

## HOUSING FINANCE UPDATE

The Conundrum Continues...

AUGUST 2013

“Over the nearly four years since the recovery began, the economy has been held back by a number of headwinds. Some of these headwinds have begun to dissipate recently ... Notably, the housing market has strengthened over the past year...”

— Ben Bernanke, Chairman, Federal Reserve Board of Governors,  
May 22, 2013<sup>1</sup>

### Introduction

As we witness recovery in the housing markets evidenced by the continued rise in home price indices and inventory decreases, it is all too easy to overlook that today's housing market is almost exclusively supported by the government—in effect, the housing finance system has been largely nationalized. Many policymakers, including the Obama Administration and the Financial Stability Oversight Council (FSOC), have articulated the desire to reduce government support and attract more private capital to the housing market. Notwithstanding this objective, there continues to be policy and regulatory initiatives that discourage the return of private capital to the sector. We are encouraged by and commend the President's recent speech on housing and the activity in the House of Representatives and the Senate to address comprehensive housing finance reform. Despite these developments, most observers consider the probability of comprehensive housing finance legislation reaching the President's desk to be relatively low in the near term and see this activity as laying the groundwork for longer-term reforms. In the absence of legislative reform, multiple regulatory agencies continue to forge ahead with piecemeal efforts that are effectively altering the current housing finance landscape.

This *ViewPoint* is the fourth in a series on housing finance policy. In this paper, we review the status of the housing market and a number of the legislative, regulatory, and policy initiatives underway. As we have indicated in previous papers, BlackRock supports a comprehensive and holistic approach to housing finance reform that recognizes the need for, and supports the presence of, a government guarantee in the mortgage market. With that said, we also recommend judicious reduction of the government's current role in the mortgage market and a more normalized level of private capital. Ultimately, the return of private capital to the mortgage market requires a transparent process that provides certainty and respect for the rights of investors.

<sup>1</sup> Chairman Ben S. Bernanke. "The Economic Outlook. Before the Joint Economic Committee, U.S. Congress, Washington, D.C." May 22, 2013.

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**Barbara Novick**  
Vice Chairman and  
Head of Government  
Relations



**Kevin Chavers,**  
Managing Director,  
Government Relations



**Alexis Rosenblum,**  
Associate, Government  
Relations

## A Fragile Recovery

The US housing market is indeed recovering. From isolated pockets of recovery a year ago, price increases have broadened nationally (although certain regional disparities remain). The US housing market finally appears to have bottomed out. In March 2012, and the subsequent recovery in US home prices has exceeded expectations. As of May 2013 nationwide prices have rebounded more than 16% from the trough, but remain more than 24% below their pre-crisis peak<sup>2</sup>. Leading indicators (i.e. pending home sales, declining inventories, and improving demand) all point to continued price rises (see Figure 1). Refinancing and mortgage modifications have eased the debt burden for borrowers and, according to Zillow's Q1 2013 Negative Equity Report, rising prices are predicted to reduce the number of underwater homes by 1.5 million by next year. Additionally, despite the recent rise in mortgage rates, affordability is near historical highs (see Figure 1).

Despite the recent market recovery, the foundation is still fragile and a number of impediments remain. One issue is the activity of housing investors rather than homeowners—much of the recent price rebound has been spurred by investors. More than half of purchasers pay cash for distressed properties<sup>3</sup>. As Figure 1 illustrates, inventories have fallen. However, the potential re-entry of this inventory to the market may impact prices. Structural impediments, such as weak income growth and high unemployment, as well as burgeoning student loan debt, have encouraged some to abandon or postpone homeownership. The homeownership rate has fallen to 65% after peaking near 69% before 2008, according to the US Census Bureau. While this is concerning, it also points to a potential source of demand when investors sell properties. Furthermore, nearly 7% of mortgage loans outstanding remain delinquent<sup>4</sup>. Finally, credit is constrained as a result of tightened underwriting and the regulatory concerns of lenders.

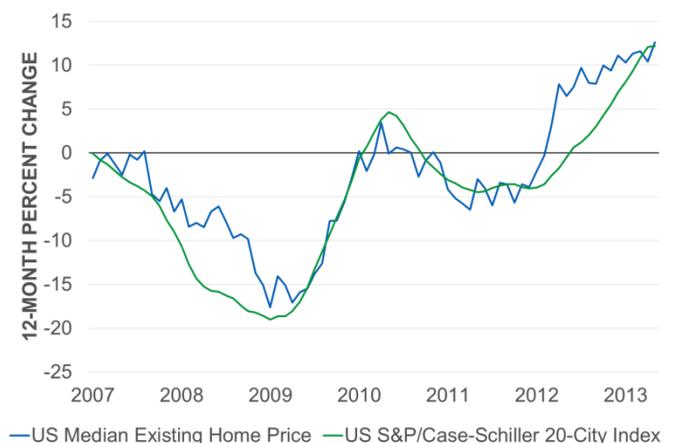
### Extensive Government Support

The housing market recovery has largely been aided by the extraordinary current levels of government support—the mortgage finance market remains almost entirely dependent on the government. Nearly 100% of newly originated mortgage loans benefit from government backing<sup>5</sup>. Private-label securitizations have virtually disappeared in the US mortgage market and agencies (i.e. GSEs, Ginnie Mae) still account for almost 100% of new MBS issuance<sup>6</sup>.

