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MEMORANDUM April 7, 2014

Subject: **Explanation and Illustration of the Johnson-Crapo GSE Reform Proposal**

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This memorandum was prepared to enable distribution to more than one congressional office. It describes the existing government-sponsored enterprise (GSE) securitization component of the housing finance system and the changes proposed by the Johnson-Crapo GSE Reform proposal. This memorandum also uses a series of figures[1] to explain the potential relationships among the participants in the proposed system. For a general overview of the housing finance system, see CRS Report R42995, *An Overview of the Housing Finance System in the United States*, by Sean M. Hoskins, Katie Jones, and N. Eric Weiss; for more on housing finance reform proposals, see CRS Report R43219, *Selected Legislative Proposals to Reform the Housing Finance System*, by Sean M. Hoskins, N. Eric Weiss, and Katie Jones.

Government-Sponsored Enterprise System

The Johnson-Crapo GSE Reform proposal would wind down Fannie Mae and Freddie Mac and would replace the Federal Housing Finance Agency (FHFA) with a new agency, the Federal Mortgage Insurance Corporation (FMIC). The FMIC would be an independent agency charged with supporting the mortgage market and providing reinsurance on eligible mortgage-backed securities (MBS). These MBS would have an explicit government guarantee. The FMIC would only pay out on its guarantee after a significant amount of private capital absorbed the first losses. In addition, the FMIC would regulate aspects of the mortgage market related to its guaranteed MBS and would establish a new multifamily housing finance system as well.

To provide a point of comparison for the Johnson-Crapo GSE Reform proposal, **Figures 1** and **2** illustrate the two government-sponsored enterprise (GSE) single-family guarantee securitization models: portfolio securitization and lender swaps. In a portfolio securitization transaction, shown in **Figure 1**, a lender originates a mortgage to a household. If the household does not have a large enough downpayment, the household or the lender may purchase private mortgage insurance. If the mortgage is a *conforming mortgage* – a mortgage that meets certain eligibility criteria based on size and borrower creditworthiness – the lender can sell the mortgage to Fannie Mae or Freddie Mac, two GSEs. The GSE pools mortgages into mortgage-backed securities (MBS). The MBS could be sold to investors in the To Be Announced (TBA) market with the GSE guaranteeing that investors will receive timely payment of principal and interest on their MBS. The GSE guarantee thus transfers credit risk from the investors to the GSEs. The

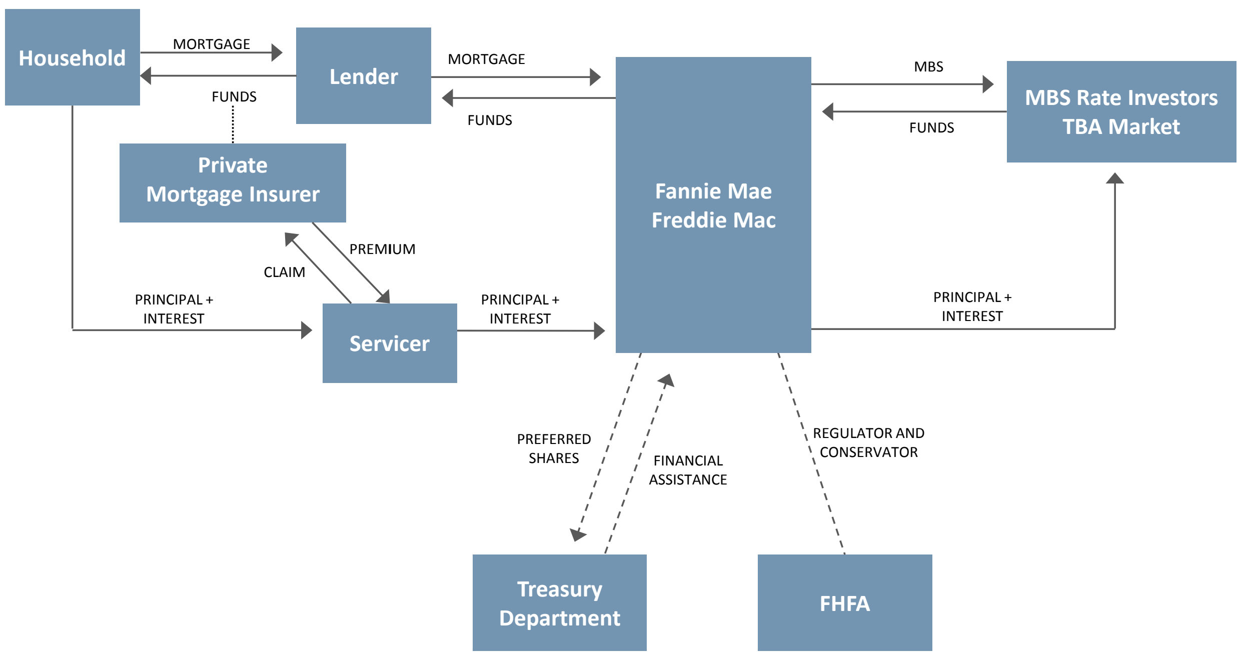
[1] The figures in this memorandum are not intended to explain every provision of the existing system or of the system proposed by the Johnson-Crapo GSE Reform proposal. Instead, the figures provide simplified illustrations of the relationships between participants in the existing system and potential relationships among participants in the proposed system.

