Role of Private Capital
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Issue: What is the current and potential future participation of private capital in housing finance? What policy actions can enhance the role of private capital?

Why: There has been a transformation of the housing finance system post crisis, with a significant increase in the role of the government. Steps that can increase the role of private capital may create a more stable housing finance system and reduce risk to taxpayers.

Investments in mortgages generally have four broad categories of risk.

1. Funding
2. Interest Rate
3. Prepayment Risk
4. Credit Risk

Primary considerations for investors who provide funding (that is the actual cash that goes to borrowers) are concerned with the long term of mortgage lending versus the short term of their funding sources and therefore also with liquidity of their mortgage investments. Much of the private capital that provides for funding of mortgages utilizes a government guarantee either in the form of the TBA market with the GNMA or GSE guarantees (implied and supported by PSPA), Home Loan Bank advances or deposit insurance.

The Credit Risk Transfer (CRT) market has grown to over $30 billion outstanding covering over $1 trillion of mortgage loans at the same time the private label mortgage backed securities (PLMBS) has remained mostly dormant since the financial crisis. I believe the relative success of the CRT market is due to the following factors:

1. Senior and junior risk is independent due to separation of the TBA market from credit concerns
2. Bankruptcy remote operating companies rather than bankruptcy remote passive entities
3. Uniform industry standards for origination and servicing
4. Alignment of interest between the GSEs and the investors
5. Operational regulatory oversight by FHFA lowers some investor concerns (but may create others due to government actions in servicer settlements)

In order to maintain the smooth functioning of the CRT market, GSE reform should have the following features:

1. Government guarantee on senior bonds with a "deductible" by vintage to facilitate new investment during a housing downturn. Note that this implies that the guarantors would take large losses but would not need to fail to trigger payments under the guarantee
2. Risk retention by GSEs or successors to keep alignment of interest
3. Limited number of programs to avoid race to the bottom
4. Need capital rule that accommodate multiple sources on level playing field (possibly based on insurance regulation rather than banking regulation)

A strategy based on mutuals such as that proposed by the NY Fed authors and the DeMarco/Bright proposal would be one way to achieve these goals.

1. Government wrap of MBS
    a. by Vintage
    b. GNMA may be good mechanism
2. Transform (or return) Fannie Mae and Freddie Mac into originator owned mutuals
    a. Use CRT to shed 75% of risk
    b. Activity based capital