Another vital factor supporting the housing market is the Federal Reserve's highly accommodative monetary policy and its mortgage buying program. Under its third round of quantitative easing (QE3) the Fed is buying \$40 billion of

**Figure 1: HOUSING MARKET INDICATORS**

#### US Home Prices



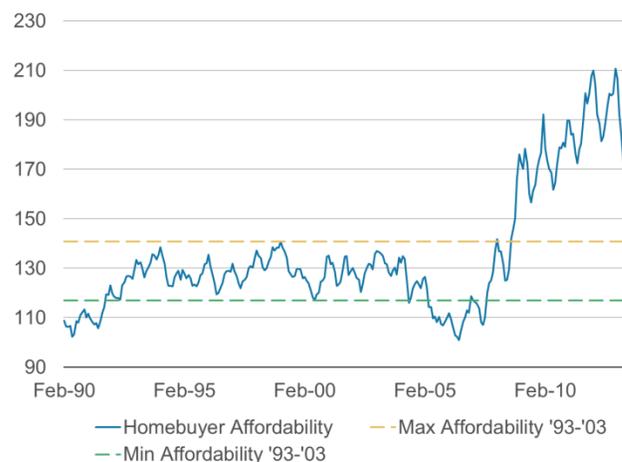
Source: National Association of Realtors, S&P Dow Jones Indices. As of May 2013.

#### US Existing Homes Sales Inventory



Source: National Association of Realtors. As of June 2013.

#### Affordability Near Historical Highs



Source: National Association of Realtors. As of May 2013.

2 S&P/Case-Schiller 20-City Composite Home Price Index.

3 DataQuick, Morgan Stanley Research.

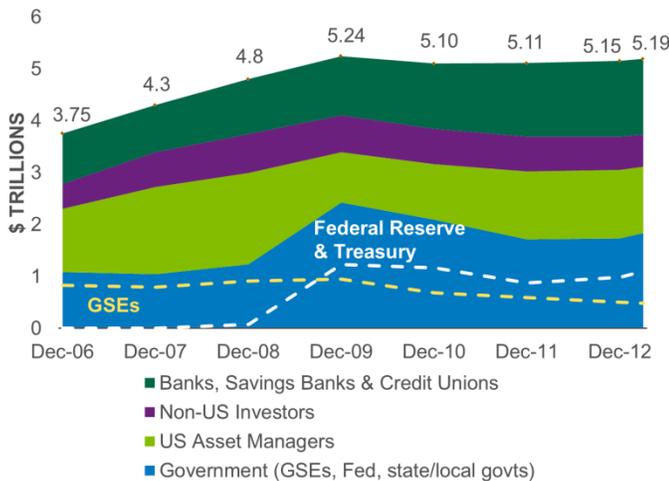
4 "Mortgage Delinquencies, Foreclosures Continue to Drop". Mortgage Bankers Association. Press Release. August 8, 2013. Seasonally adjusted delinquency rate.

5 CPR & CDR Technologies, Inc. As of July 2013.

6 "US Mortgage-Related Issuance and Outstanding". SIFMA. As of July 2013. [www.sifma.org](http://www.sifma.org).

agency mortgage-backed securities (MBS) a month, in a bid to keep mortgage rates low and stimulate the housing market. Recent comments made by Federal Reserve Chairman Ben Bernanke have made it clear that the bond buying program is not on a preset course, and the program could remain intact, increase or decrease, depending on the state of employment and inflation<sup>7</sup>.

**Figure 2: GOVERNMENT SUPPORT FOR AGENCY MARKET**



Source: Nomura Securities International Estimates. As of March 2013.

## Consensus Goal – Attract More Private Capital

Some five years since the financial crisis, the fragile state of the housing recovery and the significant level of government support attests to the need for comprehensive housing finance reform. In its 2013 Annual Report, the FSOC, a group comprised of heads of key US regulatory agencies, cited the housing market’s continued reliance on government support as an ongoing vulnerability. As a result, the FSOC indicated that, “Increasing the presence of private capital in assuming credit risk in housing finance remains a priority.” In their February 2011 report to Congress, the US Department of the Treasury (Treasury) and US Department of Housing and Urban Development (HUD) called for a plan where “private markets will be the primary source of mortgage credit and bear the burden for losses” (subject to strong oversight and standards for consumer and investor protection). Likewise the President’s housing policy speech in Phoenix and the House Financial Services and Senate Banking Committees’ bills currently under consideration, all assume increased participation from the private sector (see discussion on p. 6).

