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In Ironic Twist, Republicans Turn to Government Agency to Help Reduce Federal Mortgage Footprint

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WASHINGTON - Congressional Republicans have long been calling for the federal government to reduce its involvement in the U.S. housing market.

So it may come as a surprise that as they forge a path toward that goal, two leading GOP lawmakers are proposing measures that would take certain steps in the opposite direction by giving broad new powers to the federal government.

The idea is that once Fannie Mae and Freddie Mac are wound down, the government needs to replicate the industry-wide standardization that those two firms brought to the mortgage market.

"If you want standardization, then you need to create a monopoly of some sort," said Andrew Davidson, president of Andrew Davidson & Co., a provider of market research to mortgage bond investors.

The two bills by Sen. Bob Corker of Tennessee and Rep. Scott Garrett of New Jersey are early salvos in the effort to rebuild the nation's housing finance system.

Unlike Democrats and even some Republicans, Corker and Garrett are insisting that the federal government stop providing a guarantee, explicit or otherwise, to mortgage investors.

But certain provisions of the bills are getting a chilly reception from free-market conservatives. Those provisions, which are generally viewed favorably by industry participants, would give wide new authority to the Federal Housing Finance Agency, the agency established in 2008 to regulate Fannie, Freddie and the Federal Home Loan Banks.

Ever since Fannie and Freddie became wards of the government three years ago, the FHFA has been responsible for conserving their assets in order to reduce taxpayer losses. Under the new legislation, the FHFA's role would morph once again; it would be charged with establishing and updating a broad range of industry standards for private mortgage securitization.

The Republican lawmakers' decision to rely on a federal agency to establish such detailed rules of the road illustrates the difficulties inherent in any attempt to remove the federal government, which today provides more than 90% of all mortgage credit, from the market.

The GOP bills also reflect a growing belief in Washington, shared by industry players, that Fannie and Freddie provide more benefits to the secondary mortgage market than just the assurance that investors will be repaid.

Over the course of decades, the two government-backed mortgage giants established many of the standards - often referred to as the system's plumbing - that contribute to the enormous liquidity in the market for government-backed mortgage bonds.

"They created liquidity by generating these large pools of homogeneous product," said Brian Harris, a senior vice president at Moody's Investors Service.

The standards established by Fannie and Freddie are seen as particularly important for liquidity in the futures market for mortgage bonds, which until now has relied on government guarantees.

Industry participants fear that under a privatization scenario, the market's liquidity will decrease, and they view the creation of a new centralized authority to set market-wide standards as at least a step in the right direction.

"No one single policy or prescription can heal the housing market," Mark Fleming, chief economist at CoreLogic, a mortgage data firm, said during a recent hearing on Garrett's bill. "But regulatory certainty establishing underwriting uniformity, standardization of legal documents, and transparency is critical to the future of efficient allocation of private capital to finance mortgage assets."

But William Poole, a former president of the Federal Reserve Bank of St. Louis who is now a senior fellow at the **Cato Institute,** has taken a dimmer view of a government agency setting standards for a privatized mortgage market.

"Would anyone want to design a cell phone in Washington? I mean, that would be nutty," Poole said during an interview. "So why do we think we can do a better job than the private market can in designing a mortgage?"

Edward DeMarco, the acting director of the FHFA, said in congressional testimony last month that under Garrett's proposal, he would expect his agency's mission to change, but he suggested that the size of the agency's 520-member staff would remain similar.

"So as far as the size, I'm not sure how much it would change," DeMarco testified. "I think we would see a change in the direction and principal elements of work, from being safety and soundness examinations, to being assessing the mortgage market and establishing standards."

The two Republican bills seek to address many of the structural problems in the private mortgage securitization market, which grew quickly during last decade's housing bubble before grinding to a virtual halt.

Among those problems: the standards for obtaining a mortgage became extremely lax prior to 2007, and investors in mortgage bonds did not have access to much information about the individual loans that were bundled together in private mortgage-backed securities.

