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I. INTRODUCTION

In an opening statement regarding new liquidity, risk management, and capital standards for banks, Federal Reserve Board (the “Board”) Governor Daniel K. Tarullo said, “[t]he most important contribution we can make to the global financial system is to ensure the stability of the U.S. financial system.”¹ This statement reflects the widespread and lasting effects of the 2008 financial crisis. Moreover, Tarullo was merely echoing the central mandate of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”).²

One of the enhanced prudential standards mandated by section 165 of Dodd-Frank is the newly approved minimum liquidity coverage ratio (“LCR”) which is intended to ensure the short-term stability of financial institutions during times of strained liquidity.³ To comply with the LCR, financial institutions will be required to maintain sufficient liquidity to withstand forecasted net cash outflows over a thirty-day period during a stressed economic scenario.⁴ Whether a financial institution has sufficient liquidity for purposes of the LCR is determined by the institution’s aggregate holdings of certain asset classes defined in the rule as High-Quality Liquid Assets (“HQLA”).⁵

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⁴ Id. For a full discussion of the Liquidity Coverage Ratio, see infra Part II.
⁵ Id.
This new rule and its definition of HQLA may have serious unintended consequences for housing finance reform efforts currently underway in Congress.\(^\text{6}\)

This Note argues that the recently adopted LCR rule must be accounted for in any housing finance reform bill passed by Congress, and may potentially require a rewrite of certain aspects of the rule in order to prevent serious harm to the primary and secondary mortgage markets, banks, and the U.S. economy.\(^\text{7}\) This Note focuses on the wisdom of excluding certain asset classes, namely private label mortgage-backed securities (“MBS”) and collateralized mortgage obligations (“CMOs”),\(^\text{8}\) from the LCR rule’s definition of HQLA.\(^\text{9}\)

The rule’s HQLA definitions are critical to the LCR calculation and may dramatically affect the assets financial institutions choose to hold on their balance sheets in order to comply with the LCR requirement.\(^\text{10}\) Should Congress eventually pass housing finance reform legislation, these investment decisions may be even more limited than

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6. See infra Part V.

7. This Note will not address the policy behind instituting a liquidity coverage ratio. For the purposes of this Note, it will be assumed that such regulation is necessary to ensure the adequate short-term liquidity of financial institutions. For a discussion on this topic, see Andrew W. Hartlage, Note, The Basel III Liquidity Coverage Ratio and Financial Stability, 111 Mich. L. Rev. 453 (2012) (discussing shortcomings of the LCR as a means of regulating liquidity), and Adam R. Lewis, Note, North Carolina Community Banks: Survival Strategies for Turbulent Times, 17 N.C. BANKING INST. 333, 343–44 (2013) (critiquing the LCR’s disproportionately negative impact on smaller community banks).

8. MBS generally break down into two categories: CMOs and mortgage pass-through securities (otherwise known as participation certificates). CMOs are backed by a pool of mortgage loans and/or pass-through securities and divided into multiple tranches with varying characteristics such as principal and interest payments, maturity dates, and payment priority among tranches. In contrast, pass-through securities entitle each holder to a pro rata share of the principal and interest payments made on the pooled mortgage loans. Mortgage-Backed Securities, U.S. SEC. & EXCH. COMM’N, http://www.sec.gov/answers/mortgagesecurities.htm (last updated July 23, 2010).

9. The final LCR rule refers generally to MBS as “[a] security issued by, or guaranteed as to the timely payment of principal and interest” and does not explicitly mention either CMOs or pass-through securities. Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61440, 61529 (Oct. 10, 2014) (to be codified at 12 C.F.R. pts. 50, 249 & 329). Therefore, given that both are MBS, this Note assumes that the language in the final LCR rule referring to MBS includes both CMOs and pass-through securities. Industry analysts are unsure how CMOs will be treated, but Credit Suisse analysts believe they will count as HQLA. Jody Shenn, Banks Left Guessing If Mortgage Bonds Liquid Under Rules, 103 Banking Rep. (BNA) No. 9, at 476, 476 (Sept. 5, 2014).

intended by the final LCR rule.¹¹ The housing finance reform bills currently being considered by Congress would wind down the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").¹² These government sponsored enterprises ("GSEs")¹³ are currently the primary issuers of MBS.¹⁴ GSE-issued MBS are designated as HQLA and included in the LCR calculation.¹⁵ However, private label MBS fall outside the rule’s definition of HQLA.¹⁶ Therefore, proposed housing finance reform legislation that would eliminate Fannie Mae and Freddie Mac might unintentionally eliminate MBS, as a whole, from inclusion in the LCR calculation.¹⁷

Without future GSE securitizations, the LCR rule will discourage financial institutions from holding MBS in their liquidity portfolios if the only MBS available do not count towards regulatory compliance.¹⁸ Such a shift in the allocation of capital away from mortgage securities has the potential to dramatically impact the housing finance market by drying up funds currently available for mortgage origination.¹⁹

¹¹. See infra Part IV.B.
¹⁶. Id. at 61464–65.
¹⁷. Two of the three legislative proposals currently before Congress would replace GSE MBS with either a new MBS issuing entity or an enhanced Ginne Mae. The question is whether or to what extent these new MBS would qualify as HQLA. See infra Part IV.A.
¹⁸. See Comment Letter from Christopher B. Killian, Managing Director, Head of Securitization, Sec. Indus. & Fin. Mkts. Ass’n, to the U.S. Dep’t of the Treasury (Aug. 8, 2014), available at http://www.regulations.gov/#!docketBrowser;rpp=25;po=0; dct=PS;D=TREAS-DO-2014-0005 (stating that the LCR may decrease liquidity in the secondary mortgage market by providing a disincentive to hold private label MBS).
This Note proceeds in four parts. Part II discusses the purpose and calculation of the newly finalized LCR rule and the financial institutions to which it applies (“covered companies”). Part III lays a quantitative foundation necessary to understand the broader economic implications of the LCR. Part IV discusses current legislative proposals to reform the housing finance market and the potentially dangerous interplay between this legislation and the LCR. Finally, Part V offers two alternatives for ameliorating the potential unintended consequences of the LCR on housing finance reform.