investors buying GSE MBS, therefore, are trading primarily based on interest rate risks and are considered to be rate investors. To compensate the GSEs for their guarantee, the GSEs receive a guarantee fee.

The household makes its monthly payment to the servicer, which is sometimes the same entity as the lender. The servicer would keep part of the monthly payment for its own compensation, some of the payment would go to the GSE for its guarantee fee, and the remainder would be distributed to investors.

When the GSEs experienced significant financial stress during the financial crisis, they agreed to be placed in voluntary conservatorship in September 2008 by their regulator, the Federal Housing Finance Agency (FHFA). The GSEs experienced financial losses and have received assistance from the federal government, including approximately $187 billion in assistance in the form of senior preferred stock purchased by the Department of the Treasury. The financial assistance has allowed the GSEs to honor their guarantee obligations.

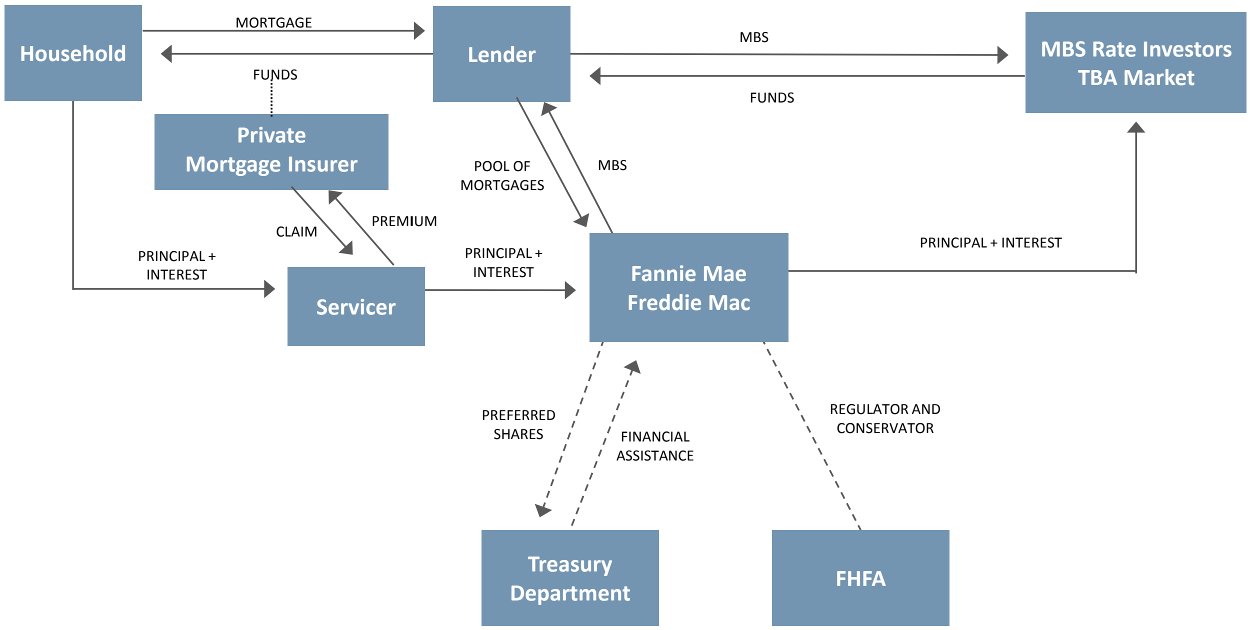
Figure 1. GSE-Based System: Portfolio Securitization



Source: Figure created by CRS.

