA has stated that CSS "plans to convert its associates to CSS employees and to stand up its own corporate functions... in the first half of 2016."[55] As of mid-2015, the GSEs had invested $146 million in CSS.[56]

Securitization, the process of transforming mortgage into MBS, has many different components with the back-office functions being just one part of it. The main components of the securitization performed by the GSEs include acquiring mortgages from lenders, issuing MBS, providing a guarantee on the MBS, and administering the MBS after they have been issued. The CSP will be

[49] Letter from SIFMA to Sen. Shelby, Sen. Brown, Rep. Hensarling, and Rep. Waters, December 7, 2015.

[50] Ibid.

[51] FHFA, *Building a New Infrastructure for the Secondary Mortgage Market*, October 4, 2012, p. 4, at http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/FHFA_Securitization_White_Paper_N508L.pdf.

[52] FHFA, *2015 Scorecard Progress Report*, March 2016, p. 24, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Progress-Report-2015-Scorecard.pdf.

[53] Fannie Mae, "CEO, Board Members Named at Common Securitization Solutions, LLC," press release, November 3, 2014, at http://www.fanniemae.com/portal/about-us/media/corporate-news/2014/6187.html.

[54] FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, p. 2, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[55] Ibid.

[56] Ibid.

used by the GSEs to help with two of those functions—issuing MBS and administering the MBS once issued.[57]

The functions that the CSP could be used to perform were chosen because they are considered "core functionalities of a securitization infrastructure that can be standardized and serve a utility function."[58] Each GSE would continue to acquire mortgages from lenders, but will then work with CSS to issue the MBS. The GSE, not CSS, would guarantee the MBS as well as set loss mitigation practices for delinquent mortgages. The CSS would not be exposed to credit risk. The CSP will be used by the GSEs to produce the disclosures that are provided to investors at the time the MBS is issued and the disclosures that provide monthly updates about the status of the MBS and of the individual mortgages that back the MBS. The functions that were performed by the GSEs to securitize mortgages will continue to be performed, but rather than all being done by the GSEs, some will be performed by CSS and the CSP.

CSS is planning on completing the CSP in two stages. The first stage, called Release 1, would allow Freddie Mac to issue some of its securities through the CSP.[59] Release 1 is expected to occur in 2016. The second stage, Release 2, would allow both Fannie and Freddie to issue the Single Security (discussed in the "Single Security" section below) through the CSP. Release 2 is expected in 2018.[60]

S. 1484 and CSP Policy Issues

Congress is interested in the development of the CSP for multiple reasons, including its effect on future housing finance reform. Several legislative proposals to reform the housing finance system would use the CSP as a central point in their future, reformed system.[61] With this in mind, FHFA has stated that it is structuring the CSP to be used by other private entities to issue MBS and designed to "support various possible future paths under housing finance reform."[62] In spite of these assurances, some in Congress are concerned that the CSP may be designed in a way that is not sufficiently compatible with their preferred version of reform.[63] Two sections in S. 1484 address several issues related to the CSP, primarily related to the relationship between the GSEs and the CSP.

Section 704 of S. 1484 would

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[57] For more on specific functions performed by CSP, see FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, pp. 10-12, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[58] FHFA, *Building a New Infrastructure for the Secondary Mortgage Market*, October 4, 2012, p. 5, at http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/FHFA_Securitization_White_Paper_N508L.pdf.

[59] Freddie Mac is expected to be able to issue its single-class securities through the CSP in 2016. See FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 9, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[60] See FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 9, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[61] See S. 1217 and H.R. 2767 from the 113th Congress. No housing finance reform bill has received committee or floor action in the 114th Congress.

[62] FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, p. 4, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[63] See letter from Sens. Corker, Warner, and Crapo, et al. to Mel Watt, director of FHFA, March 17, 2015, at http://www.corker.senate.gov/public/_cache/files/221a4274-f6fd-432d-b03b-949cc055498e/Senate%20CSP%20Letter%2003172015.pdf.

- require FHFA to direct the GSEs to establish the Secondary Market Advisory Committee;
- direct the committee to "provide advice to the [GSEs] and CSS on decisions relating to the development of secondary mortgage market infrastructure;"[64]
- require that the committee include private market participants representing a variety of different aspects of the market.