## Inconsistent Policy Landscape

While policymakers and recent legislative proposals have acknowledged that the current housing market recovery is not

## WHAT IS FSOC?

The Dodd-Frank Wall Street Reform and Consumer Protection Act created the Financial Stability Oversight Council (FSOC) comprised of 10 voting members and 5 non-voting members. Seats are held by heads of specified regulatory agencies in the US. The FSOC is tasked with “identifying risks and responding to emerging threats to financial stability”. The FSOC is chaired by the Secretary of the U.S. Department of Treasury.

### COMPOSITION OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL

#### (10) Voting Members

<b>Treasury Secretary (Chair)</b>	Jack Lew
<b>Federal Reserve Chairman</b>	Ben Bernanke
<b>Comptroller of the Currency</b>	Thomas Curry
<b>SEC Chairman</b>	Mary Jo White
<b>FDIC Chairman</b>	Martin Gruenberg
<b>CFTC Chairman</b>	Gary Gensler
<b>FHFA<sup>1</sup> Director</b>	Edward DeMarco ( <i>acting</i> )
<b>NCUAB<sup>2</sup> Chairman</b>	Deborah Matz
<b>CFPB<sup>3</sup> Director</b>	Richard Cordray
<b>Insurance Industry Rep</b>	Roy Woodall

#### (5) Non-Voting Members

<b>OFR<sup>4</sup> Director</b>	Richard Berner
<b>FIO<sup>5</sup> Director</b>	Michael McRaith
<b>A state insurance commissioner</b>	John Huff
<b>A state banking supervisor</b>	John Ducrest
<b>A state securities commissioner</b>	David Massey

As of July 31, 2013.

Acronym Definitions: 1) Federal Housing Finance Agency; 2) National Credit Union Administration Board; 3) Consumer Financial Protection Bureau; 4) Office of Financial Research; 5) Federal Insurance Office

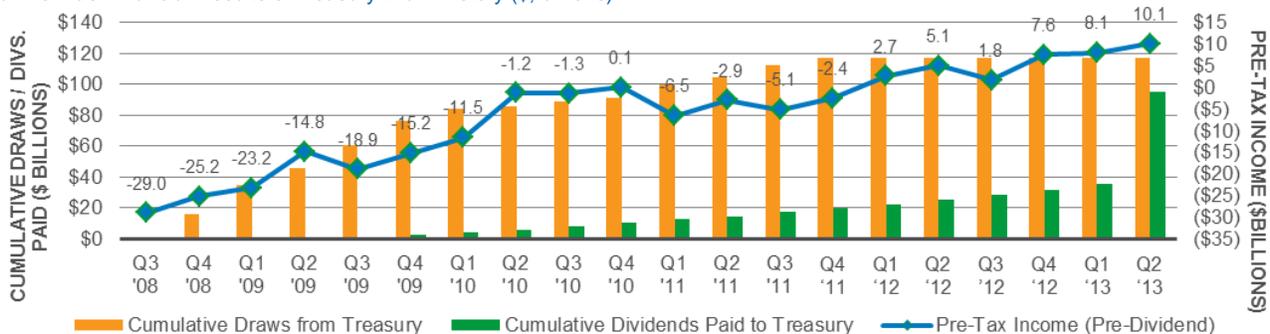
sustainable without the return of private capital, many housing policy initiatives to date have been fragmented and in some instances, effectively discourage private capital from the sector. The sheer number of initiatives and the array of people and agencies involved (see figures 3 and 4) is daunting. For example, there has been—and continue to be—a myriad of legislative principles, proposals, programs, settlements, and regulations, including the continued implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), and state and local initiatives. Figure 4 highlights the confusing array of housing-related initiatives. This lack of coordination and clarity is further exacerbated by the uncertainty surrounding the confirmation of a new Director of the Federal Housing Finance Agency (FHFA), which could have significant implications for the future of Fannie Mae and Freddie Mac.

<sup>7</sup> Federal Reserve issues FOMC statement. Press Release. July 31, 2013. Board of Governors of the Federal Reserve System. [www.federalreserve.gov](http://www.federalreserve.gov).



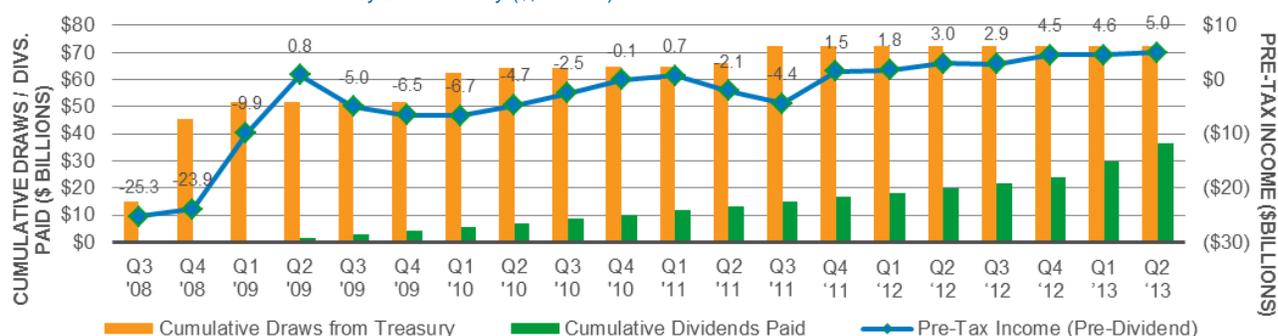
**Figure 5: GSE FINANCIAL SITUATION HAS IMPROVED**

Fannie Mae Financial Results & Treasury Draw History (\$, billions)



Based on net worth of \$62.4 billion as of March 31, 2013, Fannie Mae's dividend obligation to Treasury was \$59.4 billion for June 2013\*.