Figure 2 shows the second type of GSE securitization, a lender swap. A lender swap is similar to a portfolio transaction, but instead of Fannie Mae or Freddie Mac pooling conforming mortgages in its portfolio and securitizing them, a lender delivers to Fannie Mae or Freddie Mac a pool of conforming mortgages and swaps it for a guaranteed MBS. The lender could then sell the MBS to a rate investor or keep it in its own portfolio.

Figure 2. GSE-Based System: Lender Swap



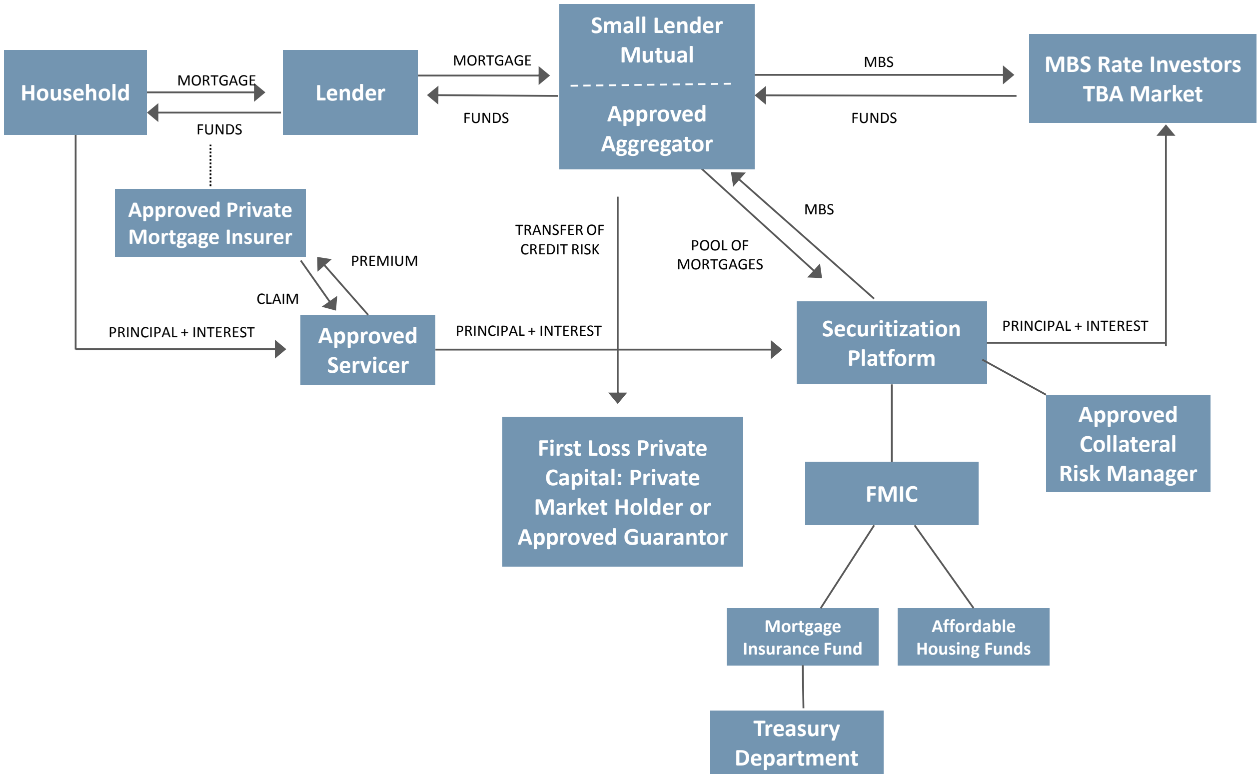
Source: Figure created by CRS.

Proposed System

Figure 3 shows a simplified model of what a reformed housing finance system might look like under the Johnson-Crapo GSE Reform proposal. **Figures 4** through **8** provide greater detail. The **Appendix** contains a glossary that explains the functions of the individual components of the reformed system.

- **Figure 4** show the functions performed by Fannie Mae or Freddie Mac in the existing system that would continue to be performed in the proposed system by new entities.
- **Figure 5** shows one potential example of how a mortgage in the proposed system could ultimately be funded.
- **Figure 6** shows how the household's monthly mortgage payment could flow in the proposed system.
- **Figure 7** shows the entities that may be exposed to credit risk in the proposed system.
- **Figure 8** shows the entities that would be approved by and, in some cases, regulated by the FMIC.