Section 705 of S. 1484 would

- require FHFA to submit (1) an annual report to Congress on the status of the CSP's development and of the legal and contractual framework needed for non-GSEs to securitize through the CSP and (2) a report within three years of enactment on a plan to transition the CSP from joint ownership by the GSEs into a private, nonprofit entity;
- require FHFA to direct the GSEs to alter the composition of CSS's board of directors to include directors not affiliated with the GSEs;
- authorize CSS to develop standards for a non-GSE company to securitize mortgages through the CSP and to facilitate issuing MBS through the CSP by a non-GSE company;
- prohibit CSS from performing certain activities, such as owning, holding, or assuming the credit risk of mortgages or MBS;
- give FHFA regulatory authority over CSS to ensure safety and soundness;
- instruct FHFA to transfer funds from the GSEs to the CSS as needed for CSS to perform its functions and direct the GSEs to transfer or sell to the CSP any property, systems, or infrastructure necessary for the CSP to perform its functions;
- require the CSP to be transferred from the joint ownership of the GSEs to a private, nonprofit entity within 5 years of enactment and, within 10 years of that transition, the GSEs would be repaid the total cost of the property that was transferred.

The Focus of the CSP. Because previous reform proposals would, in general, eliminate Fannie Mae and Freddie Mac and have private entities use a future version of the CSP, some policymakers are concerned about whether the CSP will be designed to be compatible with legislative reform. While intending the CSP to "support various possible future paths under housing finance reform,"[65] FHFA Director Mel Watt has also testified that "FHFA's first objective for the CSP is to make sure that it works for the benefit of Fannie Mae and Freddie Mac."[66] The testimony went on to note that FHFA is "requiring that the CSP leverage the systems, software and standards used in the private sector where possible, which will ensure that the CSP will be

[64] S. 1484, Sec. 704.

[65] FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, p. 4, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[66] Testimony of Director Mel Watt, in U.S. Congress, House Committee on Financial Services, *Sustainable Housing Finance: An Update from the Director of the Federal Housing Finance Agency*, 114th Cong., 1st sess., January 27, 2015.

GOVERNMENT SERIES

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adaptable for use by other secondary market actors—including private-label securities issues—in the future."[67]

Because of the core business functions that the CSP would perform for the GSEs, it is understandable that FHFA would have as its first objective ensuring that the CSP works for the GSEs. But some are concerned whether CSS, which is owned by the GSEs, has the inventive to ensure that the CSP would be as compatible as possible with non-GSE companies. If others could more efficiently issue MBS through the CSP, the GSEs could potentially lose market share.

S. 1484 would take several steps to address the concern about whether CSS would design the CSP to have broader accessibility. First, it would establish a Secondary Market Advisory Committee to ensure that the GSEs are receiving private-sector input about the future structure of the secondary mortgage market. Second, S. 1484 would reconstitute the CSS board of directors to eventually require a majority of members be unaffiliated with the GSEs.

FHFA has taken steps to respond to critics' concerns. FHFA established the Single Security and CSP Industry Advisory Group in 2015 (around the time that S. 1484 was introduced) to facilitate industry feedback.[68] In addition, even though the CSS board is currently composed of GSE employees, FHFA has directed CSS to, where possible, ensure the CSP is open access and FHFA is an observer at CSS board meetings.[69] Some may view these actions as sufficient to ensure the CSP is developed as intended whereas others may argue that the added steps from S. 1484 are necessary.

Required Functions of the CSP. As mentioned above, some argue that an open access CSP is important to ensuring that other private companies will play a larger role in the mortgage market in the future. Others maintain that access to the technology to issue MBS may be helpful but is not a sufficient condition for a vibrant private-label securities (PLS) market.[70] After all, many companies issued PLS prior to 2008 and the bursting of the housing bubble. But, as shown in **Figure 5**, the amount of PLS issued has gone from being more than $1 trillion per year in 2005 and 2006 to $13.7 billion in 2015. Companies did not lose the technological capacity to issue MBS so allowing them access to the CSP is alone unlikely to significantly boost PLS issuance. There are a number of reasons often cited for the near disappearance of the PLS market, and one of the major issues often mentioned is the lack of a clear legal framework for establishing the rights and duties of the many stakeholders in a PLS deal.[71]

[67] Ibid.