II. FINALIZED LIQUIDITY COVERAGE RATIO

A. Background and Purpose of the LCR

The LCR aims to improve the liquidity of large financial institutions. Specifically, the LCR purports to strengthen the financial stability of covered financial institutions by reducing their liquidity risk profile in conformity with the enhanced prudential standards mandated by section 165 of Dodd-Frank. On October 24, 2013, the Board adopted a proposed rule establishing the LCR. The Federal Deposit Insurance Corporation (“FDIC”) and the Office of the Comptroller of the Currency (“OCC”) (collectively with the Board, the “Agencies”) followed closely in proposing a “substantially identical” rule.


20. See infra Part II.
21. See infra Part III.
22. See infra Part IV.
23. See infra Part V.
26. Id.
27. J. PAUL FORRESTER & JASON H.P. KRAVITT, MAYER BROWN LLP, THE US BANKING
Agencies jointly issued a notice of proposed rulemaking on November 29, 2013, with a public comment period open until January 31, 2014. After considering the comments received during the public comment period, the Agencies approved a final rule for the LCR on September 3, 2014.

The final LCR rule is based on the international Basel III LCR standard promulgated by the Basel Committee on Banking Supervision. While the final LCR generally adheres to the Basel III LCR, it diverges in several material provisions discussed more fully below. Tarullo described the proposed LCR as a “super-equivalent” to the Basel III LCR because it contains stricter provisions than those of the Basel III LCR. Any departure from the international standard may significantly affect the regulatory burden, operating costs, and competitive advantage or disadvantage of financial institutions relative to financial institutions in countries that adopt the Basel III LCR.


31. See infra Part II.C.


33. A country that adopts stricter provisions than called for in the Basel III LCR rule risks hampering the competitiveness of its financial institutions. See Donald N. Lamson et al., Shearman & Sterling LLP, Basel III Framework: Liquidity Coverage Ratio (US Implementation) 4 (Sept. 29, 2014), available at http://www.shearman.com/-/media/Files/NewsInsights/Publications/2014/09/DoddFrank—Liquidity-Coverage-Ratio-Rule-Finalized-FIA-and-FR-092914.pdf (stating that the EU has already adopted LCR rules that are consistent with the Basel III LCR and less stringent than the final U.S. LCR). In adopting the final LCR rule, the Agencies acknowledged this criticism, but ultimately decided to modify the Basel III LCR “to reflect the unique characteristics and risks of the U.S. market and U.S. regulatory frameworks.”
these reasons, the ways in which the final LCR rule deviates from the Basel III standards are of great importance to U.S. financial institutions.

The 2008 financial crisis was in large part a liquidity crisis occurring within a highly interconnected financial industry.\footnote{See Robert E. Lucas, Jr. & Nancy L. Stokey, \textit{Liquidity Crises: Understanding Sources and Limiting Consequences: A Theoretical Framework} 6, 8–9 (Fed. Reserve Bank of Minneapolis, Economic Policy Paper 11-3, May 2011), available at https://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4661 & (arguing that the failures of Bear Stearns and Lehman Brothers in 2008 were the result of investment bank runs that sparked contagion effects throughout the financial industry).} The inadequate liquidity risk management at financial institutions prior to the financial crisis contributed to the spread of the crisis and inhibited the ability of financial institutions to weather the evaporation of short-term credit.\footnote{See \textsc{Lamson et al.}, supra note 33, at 4.} Poor liquidity risk management prior to the financial crisis resulted in merger, federal bailout, and outright failure for many financial institutions.\footnote{Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61448.}

The LCR attempts to remedy the liquidity shortcomings that existed prior to the financial crisis.\footnote{Id.} To that end, the LCR encourages less reliance on short-term funding that may become unavailable during a liquidity freeze and lower concentration of “asset classes that have a significant liquidity discount if sold during a period of stress.”\footnote{Id.} Further clarification on asset classes the LCR encourages financial institutions to hold, and how the LCR discourages reliance on short-term wholesale funding are discussed below.\footnote{See \textit{infra} Part II.B.}

In addition to remedying liquidity shortcomings, the LCR also serves an important informational purpose. The final LCR intends to provide greater detail to financial institutions, regulators, creditors, debtors, and investors about the short-term liquidity position of a financial institution.\footnote{Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61444.} More information about how financial institutions’ liquidity profiles vary over time and, in particular, during adverse economic scenarios will facilitate more prudent management and supervision of their liquidity risk and funding needs.\footnote{Id.} This


\textit{Id.}

\textit{Id.}

\textit{See infra} Part II.B.

\textit{Id.}

\textit{Id.}
additional data also enables both management and regulators to “take appropriate actions to address liquidity needs; and, in situations of failure, implement an orderly resolution of the covered company.”

B. Scope of the LCR and Calculation Under the Final Rule

The LCR targets “large and internationally active banking organizations.” The final rule, however, also contains a provision for a modified minimum LCR (“Modified LCR”) that applies to financial institutions that are not internationally active and do not have significant insurance or commercial activities. The Modified LCR imposes a relatively lighter regulatory burden than the full LCR, so it is important to understand what companies are covered by the LCR as opposed to the Modified LCR.

1. Covered Companies and Covered Depository Institution Subsidiaries

Financial institutions that qualify as covered companies are subject to the LCR “because of their complexity, funding profiles, and potential risk to the financial system.” Covered companies include: (1) financial institutions with total consolidated assets greater than or equal to $250 billion; (2) financial institutions with total consolidated on-balance sheet foreign exposure greater than or equal to $10 billion; (3) depository subsidiaries of the companies described under (1) and (2) with $10 billion or more of total consolidated assets; and (4) financial institutions that any of the Agencies deem appropriate based on the institution’s “asset size, level of complexity, risk profile, scope of operations, affiliation with foreign or domestic covered entities, or risk to the financial system.”