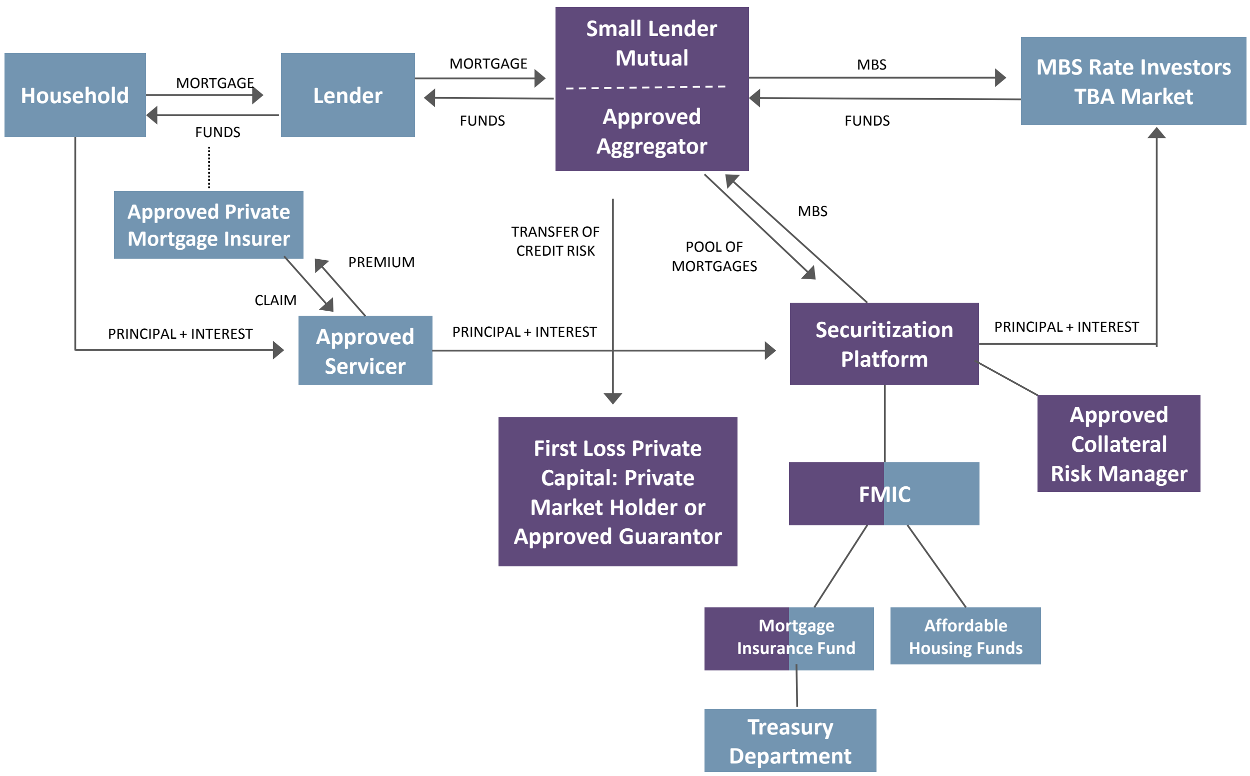
Figure 3. Johnson-Crapo GSE Reform Proposal



Source: Figure created by CRS.

Figure 4 shows how some of the functions performed by Fannie Mae or Freddie Mac in the existing system would continue to be performed in the new system but by new entities. The GSEs, among other things, perform the roles of aggregator, securitizer, issuer, and collateral manager. The GSEs also absorb some of the losses (therefore only half of the Mortgage Insurance Fund box is shaded) while Treasury has provided additional financial assistance as needed. The GSEs perform some of the standard setting and approval functions that would be performed by the FMIC, but they do not have the full regulatory authorities or powers that would be available to the FMIC (therefore the FMIC box is half shaded). In the proposed system, the Securitization Platform would be prohibited from performing the aggregating function in a retained portfolio that the GSEs perform in a portfolio securitization transaction (**Figure 1**). Instead, Approved Aggregators perform the aggregating and interact with the Platform in a process similar to the GSEs' lender swaps (**Figure 2**).