Freddie Mac Financial Results & Treasury Draw History (\$, billions)



Based on net worth of \$10.0 billion as of March 31, 2013, Freddie Mac's dividend obligation to Treasury was \$7.0 billion for June 2013.

Notes:

\* A release of \$50.6 billion in valuation allowance on deferred tax assets resulted in a reported net income of \$58.7 billion in Q1 2013 for Fannie Mae. After the \$59.4 billion June payment, Fannie Mae has paid an aggregate of \$95.1 billion in cash dividends to Treasury since conservatorship began.

Source: Fannie Mae, Freddie Mac.

The patchwork of housing reform efforts creates uncertainty and suggests a lack of political will and path to achieving a solution-oriented policy objective. We remain concerned about investors' perception of significant policy risk caused by this lack of a clear and consistent approach to housing policy.

## Government-Sponsored Enterprise (GSE) Reform

Much of the focus of current housing finance policy is centered on the reform and/or elimination of the predominant housing GSE's: Fannie Mae and Freddie Mac. Almost five years after the implementation of the conservatorship, the GSEs remain under government control and their share of market dominance has increased. A number of GSE-related bills have been introduced in Congress over the past five years. However, until recently, most of these bills appeared to be political statements or "messaging" bills rather than practical solutions-oriented legislation. More recently, we have seen comprehensive legislation introduced in the Senate and the House of Representatives, and President Obama has spoken publicly about the need to reform these agencies. Importantly, the FHFA, as conservator of Fannie Mae and Freddie Mac, is implementing a strategic plan that seeks fundamental reforms of Fannie Mae, Freddie Mac, and the housing finance system.

The environment for GSE reform is further complicated by recent positive financial performance resulting from the improvements in the underlying housing market, the GSEs' dominant market share, and increased guarantee fees (g-fees). In fact, Fannie Mae and Freddie Mac have recently produced record earnings (see figure 5). The GSE contributions to the US Treasury have materially contributed to deficit reduction and, coupled with increased tax receipts, have helped delay the need to raise the debt ceiling. Their increased contributions to the Treasury and integral role in supporting the recovery of the housing markets highlights the complexity and care which must be considered in undertaking significant reforms of the GSE's. Some observers believe that their increased role in deficit reduction make it more difficult to wind them down. However, this view is far from universally held. Others argue that the ideal time to reform the GSEs is once they have completed the effective repayment of the amount of support they received from taxpayers during the financial crisis. The outcome remains an open question that has been further complicated by a series of recent legal challenges by junior preferred shareholders of Fannie Mae and Freddie Mac and affordable housing groups regarding amendments to the Senior Preferred Purchase Agreement by the US Treasury.

Given the importance of the GSEs in the primary and secondary mortgage markets today, any reform of the GSE's

must include a clear plan for an orderly transition to a new system that does not impair liquidity or pose a threat to existing investors or interfere with the orderly functioning of this vital multi-trillion dollar market. It is also imperative that any reforms and the resultant transition to a future system do not impair the current recovery or the long term stability of the housing market.

*“any reform of the GSE’s must include a clear plan for an orderly transition to a new system that does not...interfere with the orderly functioning of this vital multi-trillion dollar market”*

### Legislative Initiatives

Notwithstanding the recent financial performance of the GSE’s, a bipartisan dialogue around GSE reform has emerged. In February 2013, the Housing Commission of the Bipartisan Policy Center (BPC) released a report that, amongst other things, proposed winding down and eventually eliminating Fannie Mae and Freddie Mac after a multi-year transition period. The plan called for the replacement of the GSEs with a corporation that would be fully owned by the US government to provide a “limited catastrophic government guarantee”. This proposal is largely in line with the so called, “Option Three” of the Obama Administration’s 2011 white paper<sup>8</sup>, which has recently defined a large component of the framework of the current GSE reform dialogue.