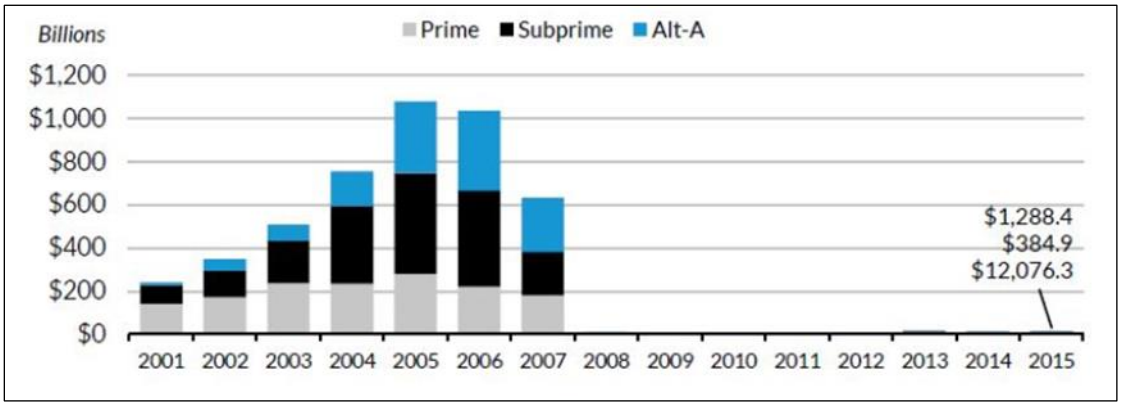
[68] Freddie Mac, "Freddie Mac, Fannie Mae and Common Securitization Solutions Create Single Security/CSP Industry Advisory Group," press release, July 8, 2015, at http://freddiemac.mwnewsroom.com/press-releases/freddie-mac-fannie-mae-and-common-securitization—otcqb-fmcc-1205485.

[69] FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, p. 7, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[70] Private-label securities (PLS) are those MBS not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae.

[71] For an example of additional issues, see letter from David H. Stevens, president and CEO of the Mortgage Bankers Association, to the Treasury Department, August 5, 2014, at https://www.mba.org/Documents/mba.org/files/MBALtrtoTreasuryonBarrierstoPLSMarketRecovery.pdf.

Figure 5. Private-Label Securities Issuance



Source: Laurie Goodman, *A Progress Report on the Private-Label Securities Market*, Urban Institute, March 8, 2016, p.1, at http://www.urban.org/research/publication/progress-report-private-label-securities-market.

Notes: The volumes listed for 2015 are in millions, so a total of $13.7 billion was issued in 2015. Prime, subprime, and Alt-A are different categories of MBS. Prime MBS are primarily backed by mortgages to individuals with high credit scores and subprime MBS are backed by mortgages to individuals who pose more credit risk. Alt-A MBS are generally considered to be between prime and subprime in terms of credit risk and often are backed by mortgages that have a blemish in the mortgage application, such as somewhat weak credit or incomplete documentation.

To address the legal uncertainty, FHFA proposed in 2012 as parts of its initial announcement about the CSP to also establish a contractual and disclosure framework (CDF). The CDF would complement the CSP by setting "the legal agreements, rules and responsibilities critical to the infrastructure as an integrated whole."[72] FHFA later dropped the CDF from its efforts to reform the mortgage market because "the deficiencies that the framework aimed to address pertain more to private-label mortgage securitization."[73]

Others have also tried to establish a new legal framework. In 2014, Treasury announced an effort to facilitate "the development of market practices and standards that would be necessary to support a safe and sustainable PLS housing finance channel."[74] The effort has included receiving comments from the public on restarting the PLS market and hosting meetings with industry participants. The American Securitization Forum (ASF) [75] and Structured Finance Industry Group (SFIG),[76] two industry groups, also have led efforts to address shortcomings in the PLS market.