The scope of the rule encompasses bank holding companies and savings and loan holding companies with total consolidated assets of

42. Id.
43. Id. at 61440.
44. Id.
45. See infra Part II.B.1.
46. See infra Part II.B.1.
47. Id. at 61440.
48. Id. at 61524.
$50 billion or more even if they do not meet the above requirements.49 They fall under the Modified LCR, however, which has less stringent requirements.50 These Modified LCR holding companies do not escape the LCR because the Agencies still view them as “large financial companies with extensive operations in banking, brokerage, and other financial activities” although less complex than the “covered companies” subject to the full LCR.51 The final rule specifically excludes community banks from the LCR or Modified LCR requirements.52

The comment period resulted in a notable change to the final rule by excluding nonbank financial companies from the scope of the rule,53 even those designated by the Financial Stability Oversight Council (“FSOC”) as systemically important financial institutions (“SIFI”).54 This provides only a temporary reprieve for these SIFIs, as the Agencies intend to tailor the LCR to include them, either individually, or within the category of nonbank financial companies, taking into account “the business model, capital structure and risk profile” of designated companies.55

2. Definition of HQLA

Before the LCR calculation can be explained, its constituent

49. Id. at 61540.
51. Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61522. The Modified LCR does not apply to certain grandfathered unitary savings and loan holding companies and bank holding companies or savings and loan holding companies that engage in insurance underwriting operations or significant activities that are not financial in nature.
52. Id. at 61440.
53. Id. at 61446.
parts must first be introduced in greater detail. The LCR is a ratio with a numerator equal to the total amount of a financial institution’s HQLA and the denominator equal to the net cash outflows from the financial institution over a thirty-day period under stressed economic conditions defined by the Agencies.56

The LCR rule, approved by the Agencies, provides specific examples of assets that qualify for inclusion in the numerator as HQLA as well as criteria for determining whether an asset qualifies as HQLA.57 The LCR rule divides HQLA into three asset classes: Level 1, Level 2A, and Level 2B.58 Level 1 assets consist of cash, U.S. Treasury and government agency securities, and certain other sovereign debt and development bank securities.59 Level 2A assets represent a riskier asset class than Level 1 assets and include securities issued by the GSEs and certain sovereign debt and development bank securities not classified as Level 1.60 Level 2B assets are comprised of certain investment grade corporate debt and certain publicly traded common equity shares.61

Whether an asset is a Level 1, Level 2A, or Level 2B determines if the financial institution must apply a discount—commonly referred to as a “haircut”—to the value of that asset when calculating HQLA.62 Furthermore, these levels determine whether that asset is capped at a certain percentage of the financial institution’s liquidity portfolio.63 The Level 1 category represents the safest and most liquid assets and, therefore, no haircut or portfolio restrictions apply.64 Level 2A assets receive a 15% haircut and Level 2B assets receive a 50% haircut in order to compensate for the greater level of risk associated with those assets.65 Furthermore, Level 2 assets combined cannot account for greater than 40% of a financial institution’s HQLA, and Level 2B assets

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57. Id. at 61529–31; see also id. at 61526 (defining “liquid and readily-marketable”).
58. Id. at 61529.
59. Id.
60. Id.
61. Id. In general, Level 2B corporate debt must be investment grade, liquid and readily marketable, and not issued by a financial sector company. Id. Level 2B common equity shares must similarly be liquid and readily marketable, not issued by a financial sector company, as well as traded on the Russell 1000 index. Id.
62. Id. at 61459.
63. Id.
64. Id. at 61530.
65. Id.
alone cannot exceed 15% of an institution’s HQLA in order to “prevent[] concentrations of less liquid assets and ensure[] a sufficient stock of the most liquid assets to meet stressed outflows during a period of significant market distress.”

An asset’s classification is significant because it ultimately determines whether the full amount of the asset will count towards HQLA or whether its value will be reduced by a haircut. Other things being equal, a Level 1 asset not subject to a haircut provides more value to a financial institution than a Level 2 asset for the purposes of meeting the institution’s required amount of HQLA necessary to comply with the LCR. Likewise, an asset that is subject to a haircut, but nonetheless counts towards HQLA, is relatively more valuable to a financial institution in terms of complying with the LCR than an asset that falls outside the HQLA definition. The LCR rule’s definition of HQLA plainly contains an incentive for financial institutions to choose to hold assets that have been “blessed” by the Agencies.

3. Net Outflows Calculation

The denominator of the LCR equation represents the net flow of funds out of the financial institution during a hypothetical thirty-day period of economic stress. Total projected outflows—contractual payments, maturities, and estimated runoff in funding sources—are subtracted from the total projected inflows for the thirty-day period. The total projected inflows amount cannot be greater than 75% of the total projected outflows in order to prevent financial institutions from

66. Id. at 61459.
67. See id. at 61530 (detailing the calculation of the adjusted liquid asset amounts due to the haircuts applicable to Level 2A and 2B assets).
70. See id. at 61532–36 (defining assumptions for outflow rates of various funding sources reflecting standardized stressed assumptions).
71. See id. at 61536–37 (listing assumptions for inflow rates of various sources of funds also reflecting standardized stressed assumptions).
72. Id. at 61531.
becoming “overly reliant on inflows, which may not materialize in a period of stress.” 73 Added to the amount of net outflows is the difference between the highest cumulative outflow during the thirty-day period and the final net cumulative outflow on day thirty. 74 This additional calculation is intended to identify liquidity pressures within the thirty-day period that may not be apparent from the net outflow amount. 75

4. Calculation of the LCR

The fully phased-in LCR will require covered financial institutions to hold an amount of HQLA on their balance sheets equal to their total projected net cash outflows in a stressed scenario as detailed above. 76 Essentially, covered financial institutions should have an amount of HQLA at least equal to the amount of cash the institution can expect to leave the company over the thirty-day stress period. 77 Stated another way, HQLA over net outflows should equal at least one. 78 In theory, a ratio of at least one should provide an adequate amount of creditworthy and easily-monetized assets to allow the financial institution to meet its obligations as they come due during a short-term crisis. 79

C. Differences Between the Finalized LCR and the Basel III LCR

The finalized LCR rule is based on the Basel Committee on Banking Supervision’s Basel III LCR. 80 While the version of the LCR adopted by the Agencies generally parallels the Basel III international