**Corker-Warner Bill:** A bill, entitled “Housing Finance Reform and Taxpayer Protection Act”, was recently introduced by Senators Corker and Warner (the “Corker-Warner Bill”). This legislation would replace Fannie Mae and Freddie Mac with an entity called the Federal Mortgage Insurance Corporation (“FMIC”), a single government guarantor, which would charge guarantee fees (g-fees) to provide a full-faith-and-credit backstop on MBS, provided that a private guarantor took a 10% first-loss risk position in front of the government guarantee. The stated goal of the establishment of FMIC is to facilitate liquidity and the availability of mortgage credit in the secondary market, while protecting taxpayers from having to absorb losses. The bill also proposes that the FMIC establish a mortgage insurance fund, maintain a database of uniform loan level information on eligible mortgages, develop standard uniform securitization agreements, and oversee the common securitization platform currently being developed by the FHFA. Fannie Mae and Freddie Mac would be wound down

over a period of time, with their assets available to the new entity. This bill has garnered attention as the first bipartisan piece of legislation addressing comprehensive reforms. We are encouraged by the bill’s preservation of a full-faith-and-credit guarantee of securities and the support of ten Senators (half Republicans and half Democrats) for this bill. The bill is very complex and raises a series of both substantive and political questions. For example, it is unclear whether there is sufficient private capital available in the market to assume the 10% first loss credit risk position, given the size of the existing agency mortgage market. The 10% first loss capital cushion also seems excessive, given that according to Moody’s Analytics “5% capitalization is more than adequate to weather future financial storms”<sup>9</sup>. Assuming the private capital to support the 10% first loss capital cushion is available, this is likely to be an expensive requirement that would unduly impair borrowers’ access to mortgage credit and reduce liquidity, thereby impeding the housing recovery and adding a substantive burden on future homeowners. In order to be enacted into law, the Corker-Warner Bill needs to clear a number of political hurdles. For example, the bill does not yet enjoy the support of the Chairman or ranking member of the Senate Banking Committee. While they have expressed support for moving forward with GSE reform, neither has signed on as a co-sponsor of the Corker-Warner Bill. Furthermore, Senate Majority Leader Harry Reid recently questioned the President’s recommendation to eliminate Fannie Mae and Freddie Mac (see discussion on the following page). Accordingly, the bill’s pathway to final passage remains uncertain.

**Hensarling Bill:** The leadership of the House of Representatives Committee on Financial Services has espoused a different philosophy than the Corker-Warner Bill. On July 11, 2013, Chairman Hensarling introduced a bill entitled “Protecting American Taxpayer and Homeowners Act” (the “PATH Act” or the “Hensarling Bill”). While the Hensarling Bill does indeed seek to attract more private capital to the sector, it calls for no future role of government support in the housing finance market beyond a reduced role for the Federal Housing Administration (FHA). This bill proposes to eliminate Fannie Mae and Freddie Mac after a five year period and to accelerate the reduction of their retained portfolio. It would not replace the GSEs with any form of government guarantee. The bill would also re-define the mission of FHA by limiting its support to first time and low-to-moderate income homeowners. It would also reduce the FHA mortgage insurance coverage to 50% (down from 100%)<sup>10</sup>. The bill calls for the maintenance of a privately owned securitization platform and seeks several changes to the

8 Reforming America’s Housing Finance Market: A Report to Congress”. The Department of the Treasury and the U.S. Department of Housing and Urban Development. February 2011. [www.treasury.gov](http://www.treasury.gov)

9 Zandi, Mark and Christian de Ritis. “Evaluating Corker-Warner”. Moody’s Analytics. July 2013.

10 Note that these loans would still be eligible for inclusion in Ginnie Mae securities which maintain a full-faith-and-credit guarantee at the security level. However, this may shrink the overall market for FHA loans.

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) housing requirements and seeks to spur development of the covered bonds market. Finally, the bill would disallow any institution that utilized eminent domain (see discussion on p. 9) to seize mortgages from being eligible for GSE or FHA backing of any loan in that jurisdiction for ten years. The bill also raises a host of substantive and political questions<sup>11</sup>. The elimination of any form of government guarantee would likely materially impair the availability and increase the cost of mortgage credit. The Hensarling Bill passed out of the House Financial Services Committee on a straight party line vote on July 24, 2013. However, most observers place a low probability on the Hensarling Bill moving forward to final passage.

*“The elimination of any form of government guarantee would likely materially impair the availability and increase the cost of mortgage credit.”*

**President Obama’s Speech:** On August 6, 2013, President Obama delivered a policy speech on housing in which he acknowledged the need to attract more private capital to the housing sector and supported a limited role for government in the housing finance system with the overall goal of improving access and affordability of homeownership. Specifically, the President laid out four core principles for housing finance reform: (i) private capital should be at the center of the housing finance system with a more limited role for government; (ii) ensure no more taxpayer bailouts for the GSEs by winding down Fannie Mae and Freddie Mac; (iii) maintain widespread access to 30-year fixed rate mortgages; and (iv) support affordability and homeownership for first-time

buyers as well as access to home rentals for those who cannot afford to buy a home. This set of principles is quite similar to “Option 3” from the Administration’s 2011 paper<sup>8</sup>. In this speech, President Obama indicated support for bi-partisan solutions, without explicitly endorsing any particular piece of legislation. Finally, President Obama praised Congressman Mel Watt as the nominee for Director of the FHFA and encouraged his confirmation without further delay.