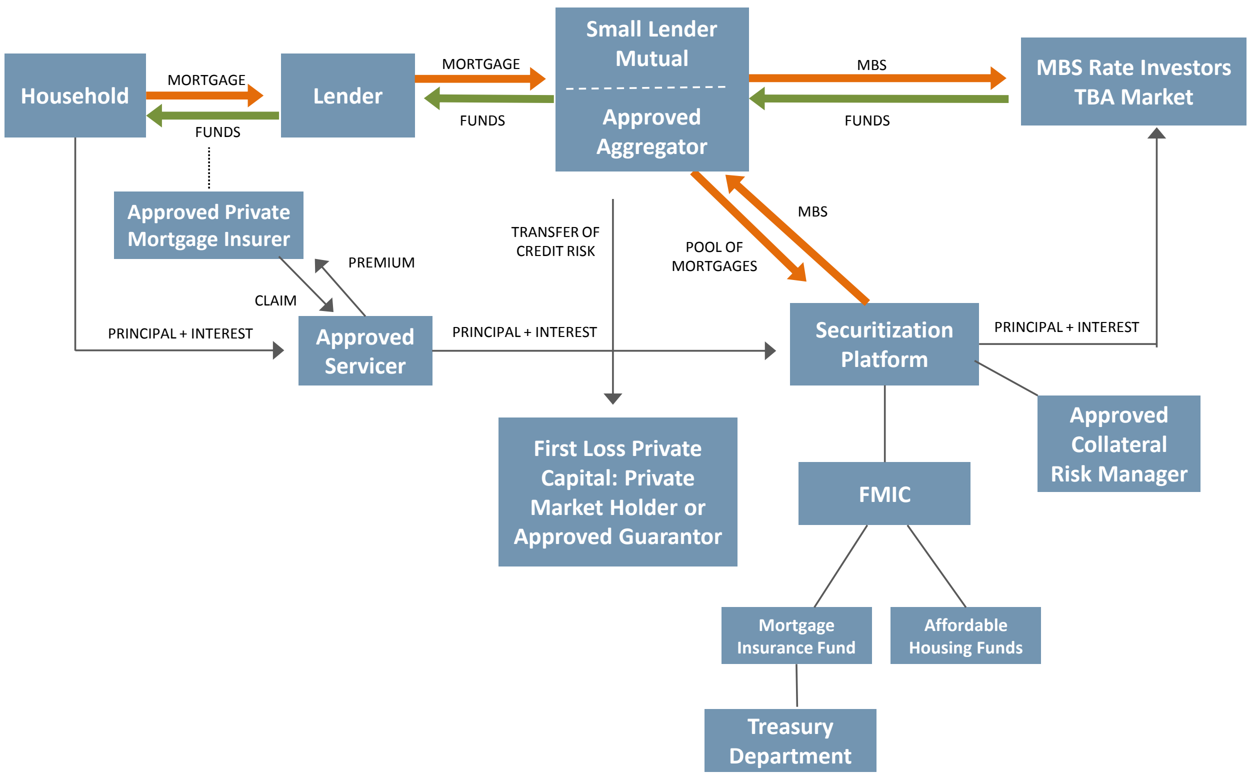
Figure 4. Functions of New System Previously Performed by the GSEs



Source: Figure created by CRS.

Figure 5 shows one potential example of how a mortgage in the new system could ultimately be funded. The lender would make a mortgage loan to a household. If the household does not have a large enough downpayment, the household or the lender may purchase private mortgage insurance from an Approved Private Mortgage Insurer. The lender could sell the mortgage to the Small Lender Mutual or another Approved Aggregator. The Mutual or Aggregator could pool mortgages, reach an agreement with private entities to assume the required first-loss position, and then send the mortgages to the Securitization Platform in exchange for an MBS that would have the FMIC guarantee. The guaranteed MBS could be sold to MBS Rate Investors in the TBA Market.