[72] FHFA, *Building a New Infrastructure for the Secondary Mortgage Market*, October 4, 2012, p. 2, at http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/FHFA_Securitization_White_Paper_N508L.pdf. FHFA initially referred to the project as developing a model pooling and servicing agreement and later referred to it as the contractual and disclosure framework. See FHFA, *A Progress Report on the Common Securitization Infrastructure*, April 30, 2013, p. 7, at http://www.fhfa.gov/Media/PublicAffairs/Documents/WhitePaperProgressReport43013.pdf.

[73] FHFA, *An Update on the Common Securitization Platform*, September 15, 2015, p. 5, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/CSP-Update-Final-9-15-2015.pdf.

[74] Department of the Treasury, "U.S. Treasury Department Seeks Public Comment On The Development Of A Responsible Private Label Securities Market," press release, June 26, 2014, at https://www.treasury.gov/press-center/press-releases/Pages/jl2446.aspx.

[75] American Securitization Forum, "ASF Project RESTART Resource Page," at http://www.americansecuritization.com/content.aspx?id=3461#.Vyz5KE0UWic.

[76] Structured Finance Industry Group, "RMBS 3.0 & other PLS Market Initiatives," at http://www.sfindustry.org/advocacy/categories/C48.

Given the continued low issuance levels seen in **Figure 5**, results from these efforts do not seem to have yet materialized and may suggest other obstacles to PLS.

S. 1484 would authorize CSS to develop standards for a non-GSE company to securitize mortgages through the CSP and to facilitate issuing MBS through the CSP by a non-GSE company. CSS would be authorized to develop the CDF that FHFA previously decided to exclude from its reform efforts. The CDF development is consistent with S. 1484 supporters' desire to restart the PLS market and increase the amount of private capital in the system. Others might argue that establishing the legal framework for PLS is a complicated undertaking that requires buy-in from many participants and may be better facilitated by an organization other than CSS.

Ownership of CSP. The close business relationship between the GSEs and CSS and the utility-like function envisioned for the CSP provide a rationale for keeping the CSP under GSE ownership absent broader reform. The mortgage market could face disruptions should CSS take actions that, although good from a business sense for CSS, limited the GSEs' access to the CSP. Others may argue that if the CSP would be owned by a non-GSE entity in a reformed, future housing finance system, it would be useful to begin that transition now even if there is disagreement on the remaining parts of housing finance reform. Some, however, may disagree with the underlying premise that the CSP should be owned by a non-GSE, and others may agree that the CSP should be sold by the GSEs but disagree with spinning the CSP off at this time.

S. 1484 would require the CSP to be transferred from the joint ownership of the GSEs to a private, nonprofit entity within 5 years of enactment and, within 10 years of that transition, the GSEs would be repaid the total cost of the property that was transferred.

Single Security

The Single Security is FHFA's initiative to alter the type of MBS that would be issued in the future. Currently, each GSE issues its own MBS. Fannie MBS and Freddie MBS[77] are different securities governed by different legal contracts and trade in different markets at different prices. The Single Security would be a single MBS that the GSEs could issue through the CSP and trade in a single market. Many of the important contractual features that cause Fannie MBS and Freddie MBS to trade differently would be aligned. As discussed in more detail below, FHFA argues that the primary benefits of the Single Security would be to enhance the liquidity of the MBS market—the ease with which MBS can be bought and sold—and remove the subsidy that Freddie Mac currently offers to keep its MBS competitive.[78]

Development of the Single Security

Fannie and Freddie MBS are typically traded in the *to-be-announced (TBA) market*. The TBA market is a forward market: the specific mortgages in the MBS being purchased are unknown on the date the trade is agreed to. Instead, the buyer and seller agree on several basic criteria[79] and the trade may not be settled (or completed) for several weeks. Two days before the trade is

[77] Note Freddie Mac's securities are often referred to as Participation Certificates (PCs) but this report refers to them as MBS to simplify.

[78] FHFA, *An Update on the Structure of the Single Security*, May 15, 2015, p. 4, at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf.