73. Id. at 61444.
74. LAMSON ET AL., supra note 33, at 2 (referencing the portion of the final rule to be codified at 12 C.F.R. § 249.30(b)).
75. Id. (noting that this calculation goes beyond the Basel III standard).
77. Id.
78. FORRESTER & KRAVITT, supra note 27, at 2.
79. Id. at 1–2.
standard,\textsuperscript{81} it contains an accelerated implementation timeline and qualifies fewer assets as HQLA.\textsuperscript{82} By approving an LCR rule that materially diverges from the international standard, the Agencies increased the regulatory burden and operating costs of U.S. financial institutions, thereby inhibiting their competitiveness with international financial institutions.\textsuperscript{83} Adopting an LCR more in line with the international standard would arguably achieve the liquidity goals of the LCR with fewer unintended consequences.\textsuperscript{84}

The Basel III standard requires each covered financial institution to be 60% compliant with the LCR by January 1, 2015, with 10% annual increases until attaining 100% compliance by January 1, 2019.\textsuperscript{85} In contrast, the U.S. LCR requires a much more aggressive phase-in. Financial institutions were required to be 80% compliant by January 1, 2015, with 10% annual increases until fully compliant by January 1, 2017.\textsuperscript{86} The Agencies stated “[t]he accelerated transition period reflects a desire to maintain the improved liquidity positions that U.S. institutions have established since the financial crisis, in part as a result of supervisory oversight by U.S. bank regulators.”\textsuperscript{87} On the other hand, industry commenters view the accelerated implementation as a competitive disadvantage for U.S. global banks relative to foreign bank competitors, as well as for U.S. regional banks that are less able to bear the additional compliance costs relative to their larger competitors.\textsuperscript{88}

\begin{itemize}
\item \textsuperscript{81} See \textit{BASEL COMM.}, supra note 30.
\item \textsuperscript{82} Press Release, Bd. of Governors of the Fed. Reserve Sys., supra note 29.
\item \textsuperscript{83} See \textit{Jaymin Berg & Bill Warlick, Stricter U.S. Bank Liquidity Rules to Affect Profitability}, \textit{FITCH RATINGS FITCH WIRE} (Ocl. 25, 2013), https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Stricter-U.S.-Bank?pr_id=806151 (explaining that the exclusion of assets that qualify as HQLA under the Basel III standard, such as private label MBS, covered bonds, and municipal securities from the definition of HQLA in the United States, will negatively affect bank profitability).
\item \textsuperscript{84} Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61450. For example, one commenter cautioned that an LCR stricter than the Basel III LCR “could lead to distortions in the market, such as dramatically increased demand for limited supplies of asset classes and hoarding of HQLA by financial institutions.” \textit{Id.}
\item \textsuperscript{85} See \textit{BASEL COMM.}, supra note 30, ¶10.
\item \textsuperscript{86} Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. at 61538.
\item \textsuperscript{87} Press Release, Bd. of Governors of the Fed. Reserve Sys., supra note 29.
\item \textsuperscript{88} See, e.g., Comment Letter from Michael P. Smith, President & Chief Exec. Officer of the New York Bankers Ass’n, to the Board, the OCC, and the FDIC (Jan. 31, 2014), \textit{available at} http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_id=R-1466&doc_ver=1 (“[T]he LCR requirements will interact with many of the laws and regulations enacted in the last five years relating to capital, leverage and other prudential
The U.S. LCR also differs materially from the Basel III LCR in its definition of asset classes that qualify as HQLA. While the U.S. LCR excludes high-quality private label MBS, municipal debt, and asset-backed securities, the Basel III LCR includes them as HQLA. Several industry commenters noted that such treatment of these assets could result in higher funding costs and scarce capital for these secondary markets. The U.S. LCR definition of HQLA entirely excludes private label MBS, whereas GSE MBS are classified as Level 2A assets. The disparate treatment of these two classes of MBS will be discussed in greater detail below, particularly the potential effect this dichotomy will have if a housing finance reform bill passes Congress.

The final LCR rule adopted by the Agencies contains clear incentives for covered financial institutions. The LCR gives preference to Level 1 assets such as U.S. Treasuries over Level 2 assets such as investment grade corporate debt and GSE MBS. Similarly, common equity is preferred over investment grade private label MBS and municipal bonds. Although the Agencies downplay the potential
effects of the incentives inherent in the LCR,\textsuperscript{97} financial institutions will seek to comply with their regulatory obligations by shifting capital away from these disfavored asset classes.\textsuperscript{98} If the Agencies were to adopt the more inclusive Basel III definitions of HQLA, the shift between assets would be less pronounced\textsuperscript{99} because more assets would be classified as HQLA.\textsuperscript{100}

III. SIZING THE IMPACT: QUANTITATIVE AND QUALITATIVE PERSPECTIVES

A. Quantitative Baseline to Assess Potential Impact of LCR on Economy

In order to appreciate the LCR’s potential impact, one must first appreciate the size of the mortgage market, both in terms of loans and securitizations, as well as the structure of ownership. As of September 30, 2014, there was $13.4 trillion in total U.S. mortgage debt outstanding, $9.9 trillion of which was residential.\textsuperscript{101} That amount represents the mortgages on approximately 34 million homes.\textsuperscript{102} Of that $13.3 trillion in mortgage debt, depository institutions held $4.1 trillion, Fannie Mae held $3.0 trillion, Freddie Mac held $1.7 trillion, the Government National Mortgage Association (“Ginnie Mae”)\textsuperscript{103} held

\textsuperscript{99} See KEVIN BUEHLER ET AL., MCKINSEY & CO., BETWEEN DELUGE AND DROUGHT: THE FUTURE OF US BANK LIQUIDITY AND FUNDING 18–19 (July 2013), http://www.mckinsey.com/client_service/risk/latest_thinking/working_papers_on_risk (stating that banks will shift their holdings between Level 1 and Level 2 assets in order to optimize profitability and compliance with the LCR).
\textsuperscript{100} FORRESTER ET AL., supra note 54, at 1.
\textsuperscript{102} Based on the average loan amount for all mortgage loans according to the Federal Housing Finance Agency’s Monthly Interest Rate Survey from June 2014. STATE HOUSE NEWS SERV., FHFA: Mortgage Interest Rates Down in June, Aug. 1, 2014.
$1.5 trillion, and private mortgage conduits held $1.1 trillion. As of September 30, 2014, there was $7.1 trillion in outstanding U.S. Agency MBS ($2.8 trillion issued by Fannie Mae, $1.6 trillion issued by Freddie Mac, $1.5 trillion issued by Ginnie Mae) and $1.0 trillion in outstanding residential private label MBS.