As we have consistently stated in our principles for housing finance reform (see figure 6), we continue to believe that the retention of a government guarantee is essential to any reform of the housing finance system which endeavors to serve a market of our size and efficiency. Further, it is vital that any such major legislation provide clarity and certainty regarding the scope of the guarantee to be provided. Moreover, an orderly transition must provide for fungibility of the existing GSE securities and any new entity securities, that would result from reform. These principles are vital to maintaining liquidity, without disrupting the efficient functioning of the mortgage markets. It is essential for every housing finance reform proposal to be evaluated against these principles and the resultant impact on the stability of the housing market.

*“an orderly transition must provide for fungibility of the existing GSE securities and any new entity securities”*

#### Federal Housing Administration (FHA) Reform

The Senate Banking Committee recently voted the FHA Solvency Act of 2013 out of committee. This bill proposes to raise the minimum for the Mortgage Mutual Insurance Fund’s capital reserve ratio to 3%. If the capital ratio did not meet

<sup>11</sup> In response to the Protecting American Taxpayers and Homeowners (PATH) Act the Democrats of the House Financial Services Committee released a series of housing finance reform principles on July 18, 2013.

**Figure 6: BLACKROCK PRINCIPLES FOR HOUSING FINANCE REFORM**



certain targets as it builds to the new minimum ratio, the bill would require HUD to take immediate action to address the shortfall. Additionally, the bill would increase the required minimum annual mortgage insurance premiums to improve long-term solvency of FHA. Premium levels would be re-evaluated annually to ensure that the premiums cover loans' expected risk and maintain the capital reserve ratio. This provision is designed to reduce the need for a taxpayer bailout of FHA. Additionally, the bill would require HUD to evaluate and revise, as necessary, underwriting standards using criteria similar to the CFPB's Qualified Mortgage (QM) rule. HUD would be required to consolidate guidelines for lenders and servicers regarding the requirements, policies, processes, and procedures that apply to loans insured by FHA. HUD would also be provided with new tools to hold lenders accountable for issuing inappropriate or fraudulent mortgages. Further, the bill would give HUD more regulatory power to stabilize the FHA's reverse mortgage program. This bill does not seek to reduce the insurance coverage of FHA nor redefine its mission like the Hensarling Bill would. We are somewhat more optimistic about the movement of FHA stabilization legislation.

### Federal Housing Finance Agency (FHFA) Initiatives

Despite the uncertainty regarding the prospects for comprehensive housing finance reform legislation, many regulators are forging ahead with initiatives that are resulting in significant, albeit piecemeal, reforms of the housing finance system. The FHFA, as conservator of the GSEs, and pursuant to its "Strategic Plan for the GSE's", is spearheading a host of initiatives. The FHFA has called for the building of a new infrastructure for the secondary mortgage market. It is pursuing the implementation of this objective via a directive to Fannie Mae and Freddie Mac to jointly develop and own a common single securitization platform. The GSE's are also seeking to implement a Uniform Mortgage Data Program aimed at enhancing loan level disclosures to provide the markets with greater transparency, allowing the market to better understand and ultimately price and absorb additional credit risk. FHFA's strategic plan also calls for the contraction of the GSEs' dominance in the marketplace. In the case of the single family guarantee business, this has resulted in a steady increase of g-fees to adequately price for risk by more closely approximating private market pricing for comparable risk, in an effort to diminish the market's reliance on the GSE execution<sup>12</sup>. Furthermore, the GSE's have been actively evaluating alternative forms of credit risk dispersion through

credit-linked notes, senior-subordinate structures, risk sharing, pool insurance, etc. FHFA has directed each of the GSE's to execute \$30 billion (notional) of such transactions by the end of the year. The objective of these non-standard execution transactions is to develop a better understanding of market pricing for such credit risks as well as the ease of execution. These efforts are designed with the goal of attracting more private capital to absorb additional credit risk and to reduce the GSE's footprint<sup>13</sup>. Additionally, FHFA has also called for an accelerated disposition of "illiquid" assets held in the retained portfolios of the GSEs.

In addition to the activities mandated by the strategic plan, on April 11, 2013, FHFA directed Fannie Mae and Freddie Mac to extend the Home Affordable Refinance Program (HARP) by two years to December 31, 2015. In the wake of the financial crisis, a major impediment to a more rapid housing market recovery and lower mortgage default rates has been the inability of a current borrower with a high mortgage rate to take advantage of lower rates through refinancing. To help these borrowers, HARP was implemented as a tool to extend credit to those borrowers who had been unable to access it due to falling home values<sup>14</sup>. As we have stated in previous *ViewPoints*, we believe HARP is an effective program and we commended its merits. That said, we should also note that markets value certainty and continued changes to the program's parameters heighten investors' concerns regarding uncertainty and policy risk, and may discourage private capital.

Reviewed in their totality, it becomes clear that the regulatory initiatives spearheaded by FHFA, are effectuating significant changes across the housing finance system. The FHFA initiatives have materially raised g-fees, tightened underwriting standards, and sought to build a securitization platform that will effectively serve as a utility to the marketplace. Further, the pursuit of alternative credit execution structures are aimed at informing policymakers and market participants regarding the capacity and cost of dispersing additional credit risk to private capital. Moreover, the implementation and extension of the HARP program has allowed underwater borrowers to more readily access the prevailing historically low interest rates and, thus, relieve their debt burden.