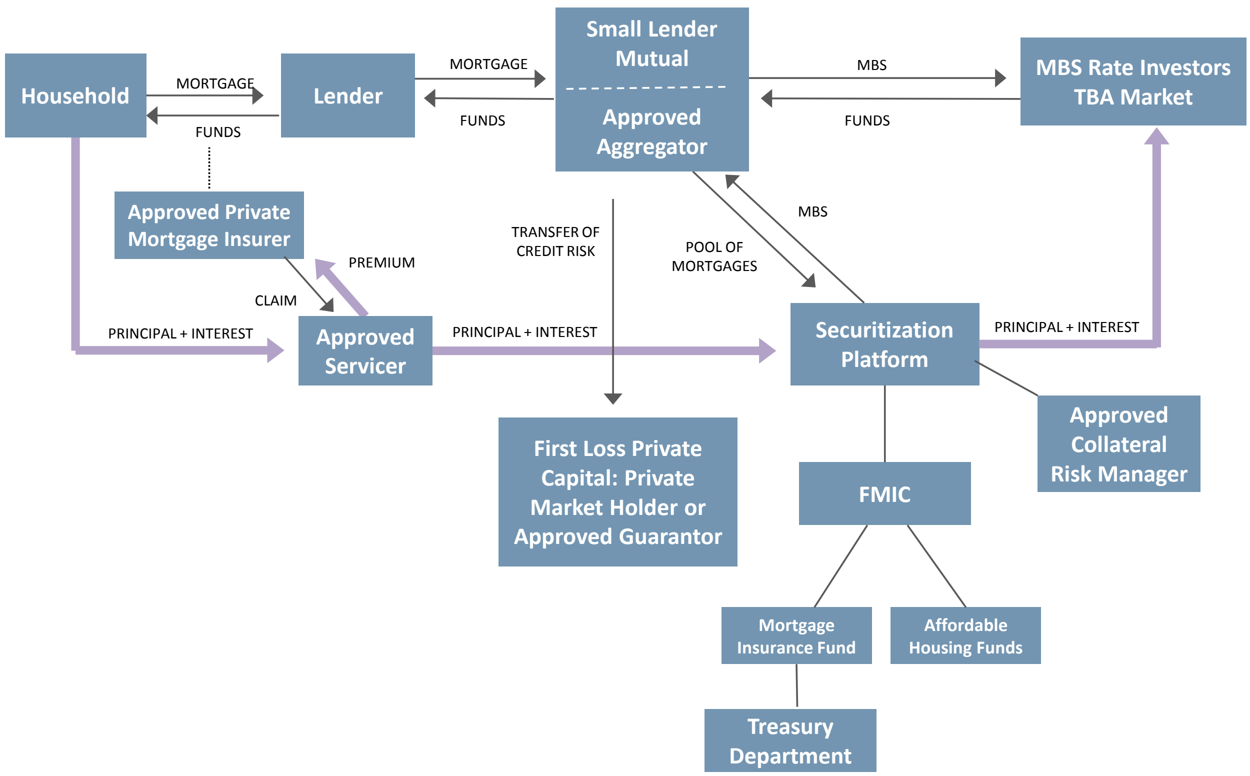
Figure 5. Funding of a Mortgage



Source: Figure created by CRS.

Figure 6 shows how the household's monthly mortgage payment could flow in the proposed system. The household would make its monthly payment to the Approved Servicer. The servicer may keep part of the monthly payment for its own compensation, pay the mortgage insurer as needed, and distribute a portion of the remainder to the MBS Rate Investors. Depending on the compensation structures used in the system, part of the monthly payment could also be used to compensate the system's other participants, such as the collateral risk manager. The Mortgage Insurance Fund and the Affordable Housing Funds could also be directly funded by a portion of a household's monthly payment, depending on the methods determined by the FMIC to distribute the required monies to those funds.