Given the size of the MBS security market, it is also important to consider who owns all of these securities. As of December 31, 2014, the Federal Reserve System (the “Fed”) held over $1.7 trillion worth of agency MBS. At that same point in time, all U.S. depository institutions combined held $724.5 billion worth of Fannie Mae and Freddie Mac MBS, $226.9 billion worth of Ginnie Mae MBS, $136.6 billion worth of privately issued residential mortgage-backed securities, as well as $193.4 billion worth of GSE debt. In comparison, U.S. depository institutions only held $345.5 billion worth of U.S. Treasury securities. MBS, particularly GSE MBS, compose a significant portion of bank portfolios especially compared to U.S. Treasuries.

Since the financial crisis, the GSEs have dominated the MBS market in both new issuance and market share at the expense of private label MBS. Absent a meaningful change like housing finance reform, the shrinking market share of private label MBS will continue. As of July 31, 2014, the GSEs accounted for 99% of MBS issuance volume for 2014 with private label MBS accounting for the remaining 1%. In

104. Mortgage Debt Outstanding, supra note 101.
105. SEC. INDUS. & FIN. MKTS. ASS’N, supra note 14.
108. Id.
110. SEC. INDUS. & FIN. MKTS. ASS’N, supra note 14.
111. See The Private Label Mortgage-Backed Securities Market: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs, 113th Cong. (2014) (statement of Sen. Tim Johnson, Chair, S. Comm. on Banking, Hous. & Urban Affairs) (discussing the current dearth of private capital in the mortgage market and stating that housing finance reform is necessary to attract private capital back to the market).
2013, the GSEs accounted for 98% of total MBS issuance and private label MBS accounted for the remaining 2%, continuing the GSEs’ market dominance that began in 2008 during the financial crisis.113

Despite financial institutions’ seemingly vast current holdings of securities, covered companies faced at least a $200 billion shortfall of HQLA when the Agencies proposed the LCR rule in October 2013.114 To comply with the LCR rule, banks will be compelled to optimize their liquidity portfolios by selling MBS and buying more lower-yielding Level 1 assets.115 By adding regulatory value, as opposed to economic value, to Level 1 assets, the LCR creates new incentives to hold these asset classes at the expense of Level 2 assets like GSE MBS or excluded assets like private label MBS.116

The Fed further complicated matters by ending its most recent bond-buying program, known as quantitative easing (“QE”), in October 2014.117 Beginning in 2009, the Fed expanded its balance sheet through three rounds of massive purchases of Treasury securities and GSE MBS in order to stimulate economic activity.118 During the most recent round (QE3), the Fed purchased $40 billion of GSE MBS per month.119

Standing alone, the LCR incentivizes banks to hold fewer MBS, specifically private label MBS.120 The Fed ending its MBS purchases combined with sales of MBS by financial institutions in order to comply with the LCR creates the potential for a significant reduction in demand

113. Id.
115. See Berg & Warlick, supra note 83 (“To achieve compliance with the proposed LCR, Fitch believes banks would likely need to derisk their investment portfolios and move towards very liquid lower-yielding government and agency securities.”).
119. Hilsenrath, supra note 117.
120. Comment Letter from Christopher B. Killian, supra note 18, at 10.
for MBS that may unintentionally siphon capital out of the secondary mortgage market. As will be discussed further below, housing finance reform bills currently in Congress have the potential to exacerbate this flight of capital from the mortgage market.121

B. Criticisms from the Public Comment Period

The Agencies received over 100 comments during the public comment period from banks, nonbank financial firms, industry groups, public officials, public interest groups, and other interested parties.122 Common themes appeared in the majority of financial industry comments.123 Nearly all agreed that the LCR was necessary and a good idea in principle.124 However, those same commenters found the U.S. LCR far too strict and preferred a standard more similar to the Basel III LCR.125 In particular, financial institutions criticized the exclusion of high-quality private label MBS and municipal securities from HQLA.126

Many commenters expressed concern that excluding these assets from the definition of HQLA would disrupt markets and harm consumers, as well as state and local governments.127 These commenters fear that exclusion would sap demand for municipal securities which, in turn, would lead to increased borrowing costs for municipalities, harming local economies and hindering infrastructure investments.128

Commenters expressed similar concerns with regard to private label MBS. They feared that excluding private label MBS from HQLA would cause a shortage in demand for MBS, which they feared would lead to decreased funding for mortgages and increased borrowing costs

121. See infra Part V.
124. See, e.g., Comment Letter from Paul Ackerman, supra note 91.
125. Comment Letter from 14 Regional Banks, supra note 109.
126. See, e.g., Comment Letter from Paul Ackerman, supra note 91.
127. Id.
for consumers. In the view of many commenters, providing a way to include highly-rated private label MBS in the definition of HQLA would facilitate a return of private capital to the secondary mortgage market and mitigate any impacts on mortgage rates for consumers.

IV. INTERPLAY BETWEEN HOUSING FINANCE REFORM AND LCR

President Obama signed Dodd-Frank into law on July 21, 2010, nearly two years after Fannie Mae and Freddie Mac were placed into government conservatorship. Despite the nearly $190 billion provided by the U.S. Treasury to the GSEs as part of their bailout and its sweeping 848 pages of financial regulation, Dodd-Frank left unanswered the question of what to do with the GSEs and how to reshape the U.S. housing finance system. Section 1074 of Dodd-Frank directed the Secretary of the Treasury to “conduct a study of and develop recommendations regarding the options for ending the conservatorship of [Fannie Mae] and [Freddie Mac], while minimizing the cost to taxpayers.” Although section 1074 deferred any definite action on housing finance reform, it provided a timeline for beginning the legislative process that was avoided in passing Dodd-Frank. It also set the substantive agenda for any future housing finance reform.