Later, when large numbers of mortgages began to go sour, disputes arose between the various parties to these transactions - including the banks that bundled and sold the mortgages, the firms that service the individual loans, the banks that serve as trustees to the deals, and the investors who own the mortgage bonds. An additional point of contention involves the obligations that mortgage servicers have to borrowers seeking to modify their loans.

Yet another set of legal questions involves Mortgage Electronic Registration Systems, Inc., or MERS, a company that was established by industry participants to build a central registry for transfers of property titles. Some courts have found certain practices by MERS to be in conflict with state laws.

Corker's bill seeks to address the latter problem by instructing the FHFA to develop - and then to maintain and operate - a national database for all title transfers. This system, based on the existing MERS system but codified into federal law, would be known as MERS 2.

Corker would also instruct the FHFA to develop a standard legal document, known as a pooling and servicing agreement, that sets the terms of the servicer's duties in a securitization deal. In the past the terms of such agreements have varied. The standardized new agreement would require that servicers establish a single point of contact for troubled borrowers, and it would establish a uniform mathematical model for determining whether a borrower qualified for a loan modification, among other details.

Garrett's bill, which was approved Wednesday by the House subcommittee in charge of oversight of the GSEs, includes similar language on the FHFA's role in establishing standards for mortgage servicers. But in several other respects, it would go further than Corker's proposal.

For example, Garrett's legislation would require the FHFA to establish various classes of mortgages, based on their risk of default, using factors such as the size of the down payment, the borrower's credit history, and the ratio between the borrower's income and the monthly payment.

Furthermore, under Garrett's bill, the FHFA would establish qualification standards for firms that want to bundle and sell mortgage bonds. Those standards would consider the experience and integrity of the firm's principals, and would include a requirement that audited financial statements be submitted to FHFA. Similar qualification standards would be established for the trustees in mortgage securitizations.

And those are really just the start of the FHFA's new duties under Garrett's proposal. Those standard-setting provisions have generally gotten a warm reception from industry players.

"We do think that the government does play a role in creating the right plumbing, standards, systems and structures," Chris Katopis, executive director of the Association of Mortgage Investors, said in an interview.

Kathryn Kelbaugh, vice president and senior analyst at Moody's, said that "Fannie and Freddie have something that's pretty good right now. It's a pretty good base."

At two recent congressional hearings on Garrett's bill, witnesses from the Mortgage Bankers Association, the American Securitization Forum, and the National Association of Realtors also responded positively to the provisions that would expand the responsibilities of the FHFA.

"By facilitating predictability and reliability, standardization helps investors measure their risk exposure," David Stevens, president of the Mortgage Bankers Association, testified. "Safe, well-defined product standards help consumers compare their financing options."

At times, some House Democrats seemed almost gleeful that a conservative Republican colleague was proposing an expanded government role in the mortgage market, even though the goal of the bill is to do so in a way that allows the federal government to unwind its guarantee.

"I believe that bringing certainty and uniformity to how mortgage-backed securities are underwritten, securitized, and sold is a useful goal," said Rep. Maxine Waters of California, the top Democrat on the House subcommittee that has jurisdiction over Fannie and Freddie.

Waters then said to Garrett, "I'm also pleased that you recognize that government should have a large role in creating clear rules of the road for this market."

This should not suggest that the two Republican bills offer an easy path to bridging the partisan divide over housing finance reform. Both measures would repeal the risk-retention provisions of the Dodd-Frank Act, an idea that draws opposition from Democrats. And there remains sharp disagreement in Congress over whether the government should remove its guarantee from the majority of the mortgage market.

Moreover, it remains unclear whether the ideas put forth by Garrett and Corker will be part of whatever package of housing finance reform eventually passes Congress. That legislative push is not expected to gather steam until 2013 at the earliest, and the president at that time will undoubtedly play a major role in the process.

Still, it is somewhat remarkable that the opening legislative bid from two Republicans known for their free-market views envisions such a significant role for the federal government.

Garrett, while expressing openness to ideas about how to improve the legislation, brushed aside Democrats' criticism that his legislation would create too big a government intrusion in the mortgage market.

"As if we haven't seen a significant intrusion into the housing finance market for the last few years," he said at a recent hearing.