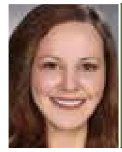

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Is Private Capital Returning to the Market?

Higher guarantee fees and lower conforming limits may bring big changes

About six years ago, the government-sponsored enterprises (GSEs) were placed into conservatorship, making their future uncertain, to say the least. Building on the Corker-Warner Housing Finance Reform and Taxpayer Protection Act introduced in June 2013, a new and more widely accepted bipartisan proposal, the Johnson- Crapo bill, was introduced this past March. The Johnson-Crapo bill intends to replace the GSEs with an entity much like the Federal Deposit Insurance Corp. (FDIC). This new entity, the Federal Mortgage Insurance Corp. (FMIC), aims to open up the doors for private capital to return and liquidity to improve.

The Johnson-Crapo bill, which proposes a position where private capital incurs first loss, intends to help the economy return to a more stable housing market through a federal guarantee for catastrophic loss, which in turn will generate private capital and ease taxpayers' burden in the event that the housing market faces another setback. The proposed bill includes a five-year plan focused on winding down the GSEs in favor of private entities regulated by the FMIC. The private investors would cover the first 10 percent loss followed by the FMIC guarantee.

Essentially, the FMIC would regulate the secondary mortgage market by establishing guarantee fees to insure against major losses on qualified mortgage-backed securities (MBS). The private capital entities would cover the 10 percent requirement through a private guarantee or a private risk-share agreement, which would kick in prior to the FMIC's guarantee.

The FMIC would impose additional requirements beyond the 10 percent-first position in the form of 10 basis points to benefit affordable-housing programs. The Johnson-Crapo bill specifically outlines how this money, which could raise as much as $5 billion per year, would be spent:

- **75 percent** of the funds would go toward a housing trust fund;
- **15 percent** would go toward a capital magnet fund; and
- **10 percent** would go toward a new market access fund, with the purpose of helping introduce innovative, yet responsible, lending products and services for single- and multifamily housing in underserved markets.

Even if the bill does not pass both houses of Congress this year, originators should know that private capital is slowly returning to the securitization market. For example, jumbo loans — i.e., loans that cost more than $417,000 in most areas of the country or more than $625,000 in higher-cost areas — are making a comeback with private capital investors. Recently, the Federal Housing Finance Agency (FHFA) and various legislators also have focused on decreasing the jumbo threshold.

Reducing the conforming limit at a rate of 5 percent per year for a period of five years would increase the jumbo loan market, and in turn ramp up private capital, as well. The FHFA reports that if these percentage cuts had been implemented before this year, then 1 percent of the total GSE loan volume could have switched into the jumbo market. The key to growing private capital in this respect will be to balance pricing that is attractive to consumers and that entices private capital investors for both jumbo and conforming MBS.

The FHFA is also exploring other initiatives to bring more private capital back to the mortgage market. For instance, a guarantee fee increase to 10 basis points and loan-level pricing adjustments of at least 25 basis points were supposed to go into effect this past March and April, but the impact of these changes is still being evaluated by the FHFA's new director, Mel Watt. If implemented, these hikes may encourage private capital investors to return to the MBS market. At a minimum, guarantee fees most likely will increase by at least 25 basis points in four states — Connecticut, Florida, New Jersey and New York, as foreclosure costs are significantly higher in these states than others.

Any GSE reform will impact investors, lenders, home prices, rates and, most importantly, borrowers, so changes must be carefully evaluated. The Johnson-Crapo bill has the potential to increase private capital and improve liquidity, and the FHFA's attempt to contract the GSEs will likely spark further positive change within the mortgage market.

Additionally, implementing risk-sharing options and evaluating appropriate guarantee fees could lead to strengthened competition and ultimately a more stable secondary market. On the downside, however, this will probably translate to higher costs to the consumer, which will further limit mortgage activity.

Transparency is the key to sparking private capital interest, clearly not a focus in the past private capital investment

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environment. In today's housing and investment industry, investor confidence is dependent on access to accurate loan origination and performance data. Originators should consider one thing for certain: GSE reform is on the horizon, as the Johnson-Crapo bill has already passed through the Senate Banking Committee and has moved onto the voting floor. Transitioning to an FDIC-like entity that takes on catastrophic insurance appears to be a likely reality — as does the return of private capital.