129. Comment Letter from 14 Regional Banks, supra note 109.
130. Id.
133. Id.
134. Action on the future of the GSEs was deferred despite an explicit Congressional finding in Dodd-Frank that GSE reform was important and the conservatorship arrangement was unsustainable. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) § 1491, 124 Stat. 1376, 2205–06 (2010).
135. Dodd-Frank § 1074, 124 Stat. at 2067. The study, “Reforming America’s Housing Finance Market,” was released jointly by the Departments of Treasury and Housing and Urban Development on February 11, 2011. The study concluded that Fannie Mae and Freddie Mac should be wound down, the government’s role in the housing market should be reduced, and private capital should be encouraged to return to the market. David A. Luigs, Whither Fannie and Freddie? Reform of the U.S. Secondary Mortgage Market, 5 FIN. INST. REP. (Debevoise & Plimpton) No. 3, at 6, 7–9 (Mar. 2011).
136. See Dodd-Frank § 1074(b), 124 Stat. at 2068 (mandating the Secretary of the Treasury provide a study on ending Fannie Mae and Freddie Mac’s conservatorship to both the Senate Banking Committee and House Financial Services Committee by January 31, 2011).
legislation by requiring the Treasury Secretary’s report to address a wide range of options for the GSEs including wholesale liquidation, privatization, incorporation into a Federal agency, as well as any other options the Treasury Secretary deemed viable.\footnote{Dodd-Frank § 1074, 124 Stat. at 2067–68.}

Several bills currently debated in Congress address the issues of housing finance reform and the future of the GSEs, which Dodd-Frank left unresolved. While each of these bills approaches the issue differently, their proposals parallel the options identified in § 1074 of Dodd-Frank.\footnote{See infra Part IV.A.} The legislative proposals currently before Congress range from complete privatization of the mortgage market\footnote{For a discussion of the Protecting American Taxpayers and Homeowners Act of 2013 (“PATH”), see infra Part IV.A.2.} to a public-private hybrid mortgage market.\footnote{For a discussion of the Housing Finance Reform and Taxpayer Protection Act of 2014 (“Johnson-Crapo”), see infra Part IV.A.1} Despite two separate bills passing committee—one by the Senate Banking Committee\footnote{Press Release, U.S. Senate Comm. on Banking, Hous., & Urban Affairs, Senate Banking Committee (May 15, 2014), http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.MinorityNews&ContentRecord_id=073129bb-cc29-7915-58af-6ebdf149c1a2&Region_id=&Issue_id=&IsPrint=1 [hereinafter Senate Banking Committee].} and one by the House Financial Services Committee\footnote{Press Release, U.S. House of Rep. Comm. on Fin. Servs., PATH Act Passes Committee (July 24, 2013), http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=343722 [hereinafter PATH Act Passes Committee].}—each proposal only represents a first step and significant alterations and compromises will be necessary to gain enough support to pass both chambers of Congress.\footnote{See Housing Finance Reform and Taxpayer Protection Act of 2013: Hearing on S. 1217 Before the S. Comm. on Banking, Hous. & Urban Affairs, 113th Cong. (May 15, 2014) (statement of Sen. Tim Johnson, Chairman, S. Comm. on Banking, Hous. & Urban Affairs) (“[Johnson-Crapo] is not the final product. This is only the first step toward real reform, and we will continue to work together to improve the bill and attract additional support.”).}

Furthermore, there is little indication that Congress will make any meaningful progress toward passing housing finance reform legislation even with the Republican Party now in control of both chambers after the 2014 midterm elections.\footnote{See Christopher Whalen, What Republicans’ Election Win Means for Housing Reform, AM. BANKER (Nov. 13, 2014), http://www.americanbanker.com/bankthink/whathouse-republicans-election-win-means-for-housing-reform-1071186-1.html (detailing several obstacles to passing housing finance reform despite Republican majority control of Congress).} While some members of
Congress are optimistic that housing finance reform legislation could pass in 2015, some industry analysts are doubtful that Congress will take up the issue before the 2016 presidential election, if it takes up the issue at all. Even those optimistic about the prospects of housing finance reform legislation concede that the current stability in the housing market and profitability of the GSEs—profits which flow directly to the U.S. Treasury—pose a significant impediment to any action on reform. While any sustainable long-term reform of the GSEs requires comprehensive Congressional action, the ultimate design of the reform, in particular the extent of the government’s involvement in the mortgage market, remains undetermined.

Due to the varying provisions of the proposed legislation currently before Congress, the future of the housing finance system will look very different depending on which version ultimately becomes law. In particular, MBS will take on different characteristics from


147. See Finkle, supra note 145 (“[T]he status quo is difficult to overcome in part because the government is generating huge profits from the GSEs, which remain in conservatorship.”).

148. See JIM PARROTT, URBAN INST., HOUSING FINANCE POLICY CENTER COMMENTARY: WHY LONG-TERM GSE REFORM REQUIRES CONGRESS 1 (May 22, 2014), available at http://www.urban.org/UploadedPDF/413128-Why-Long-Term-GSE-Reform-Requires-Congress.pdf. However, there is by no means consensus that housing reform legislation should be passed. See Nick Timiraos, Investor Fires Salvo Against Fannie, Freddie, WALL ST. J., Mar. 3, 2014, at A5 (noting shareholders, including prominent institutional investors, support leaving the GSEs intact as private, standalone enterprises).

149. See Finkle, supra note 145.


151. Id.
those issued under the current housing finance system. For these reasons, an overview of the key provisions of each proposed bill will aid in the discussion of the future status of MBS in a reformed housing finance system.