[79] The six general parameters include the issuer, maturity, coupon, price, paramount, and settlement date. James Vickery and Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, Federal Reserve Bank of New York, at http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.

settled, the seller informs the buyer about the specifics of the MBS pools being sold. Any MBS pool meeting the required criteria can be delivered, meaning that those MBS are fungible, so long as the MBS being sold satisfies the original criteria agreed to in accordance with the settlement guidelines established by the SIFMA, an industry trade group.[80] Fungibility—the ability of the seller to deliver any MBS and the willingness of the buyer to accept the delivered MBS—is important to the functioning of the TBA market.

The issuer is one of the criteria that are agreed to at the time the deal is made. Fannie and Freddie are different issuers with different policies and practices that influence the price of their MBS. For example, Freddie Mac MBS investors are paid 10 days earlier each month than Fannie Mae MBS investors.[81] These differences lead to Fannie and Freddie MBS trading as different products with different liquidities. Fannie MBS are much more liquid than Freddie's with FHFA reporting that Fannie MBS trade at nine times the volume of Freddie's even though the annual production volume of Fannie's is only 70% of Freddie MBS.[82]

The difference in liquidities of the two MBS leads to Freddie MBS trading at a discount relative to Fannie MBS.[83] This means that, all else equal, a lender could sell its mortgages to Fannie and receive a better price than if the same mortgages were sold to Freddie. To remain competitive, Freddie must offer lower guarantee fees to encourage lenders to sell to it. These lower fees act as a subsidy and result in lower revenues flowing to Freddie. Because Freddie remits its profits to Treasury, the subsidy results in a transfer from taxpayers to lenders. One study estimated the annual amount of the subsidy at between $400 million and $600 million.[84] Using a different method, an alternative analysis found the subsidy to be smaller, at approximately $100 million per year.[85]

FHFA argues that the Single Security could address the liquidity and subsidy concerns. Combining the two MBS markets into one would result in a deeper, more liquid market. In addition, FHFA states that the Single Security would eliminate the need for Freddie to provide a subsidy to lenders because the MBS that it guarantees would trade at a comparable price to those that Fannie guarantees (assuming all else about the MBS are equal). Whether the subsidy is fully eliminated, however, depends on whether future guarantee fees are raised to Fannie's levels, lowered to Freddie's levels, or somewhere in between.

One of the key parts of creating the Single Security is aligning important contractual and business practices between the two GSEs. Differences in how the GSEs create or administer the MBS that they issue as Single Securities could result in price differentiation so that investors would not treat the MBS as fungible. For example, if mortgages that Fannie used for its MBS defaulted or were refinanced at a higher rate than the mortgages used for Freddie MBS, investors would not value the Single Security issued through the CSP by Fannie at the same price as the Single Security issued by Freddie. This would result in the Single Security market breaking down and

[80] The SIFMA guidelines are called the Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities.

[81] FHFA, *An Update on the Structure of the Single Security*, May 15, 2015, p. 9, at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf.

[82] Ibid.

[83] Other factors can also contribute to pricing differences, such as differences in prepayment rates.

[84] Laurie Goodman, *The $400 Million Case for a Single GSE Security*, Urban Institute, September 5, 2014, at http://www.urban.org/urban-wire/400-million-case-single-gse-security.

[85] Letter from Wells Fargo to FHFA, October 13, 2014, available at https://www.fhfa.gov/AboutUs/Contact/Pages/input-submissions.aspx.

returning to the current structure of a separate market for Fannie MBS and Freddie MBS. FHFA has directed the GSEs to begin aligning those policies and disclosures that are most important to ensuring the pricing of the MBS are substantially similar but does not require perfect alignment for all policies and contracts across the GSEs.[86]

When creating a Single Security, each GSE would continue to purchase mortgages that conform to their standards just as they do now. Rather than issuing the MBS through their own systems as is currently done, the GSEs would issue them through the CSP. Each GSE would continue to guarantee the MBS that they issue. As with the current MBS, the Single Security could be traded on the TBA market.

The timing of the release of the Single Security is tied to the development of the CSP. The CSP and the Single Security are linked to the point that FHFA stated that a "primary reason for building the CSP is to enable the enterprises to issue the Single Security."[87] Both GSEs could issue Single Securities through the CSP as part of Release 2, the second stage of the CSP's development, which is planned for 2018. To provide liquidity to the market and ensure that the price of existing MBS is not impaired, FHFA plans on allowing existing Freddie MBS to be exchanged "for a comparable Single Security backed by the same mortgage loans."[88] FHFA does not anticipate that existing Fannie MBS would need to be swapped for a Single Security MBS because Fannie MBS will be sufficiently similar to the Single Security that investors are expected to view them as fungible.