### Dodd-Frank Rulemakings

In addition to the GSE reform initiatives being implemented by FHFA, the regulatory agencies continue to promulgate key rulemakings required by Dodd-Frank which are important

<sup>12</sup> The FHFA has also considered varying g-fees by geography to reflect the costs imposed on investors and guarantors by different state lending laws.

<sup>13</sup> In fact, as of the date of this *ViewPoint*, Freddie Mac recently priced a structured agency credit risk transaction and Fannie Mae has undertaken a risk transfer transaction with a mortgage insurance company.

<sup>14</sup> The eligibility requirements for a HARP refinance provide that a loan must be owned or guaranteed by Fannie Mae or Freddie Mac and it must have been sold to Fannie Mae or Freddie Mac on or before May 31, 2009. The mortgage cannot have been refinanced under HARP previously unless it is a Fannie Mae loan that was refinanced under HARP between March 2009 and May 2009. The current loan-to-value (LTV) ratio must be greater than 80 percent and the borrower must be current on mortgage payments with no late payments in the last six months and no more than one late payment in the last 12 months.

to the future of the residential mortgage markets. They include the “Ability-to-Repay” rule and the definition of “Qualified Mortgage” (“QM”), National Servicing Standards, and the Risk Retention rule, including the definition of a Qualified Residential Mortgage (“QRM”).

#### **“Ability-to-repay” Rules And “Qualified Mortgage” Definition**

The “Ability-to-Repay” rules and the QM definition were released by the Consumer Financial Protection Bureau (CFPB) on January 10, 2013. The regulation is intended to protect consumers from irresponsible mortgage lending by requiring lenders to ensure prospective buyers have the “ability-to-repay” any mortgage that is given to them. It also effectively provides a safe harbor for originators such that they can quantify their downside risks.

A “Qualified Mortgage” (QM) was defined by the CFPB as a loan with no excess up-front points and fees. A QM cannot have certain “risky” features, such as terms greater than 30 years, interest-only payments, or negative amortization payments. A QM is generally considered to be a loan where the borrower generally has a debt-to-income (“DTI”) ratio less than or equal to 43%.

On balance, we are supportive of these rules as we believe they provide additional protections for borrowers and should improve the underlying credit quality of the loans. Moreover, the clear definitions afford investors transparency and more certainty regarding the underlying collateral.

#### **National Mortgage Servicing Standards**

The CFPB issued final “National Mortgage Servicing Standards” rules on January 17, 2013. The rules become effective on January 10, 2014. Specifically, the regulations: (i) standardize the minimum information and communications that must be provided to borrowers about their mortgages; (ii) establish standards for communication and intervention with delinquent borrowers and; (iii) require servicers to follow loss mitigation procedures and restricts dual-tracking<sup>15</sup>. We have consistently stated that we support clear and consistent national mortgage servicing standards and encourage their uniform implementation. We would additionally encourage uniform servicing standards to clearly delineate the roles and responsibilities of servicers vis-à-vis investors.

#### **Risk Retention Rules And “Qualified Residential Mortgage” Definition**

The Risk Retention rules for securitized assets and the related definition of Qualified Residential Mortgage (QRM), which would establish qualified credit standards that exempt issuers from credit risk retention requirements, have yet to be

issued. It is important that these definitions are consistent with the QM definition and National Servicing Standards. The regulations must not create an inherent conflict in the origination and subsequent securitization in issuance of residential mortgages. This is integral given the goal of attracting more private capital back to the sector, including the return of a robust private label MBS market. While there has been no clear indication of timing of their issuance, it is important for the orderly functioning of the residential mortgage markets that QRM syncs with QM<sup>16</sup>.

#### **Credit Rating Agency Reform**

Finally, the reform of the credit rating agencies pursuant to Dodd-Frank being considered by the SEC will also have a material impact on the re-emergence and functioning of the private label MBS market. We have addressed our views regarding credit rating agency reform in the [ViewPoint - Credit Rating Agencies: Reform, Don't Eliminate](#). We encourage regulators to develop a clear understanding of how investors use credit ratings and to establish agreement on the objectives of credit rating agency reform. In particular, we support measures that increase transparency of data underlying credit ratings decisions for investors, and we discourage measures that attack the fundamental business of credit rating agencies.

#### **Eminent Domain**

Given the policy objective of attracting more private capital to the housing finance sector, we are particularly troubled by the proposed misapplication of the “takings” powers of some municipalities. Over the past year, a number of local governments have considered the seizure of mortgages, which are in MBS trusts, by using “eminent domain” and forcing restructurings of performing loans. Without addressing the Constitutionality or legality of such an approach (which is currently being considered in the case of Wells Fargo Bank, N.A. and Deutsche Bank National Trust Company v. City of Richmond, California and Mortgage Resolution Partners, LLC), this concept is fundamentally at odds with the stated policy objective of attracting private capital to the sector. This distorted use of eminent domain is, in effect, an effort to take money from good-faith investors, everyday workers, savers and retirees who have invested their hard-earned dollars in these mortgages; their investments stand to be forcibly restructured under these proposed programs.