Figure 6. Borrower's Payments

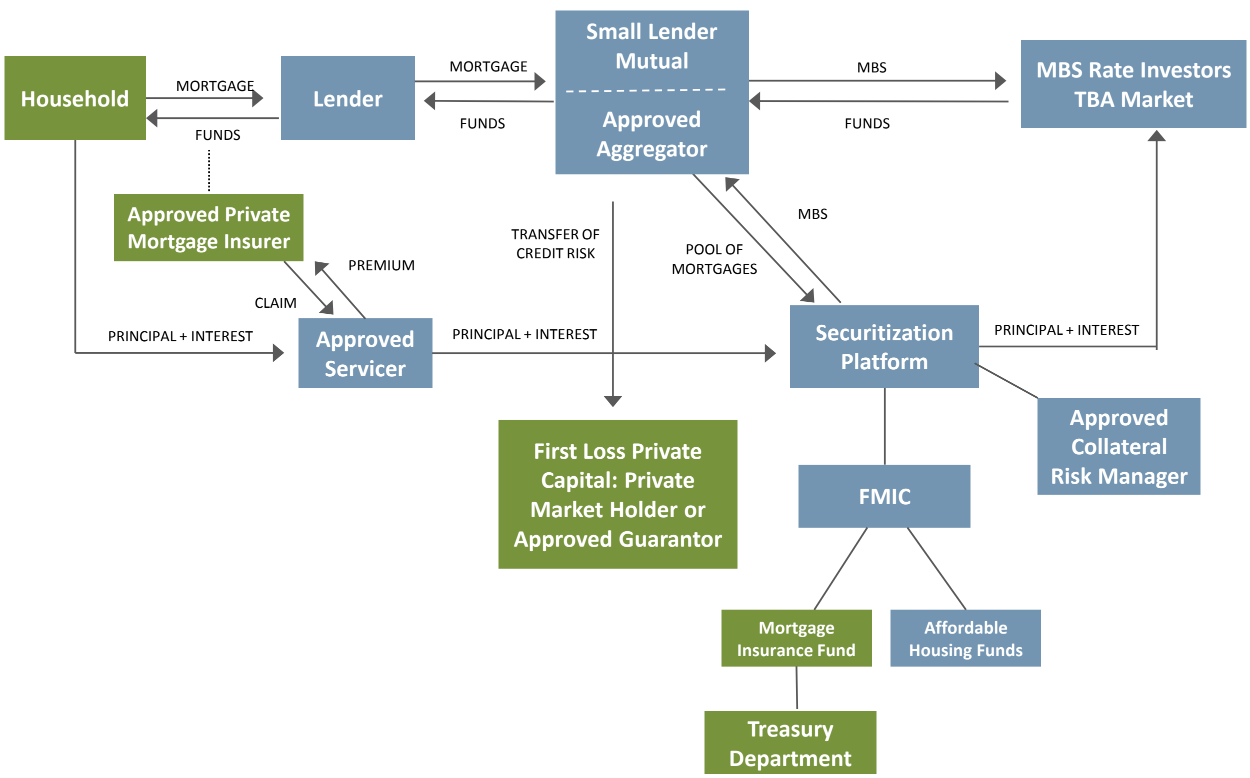


Source: Figure created by CRS.

Figure 7 shows the entities that may be exposed to credit risk in the proposed system. If the household does not make the required monthly payments and goes into foreclosure, the household may have the equity in its house wiped out. If the initial transaction involved mortgage insurance, the Approved Private Mortgage may have to pay a claim. The first loss private capital could also be exposed to losses. If losses exceed the amount required to be absorbed by the first loss position, the Mortgage Insurance Fund (MIF) would be drawn upon. The Mortgage Insurance Fund would have a full-faith-and-credit guarantee. Section 303 of the proposal states that "The full faith and credit of the United States is pledged to the payment of all amounts from the Mortgage Insurance Fund which may be required to be paid under any insurance provided under this title."

The conditions in which the MIF would be drawn upon differ depending on which method for providing first loss private capital is employed, Private Market Holder or Approved Guarantor. Under a capital markets execution, Private Market Holders would agree to bear losses of at least 10% of the MBS's value prior to the government guarantee being triggered. Under the guarantor execution, Approved Guarantors would pay investors any shortcoming in the amount that the investors are owed (such as due to delinquencies of the mortgages in the MBS) until the guarantor is insolvent, at which point the government guarantee would be triggered. The guarantor would have to hold 10% capital. The government guarantee is triggered through the capital markets option based on the performance of a particular security, but the guarantee for the guarantor option is triggered based on the performance of an entity, the approved guarantor.