Single Security Policy Issues

S. 1484 does not address the Single Security directly, but because of the close relationship between the Single Security and the CSP, those parts of S. 1484 that affect the CSP are likely to affect the Single Security. There are several additional topics related to the Single Security that policymakers may wish to consider.

Promoting Liquidity. The market for GSE MBS is already one of the deepest and most liquid markets in the world. This liquidity benefits many different stakeholders in the housing finance system. Having a large and liquid secondary market can boost the demand for MBS by investors, which in turn can lower the interest rate charged to borrowers in the primary market.[89] In addition, by providing several weeks between when a trade is agreed to and eventually settled, the TBA market allows sellers of MBS to know the price and amount of MBS that they will sell at a future date. This can reduce the uncertainty they face in determining how many new mortgages to purchase or originate in the primary market and at what price. The time between when a trade is agreed to and when it is settled also helps borrowers to lock in interest rates a month or more before their loan is finalized.

If the Single Security enhances the liquidity of the TBA market, many of the different stakeholders would benefit. FHFA states that it is taking steps to ensure that the Single Security would strengthen the TBA market's liquidity by, for example, ensuring that there is sufficient

[86] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 27, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[87] FHFA, *2016 Scorecard for Fannie Mae, Freddie Mac, and Common Securitization Solutions*, December 17, 2015, p. 25, at http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2016-Scorecard.pdf.

[88] FHFA, *An Update on the Structure of the Single Security*, May 15, 2015, p. 19, at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf.

[89] James Vickery and Joshua Wright, "TBA Trading and Liquidity in the Agency MBS Market," Federal Reserve Bank of New York, *Economic Policy Review*, May 2013, at http://www.newyorkfed.org/research/epr/2013/1212vick.pdf.

alignment of practices and policies across the two GSEs to result in the development of a single market. Some industry participants, however, are concerned that there is insufficient alignment, which could prevent the Single Security from being successful. One group argued that "greater up-front harmonization of the GSEs' policies and procedures is not only necessary, but fundamental to the success of the Single Security initiative."[90] Failure to sufficiently align pertinent factors could lead to price differentiation and a fragmentation of the market. FHFA has acknowledged this issue but whether it has struck the right balance is an open question.

Effect on Innovation and Competition. Alignment of the GSEs' policies could come at the expense of innovation. A GSE may be limited, for example, in its ability to alter unilaterally the type of loans that it purchases in its attempt to expand credit. Changes made by one GSE that are not made by the other could result in the market pricing the Single Security issued by each GSE differently. One industry group cited differences in how the GSEs introduced low down payment mortgages as an example of a lending program not implemented in the same way by both GSEs.[91] To prevent this differentiation from happening, FHFA may limit the types of innovative activities that a GSE could introduce.

Some industry groups note that the move to aligning policies through the creation of the Single Security could also affect competition between the GSEs. One group raised concerns about the "possibility that moving from a duopoly to a monopoly will reduce primary lenders' ability to negotiate the best purchase prices between Fannie Mae and Freddie Mac which could increase borrower costs."[92] Others argue that existing differences in pricing between Fannie and Freddie (which results in Freddie having to subsidize its purchases) undermines competition, "rendering the market much less responsive to the needs of borrowers and lenders."[93] They assert that the Single Security would put the two GSEs on equal footing and could encourage competition.

Housing Finance System Reform. The move to the Single Security will involve a transition for market participants. It is possible that future housing finance reform could incorporate the Single Security into a reformed system. Some are worried, however, that if reform is enacted that does not incorporate the Single Security or uses a modified version, participants would have to engage in a "double transition" that could increase the risk of disruption to the housing market.[94] Depending on how the future system is structured, there could be benefits associated with using a different structure rather than the Single Security but those benefits would need to be weighed against the costs of requiring an additional transition.