The use of eminent domain has largely been marketed to localities by an investment firm which stands to benefit significantly from this proposal at the expense of existing investors in MBS. Recently, several Members of Congress have publicly questioned this tactic. Further, in response to the Richmond decision to actually deploy this tactic, FHFA

<sup>15</sup> Where a servicer is simultaneously evaluating a consumer for loan modifications or alternatives at the same time that it prepares for foreclosure.

<sup>16</sup> See BlackRock comment letter. [Credit Risk Retention - Letter to Regulatory Agencies - July 28, 2011](#).

has expressed its concerns regarding this use of eminent domain and indicated its intention to act. While some municipalities have decided to abandon eminent domain proposals (e.g., Chicago, IL; Brockton, MA; and San Bernardino, CA), others continue to pursue the idea. Some argue that this is a local issue and is not yet ripe for a policy response. To the contrary, these proposals would have a profound impact on national housing policy and global markets. Furthermore, the city of Richmond, CA has taken steps to implement this initiative.

There is a relatively simple and direct national solution to quell the deployment of this inequitable scheme. The disqualification of the refinancing of such “taken” loans into FHA and agency mortgages would effectively end the use of this tactic. FHFA has indicated it may stop doing business within any locale that utilizes eminent domain to restructure mortgages<sup>17</sup>. HUD has indicated, given pending legal actions, that it does not yet know whether loans taken by eminent domain would be eligible for FHA insurance. The Hensarling Bill calls for the prohibition of loans from any jurisdiction which uses eminent domain to “take” mortgage loans from being eligible for loans backed by the GSE’s or FHA to “monitor developments” and “keep the Committee informed” regarding its refinancing of mortgages seized through eminent domain in various districts.

The nation’s system of housing finance relies on investors to provide crucial funds for borrowers. Eminent domain programs that reward a private entity at the expense of investors threaten the viability of this funding model. Eminent domain, if used to seize mortgages, will likely serve as another impediment to the return of private capital to the sector. It could also cripple the burgeoning, yet fragile, housing market recovery. Ironically, amid the recent surge in housing, the market is curing the problem eminent domain professes to fix without external intervention. According to Zillow, rising prices will reduce the number of underwater homes by 1.5 million by next year. We implore policymakers in Washington to not only speak out against this misguided and wasteful initiative, but also, to implement policies which restrict its use.

## Servicer Settlements

In addition to the misapplication of the use of eminent domain, there are regulatory initiatives which, in application, operate to dissuade the return of private capital to the sector. As highlighted in an earlier *ViewPoint*, we are concerned that the State Attorneys’ General servicing settlement allowed sanctions on servicers to unwittingly be “paid” by investors,

who were neither at fault nor represented in the negotiations and may even have been harmed by the servicer actions. Regrettably, the Office of the Comptroller of the Currency (OCC) and the Federal Reserve adopted the very same construct in their servicing regulatory settlement action. These types of actions deter investors from putting money at risk in the sector and are at cross-purposes with the public policy goal of attracting substantial amounts of private capital. They further speak to the continued need for a coordinated holistic approach to housing finance reform policy across all of the agencies and policy makers, and includes a seat at the table for investors.

## Conclusion

We are indeed in the midst of a welcomed recovery in the housing markets. House prices are on the rise, excess inventory is in decline, mortgage delinquencies are retreating, and affordability is at record levels. However, the historic levels of government support of the residential mortgage markets highlight the fragility of the recovery and the need for sensible reform. We commend and are encouraged by recent developments including the President’s engagement on the topic and support for a continued, albeit more limited, government guarantee and role in housing finance as well as bi-partisan efforts to move forward with holistic reform legislation.

Notwithstanding the obscure path to passage of comprehensive legislation, regulators continue to effect fundamental changes to the housing finance system. Given, the current dominance of the GSE’s in the residential mortgage markets now and for the foreseeable future, the impact of these regulatory initiatives is quite pronounced. The lack of a holistic, coordinated approach with clear objectives results in initiatives which work at cross purposes with the broader goals of reform in many instances. This predicament underlies the need for a more holistic and coordinated solution as these initiatives have significant implications, not only on the near term housing policy landscape, but also on the future state of the housing market.

While there are differing views as to the proper degree of government support (from none to some), there is an emerging consensus that any serious approach to reform of the housing finance system must attract more private capital and reduce the unprecedented level of government support currently in place. We encourage policy makers to pursue comprehensive and well-defined solutions that respect investors’ rights and interests in order to ensure that the current housing market recovery is sustainable over the long term.

<sup>17</sup> “FHFA Statement on Eminent Domain”. Federal Housing Finance Agency. August 8, 2013.

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