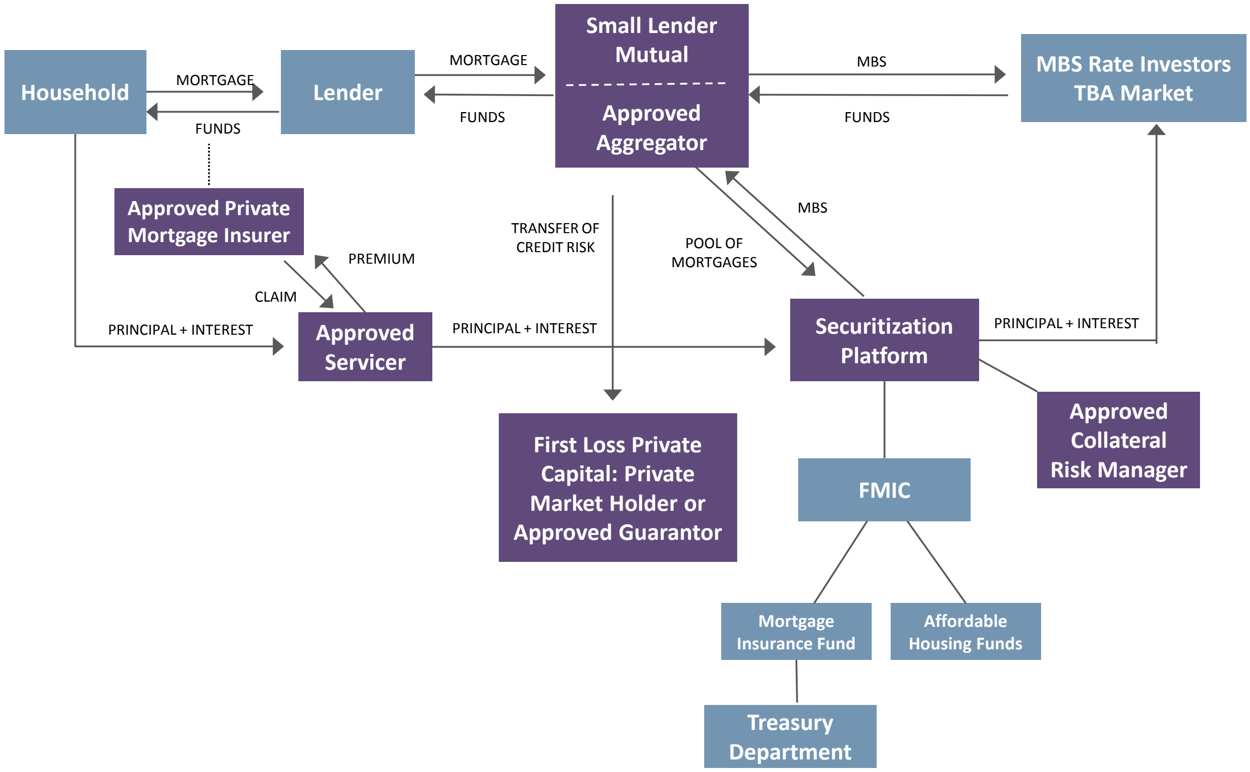
Figure 7. Credit Risk



Source: Figure created by CRS.

Figure 8 shows the entities that would be approved and, in some cases, regulated by the FMIC. If an approved entity is an insured depository or an affiliate of an insured depository, that entity would continue to be regulated by its primary federal banking regulator, but the FMIC would have some regulatory authority. As part of the approval process, the FMIC would verify that participants that apply for approved status satisfy certain criteria (some of which are listed in the proposal) and that the participants continue to meet the necessary conditions after being approved. The FMIC would also approve the credit risk-sharing mechanisms that could be used to transfer credit risk.

Figure 8. Approved or Regulated by FMIC



Source: Figure created by CRS.

Appendix. Glossary of Key Terms

Affordable Housing Funds –Three funds that would support affordable housing: the Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund.

Approved Aggregator – An entity approved by the FMIC to deliver eligible single-family mortgage loans to the Securitization Platform for securitization as a guaranteed MBS.

Approved Collateral Risk Manager – An entity approved by the FMIC to manage mortgage loan collateral, including tracking mortgage loan repurchases, managing any disputes, and other activities.

Approved Guarantor – An entity approved by the FMIC to guarantee the timely payment of principal and interest on securities collateralized by single-family mortgage loans and insured by the FMIC.

Approved Mortgage Insurer – An entity approved by the FMIC to provide private mortgage loan insurance on eligible single-family mortgage loans that collateralize guaranteed MBS.

Approved Servicer – An entity approved by the FMIC to service single-family mortgage loans.

First Loss Private Capital – The position or guarantee that is required to absorb any initial credit loss on a guaranteed MBS prior to the FMIC becoming obligated to make any payment of insurance.

FMIC – The Federal Mortgage Insurance Corporation.

MBS Rate Investors – Investors that buy MBS that have a credit guarantee. Rate investors are trading primarily based on interest rate risks and, because of the credit guarantee, not credit risk.

MIF – The Mortgage Insurance Fund.

Private Market Holder – The holder of a first loss position of a guaranteed MBS that is securitized using a capital markets execution.

Small Lender Mutual - The FMIC would establish a Small Lender Mutual that would help mortgage originators gain access to the secondary market and the FMIC guarantee. A Small Lender Mutual could apply to be an Approved Aggregator.

Securitization Platform – The securitization infrastructure regulated by the FMIC that would facilitate the securitization of mortgage loans.

TBA Market – The To Be Announced market, a forward market for selling Fannie Mae, Freddie Mac, and Ginnie Mae MBS in which the specific security sold in the transaction is not chosen at the time of the original trade but is chosen right before delivery. At the time of the original trade only a few basic criteria are agreed to.