In addition, part of the success of the Single Security could depend on the presence of the GSEs' guarantees and the market's confidence in their guarantees. Should that guarantee be called into question, which is unlikely to be an issue while they are in conservatorship but could be an issue

[90] Letter from Structured Finance Industry Group to FHFA, October 7, 2015, available at https://www.fhfa.gov/AboutUs/Contact/Pages/input-submissions.aspx.

[91] Letter from SIFMA to FHFA, August 3, 2015, available at https://www.fhfa.gov/AboutUs/Contact/Pages/input-submissions.aspx.

[92] Letter from American Bankers Association to FHFA, October 2, 2014, available at https://www.fhfa.gov/AboutUs/Contact/Pages/input-submissions.aspx.

[93] Laurie Goodman and Lewis Ranieri, *Charting the Course to a Single Security*, Urban Institute, p. 6, at http://www.urban.org/sites/default/files/alfresco/publication-pdfs/413218-Charting-the-Course-to-a-Single-Security.PDF.

[94] See Letter from Structured Finance Industry Group to FHFA, October 7, 2015, and Letter from Financial Services Roundtable to FHFA, October 13, 2014. May be accessed at https://www.fhfa.gov/AboutUs/Contact/Pages/input-submissions.aspx.

depending on how reform would treat the GSEs, the liquidity of the Single Security could be affected.

Congressional Action on GSE Reform

The three policies issues explained above—risk-sharing transactions, the Common Securitization Platform, and the Single Security—are part of FHFA's reform of the housing finance system. FHFA faces limitations in terms of how much it can reform the system as more expansive reforms may require legislative action. The 114th Congress has not seen committee or floor action on broader reform legislation. Congress has, however, considered two proposals to, as supporters call it, "jumpstart" legislative action on GSE reform.[95]

Limitations on Sale of Preferred Stock

As compensation for the support it has provided to the GSEs, Treasury has received a significant ownership stake in Fannie and Freddie in the form of senior preferred stock. It also has the right to purchase up to 79.9% of the common stock of each GSE at a nominal price.[96]

Some argue that the best path forward for the housing finance system is for Treasury to sell its stake and for FHFA to allow the GSEs to exit conservatorship.[97] This plan is often referred to "recapitalize and release," and would allow the GSEs to rebuild their capital and return to sound financial footing before being released to private control. Those in favor of recapitalize and release argue that the existing reforms—including risk sharing, the Common Securitization Platform, and the Single Security—in conjunction with other steps that FHFA could take are sufficient to address the shortcomings that previously resulted in the GSEs having to enter conservatorship and receive financial assistance from Treasury. An analysis of the arguments for and against the recapitalize and release plan is beyond the scope of this report.[98]

Many in Congress opposed the idea of Treasury selling its stake and allowing a return to the old system, as they believe such action could result in a reversion to the same problems that plagued the pre-crisis system.[99] To prevent this outcome, Division O, Section 702 of P.L. 114-113, the Consolidated Appropriations Act, 2016, prohibits Treasury from selling or otherwise transferring its shares of senior preferred stock in the GSEs until at least January 1, 2018, unless legislation has been enacted that would allow for the stock's sale or transfer. It also includes a sense of Congress that

[95] See Senator Corker, "Corker, Warner, Vitter, Warren Reintroduce 'Jumpstart GSE Reform Act'," press release, September 16, 2015, at http://www.corker.senate.gov/public/index.cfm/2015/9/corker-warner-vitter-warren-reintroduce-jumpstart-gse-reform-act. For an example of the argument made by critics of the bill, see Tim Pagliara, "'Jumpstart GSE Reform' Will Only Prolong the Conservatorships of Fannie and Freddie," *The Hill*, December 22, 2015, at http://thehill.com/blogs/congress-blog/economy-budget/263954-jumpstart-gse-reform-will-only-prolong-the.

[96] Text of the Senior Preferred Stock Purchase Agreements (PSPAs) can be accessed at http://www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx.

[97] For an example of this argument, see Jim Millstein, *An Administrative Plan to Restructure and Reform the GSEs*, Urban Institute, March 29, 2016, at http://www.urban.org/policy-centers/housing-finance-policy-center/projects/housing-finance-reform-incubator/jim-millstein-administrative-plan-restructure-and-reform-gses.

[98] For additional information on reform options, including recapitalize and release, see CRS Report R40800, *GSEs and the Government's Role in Housing Finance: Issues for the 113th Congress*, by N. Eric Weiss.

[99] Senator Corker, "Corker, Warner Applaud Inclusion of Jumpstart GSE Reform Provision in Omnibus," press release, December 16, 2015, at http://www.corker.senate.gov/public/index.cfm/2015/12/corker-warner-applaud-inclusion-of-jumpstart-gse-reform-provision-in-omnibus.

> Congress should pass and the President should sign into law legislation determining the future of Fannie Mae and Freddie Mac, and that notwithstanding the expiration of subsection (b) [on January 1, 2018], the Secretary should not sell, transfer, relinquish, liquidate, divest, or otherwise dispose of any outstanding shares of senior preferred stock acquired pursuant to the Senior Preferred Stock Purchase Agreement until such legislation is enacted.[100]

In addition, Treasury officials have stated that the Administration has no intention of selling its shares in the absence of legislative enactment of comprehensive housing finance reform.[101] FHFA, for its part, has also not given any indication that it will allow the GSEs to exit their conservatorships in the near term, and exiting their conservatorships might not be economically feasible without Treasury unwinding its ownership positions in the companies.

Section 703 of S. 1484 contains a prohibition on the sale or transfer of the preferred shares that is similar to the restriction enacted as part of the 2016 consolidated appropriations law, except that it does not include the January 1, 2018, sunset.

Prohibiting Use of Guarantee Fees as Spending Offsets

In the GSEs' current state—profitable, primarily owned by the government, and in conservatorship—some see the GSEs' guarantee fees as a possible source of revenue that could offset unrelated federal spending or tax cuts. The fees the GSEs charge for their guarantee of timely payment of principal and interest are compensation for the GSEs assuming the MBS's credit risk. In 2011, P.L. 112-78, the Temporary Payroll Tax Cut Continuation Act of 2011, extended the payroll tax cut, unemployment compensation, and certain health provisions, and it used guarantee fees as a way of partially offsetting the cost of the bill. The GSEs were required to raise their guarantee fees by 10 basis points[102] on average until October 1, 2021, and send the additional revenue raised by the higher guarantee fees to Treasury.

Since 2011, guarantee fees have been considered as possible offsets for other types of spending. For example, guarantee fees were included as a revenue source for the version of the highway bill that was passed by the Senate on July 30, 2015, though the guarantee fee increase was not in the final version that became P.L. 114-94. Besides P.L. 112-78, no guarantee fee increases have been approved by Congress.

The presence of the GSEs as a potential offset, some argue, provides Congress with a disincentive to reform the GSEs because doing so may make it more politically difficult to draw on them as potential revenue sources.[103] To remove this obstacle, Congress has sought to prohibit the use of guarantee fees as an offset. For example, the budget resolution of FY2016 includes a scoring provision that prohibits the House and Senate from counting as an offset any provision that increases, or extends, the increase of any guarantee fees of the GSEs.[104]

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[100] P.L. 114-113, Division O, Sec. 702.

[101] Trey Garrison, "Stegman: White House Will Not Consider Recap and Release of GSEs," *Housingwire*, October 19, 2015, at http://www.housingwire.com/articles/35393-stegman-white-house-will-not-consider-recap-and-release-of-gses.

[102] A basis point is 1/100th of 1%.

[103] See Sen. Corker, "Corker, Warner, Vitter, Warren Introduce 'Jumpstart GSE Reform Act'," press release, March 14, 2013, at http://www.corker.senate.gov/public/index.cfm/2013/3/corker-warner-vitter-warren-introduce-jumpstart-gse-reform-act.

[104] Specifically, Sec.3110 of S.Con.Res. 11 states that for the purposes of determining points of order under the Congressional Budget Act of 1974 or any concurrent resolution on the budget, such provisions shall not be counted.

Section 702 of S. 1484 contains a similar provision. It would prohibit the use of guarantee fees as an offset unless the guarantee fees are part of legislation that either instructs Treasury to sell its senior preferred stock or reforms the secondary mortgage market.

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