A. Current Legislative Proposals

1. The Housing Finance Reform and Taxpayer Protection Act of 2014

The Senate Banking, Housing, and Urban Affairs Committee approved a housing finance reform bill sponsored by Committee Chair Sen. Tim Johnson (D-SD) and Ranking Member Sen. Mike Crapo (R-ID) on May 15, 2014. This piece of legislation, the Housing Finance Reform and Taxpayer Protection Act of 2014 (“Johnson-Crapo”), was originally introduced by Sens. Bob Corker (R-TN) and Mark Warner (D-VA). Johnson-Crapo is the second iteration of the Corker-Warner bill, having been amended to incorporate the findings from a series of hearings held during the fall and winter of 2013 after the Corker-Warner bill was introduced. The purpose of the committee hearings was to “explore[e] essential elements necessary for reform” and in so doing, gather bipartisan input and support for a bill with a realistic chance of passing the full Congress and being signed into law. Johnson-Crapo remains consistent with the original Corker-Warner bill, which served as the “base text” and whose “overall

152. See infra Part IV.B.
153. Senate Banking Committee, supra note 141.
155. Id.
156. Id.
158. Id.
architecture” was maintained.160

Among the competing housing finance reform proposals, Johnson-Crapo likely holds the most promise of serving as the foundation for any reform that eventually succeeds in passing the full Congress.161 The Senate Banking Committee received praise for its careful and methodical consideration of the multitude of issues raised by legislation of this complexity during the hearing process.162 Johnson-Crapo also has the backing of the Obama administration, although this was not enough to secure the votes of six holdout Democrats on the committee.163 While Johnson-Crapo is currently the most viable proposal, it still suffers from a lack of support among both Democrats, who are concerned with its effects on affordable housing, and Republicans, who criticize the size of the government’s role under the bill.164

The change in committee leadership after the 2014 midterm elections will likely cause significant headwinds for Johnson-Crapo. Sen. Richard Shelby (R-AL) is in line to serve as the next chairman of the Banking Committee with Sen. Sherrod Brown (D-OH) the presumed ranking Democrat.165 Significantly, both senators voted against Johnson-Crapo during the full committee vote in May 2014.166 As a result of the leadership change, the Republican-controlled Senate Banking Committee will focus on either drafting a new bill or amending

160. Johnson, Crapo Announce Agreement on Housing Finance Reform, supra note 141; see also ZANDI & DERITIS, supra note 150, at 1.
161. Nick Timiraos, Fannie-Freddie Overhaul Hits Snag: Thin Democratic Support, WALL ST. J., Mar. 3, 2014, at A5. The Senate Banking Committee approved Johnson-Crapo on a 13-9 vote with seven Republicans and six Democrats in favor, whereas the competing House bill received no support from Democrats.). Although bipartisan support for Johnson-Crapo was met with bipartisan dissent, the competing House PATH bill passed a committee vote with only Republican support. See Finkle, supra note 145.
164. Id.
166. Id.; Timiraos, supra note 161.
Johnson-Crapo mandates Fannie Mae and Freddie Mac to wind up and revokes their charters. Johnson-Crapo also creates a new federal agency called the Federal Mortgage Insurance Corporation (“FMIC”) to regulate the mortgage finance market. The FMIC would be an independent regulator modeled after the FDIC serving a dual role as both MBS insurer and rule maker. In addition to these key provisions, Johnson-Crapo calls for private capital to take the first-loss position ahead of FMIC insurance; that is, private actors will absorb losses on FMIC-backed securities up to a specified percentage of the principal of the MBS before the FMIC is required to cover any losses.

As an MBS insurer, the FMIC would first be charged with establishing a common securitization platform organized as a member-owned utility. Investors in new securitizations from the platform would receive an explicit government guarantee of timely payment of principal and interest from the FMIC. However, the FMIC guarantee would only be implicated when the private capital buffer required by the statute is exhausted. Johnson-Crapo requires private market actors to take a first-loss position of “not less than 10 percent of the principal or face value of the single-family covered security at the time of issuance.” Therefore, the FMIC offers an explicit, but limited, government guarantee. The FMIC would provide this guarantee through a newly-created Mortgage Insurance Fund, which would be financed by fees assessed on securitizations and backed by the full faith and credit of the U.S. Treasury.

As a rulemaking regulator, the FMIC would be charged with

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167. Finkle, supra note 165.
169. Id. § 201.
170. ZANDI & DE RITIS, supra note 150, at 1.
171. S. 1217 § 301.
172. Id. § 321.
173. Id. § 303.
174. Id. § 302.
175. Id. The statute allows the private capital first-loss position to take the form of an approved bond guarantor providing insurance or a capital markets transaction to absorb credit losses. For a detailed explanation of the credit-sharing methods in Johnson-Crapo, see SEAN HOSKINS, CONG. RESEARCH SERV., RL7-5700, EXPLANATION AND ILLUSTRATION OF THE JOHNSON-CRAPO GSE REFORM PROPOSAL 8 (Apr. 7, 2014).
176. S. 1217 § 303.
creating “securitization standards and underwriting requirements in loans that make up securities backed by the government.”

177 FMIC-backed securities would only be comprised of mortgage loans meeting certain underwriting standards. 178 Johnson-Crapo directs the FMIC to conform its underwriting standards for single-family mortgage loans that are eligible for an FMIC guarantee to the Consumer Financial Protection Bureau’s Qualified Mortgage rule. 179 In addition, the rule requires a minimum down payment of 3.5% for first-time homebuyers and 5% for non-first-time homebuyers. 180 Taken together, the explicit government backstop, private capital buffer, uniform underwriting standards, as well as many other provisions not discussed here, are intended to “provide[] certainty to investors and homeowners through standardization and improved market liquidity.”

Johnson-Crapo establishes a “Small Lender Mutual,” an additional provision to increase liquidity. 182 The entity would seek to ensure small lenders have access to the secondary mortgage market by purchasing and aggregating eligible loans from these lenders for securitization. 183

Johnson-Crapo appears to be the leading prospect for housing finance reform legislation. 184 However, its hybrid public-private approach contrasts with the proposed legislation approved by the House Financial Services Committee, which calls for the near complete

179. Id. § 2(29)(A)(ii)(II). The CFPB’s Qualified Mortgage rule, codified at 12 C.F.R. § 1026 (2013), requires borrowers to have a debt-to-income ratio of less than 43%, prohibits lenders charging excessive fees and points, and also prohibits lenders from underwriting mortgage loans with high-risk features like interest-only payments, negative amortization, and balloon payments.
181. Senate Banking Committee, supra note 141.
182. S. 1217 § 315. Insured depository institutions with less than $500 billion in total assets and non-depository mortgage originators with a minimum net worth of $2.5 million and less than $100 billion in annual mortgage loan production are eligible to participate in the Small Lender Mutual. § 315(e).
183. See id. § 315(b) (describing the purpose of the “Small Lender Mutual”).
184. See Prior & Lee, supra note 163 (stating Johnson-Crapo has bipartisan support in the Senate and support from the White House although it also suffers from bipartisan opposition in the Senate).
privatization of the mortgage finance system.185

2. Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767

On July 24, 2013, the House Financial Services Committee passed the Protecting American Taxpayers and Homeowners Act of 2013 (“PATH”).186 Twelve fact-finding hearings, most of which centered on the themes of failed government regulation and how best to create a sustainable private mortgage finance market, produced PATH.187 Significantly, no Democrats on the Republican-led Financial Services Committee voted for the proposal.188 However, the Republican committee majority led by its chairman, Rep. Jeb Hensarling (R-TX), was sufficient to move PATH forward despite Democratic opposition and two Republican committee members also voting against the measure.189

Neither Johnson-Crapo190 nor PATH managed to enlist the support necessary for a vote on the floors of their respective chambers.191 As previously noted, PATH did not attract the vote of a single Democrat, whereas Johnson-Crapo garnered bipartisan support.192 Furthermore, PATH attracted negative responses from outside Congress including being labeled an “unviable proposal” by Moody’s Chief Economist Mark Zandi.193 PATH, however, is not

185. See infra Part IV.A.2.
186. PATH Act Passes Committee, supra note 141.
188. Finkle, supra note 145.
191. See Newhauser, supra note 145 (“[PATH] passed the committee, but went no further as leadership made the calculation that the legislation could not pass the full House.”).
192. Michael Shaw & Kate Ackley, Senate Panel Approves Housing Finance Overhaul, CQ ROLL CALL (May 15, 2014).
193. MARK ZANDI & CRIS DERITIS, MOODY’S ANALYTICS, EVALUATING PATH 1 (July
without its free market industry supporters.  

PATH has three overarching planks: (1) eliminate Fannie Mae and Freddie Mac, (2) revamp the Federal Housing Administration (“FHA”), and (3) “privatize the rest of the housing finance system.” The GSEs’ charters would be repealed after five years during which time they would slowly be forced to transition out of the market by raising fees charged to guarantee timely payment of principal and interest on the MBS they securitize, decreasing conforming loan limits, and limiting their purchases to only qualified mortgage (“QM”) loans. Interestingly, with the exception of the conforming loan limits, Fannie and Freddie are already taking these steps.

In addition to these reforms, PATH would restrict the mortgages and consumers that the FHA can serve and require the FHA “to reduce its insurance coverage on mortgage loans from the current 100% to 50%, while sharing the risk with private investors.” According to Mark Zandi, Moody’s Chief Economist, under the PATH regime “the FHA would account for no more than one-fifth of the mortgage market on average” with private mortgage loans with no government support accounting for the remaining four-fifths of the mortgage market.

PATH envisions privatizing the mortgage market by establishing a not-for-profit, non-governmental national mortgage market utility to operate a common securitization platform for residential MBS and “develop standards related to originating, 


195. ZANDI & DERITIS, supra note 193, at 1.


197. Id. § 104; ZANDI & DERITIS, supra note 193, at 1.

198. H.R. 2767 § 105; ZANDI & DERITIS, supra note 193, at 1.


200. ZANDI & DERITIS, supra note 193, at 1.

201. H.R. 2767 § 232.

202. ZANDI & DERITIS, supra note 193, at 1.

203. Id. at 2.
servicing, pooling, and securitizing residential mortgage loans.” PATH would also clear the way for covered bonds to provide an additional source of funding for the mortgage market. Unlike securitizations, where the mortgage loans backing the MBS are sold, covered bonds are backed by pooled loans that the issuing bank retains on its balance sheet. The virtue of this risk retention is the incentive it provides to covered bond issuers to “maintain high origination standards” which “tends to align the interests of the banks and regulators in a way that securitisation never will.” Although covered bonds are common in Europe, no significant covered bond market exists in the United States due to the lack of enabling legislation or regulatory guidance such as that proposed by PATH.

Enabling a covered bond market in the United States would aid in PATH’s goal of attracting more private financing to the mortgage market. However, there are various regulatory impediments to issuing covered bonds in the United States including lack of incentives due to regulations like the LCR, which does not classify covered bonds as HQLA.

Some industry commentators are critical of PATH, asserting that any advantages it might offer are outweighed by higher costs and reduced access to mortgage financing. Nonetheless, proponents of PATH refute these claims and assert that PATH would actually make mortgage financing more affordable than under the current law.

3. The Partnership to Strengthen Homeownership Act of 2014 (H.R. 5055)

Reps. John Delaney (D-MD), John Carney, (D-DE), and Jim

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204. H.R. 2767 § 312.
205. § 353.
207. Id.
208. ZANDI & DERITIS, supra note 193, at 2.
209. See Pinedo & Marlatt, supra note 206 (advocating for the regulatory changes to increase the use of covered bonds as part of a diversity of private funding for the U.S. mortgage market).
210. Id.
211. ZANDI & DERITIS, supra note 193, at 3 (Adopting PATH “would drive mortgage rates nearly 90 basis points higher than they currently are.”).
212. PATH Act Passes Committee, supra note 142.
Himes (D-CT) introduced the Partnership to Strengthen Homeownership Act to the House on July 10, 2014.\(^{213}\) The proposed bill has been referred to the House Financial Services Committee for consideration\(^{214}\) and Representative Delaney hopes it will be considered in 2015.\(^{215}\) Unlike PATH, this third alternative for housing finance reform legislation seeks to maintain government involvement in the housing market by establishing an insurance program through Ginnie Mae.\(^{216}\)

The Delaney bill envisions a public-private hybrid housing finance system similar to Johnson-Crapo.\(^{217}\) Unlike Johnson-Crapo’s 10% private capital buffer, however, the Delaney bill only calls for private capital to take a 5% first-loss position on insured MBS.\(^{218}\) Ginnie Mae and a private reinsurer would share the exposure to the remaining 95% of the guaranteed principal amount.\(^{219}\) Ginnie Mae’s portion of the insurance would be backed by the full faith and credit of the U.S. government, giving these MBS a semi-government guarantee.\(^{220}\) Similar to both Johnson-Crapo and PATH, the Delaney bill would also revoke Fannie Mae and Freddie Mac’s charters.\(^{221}\)

B. Treatment of Mortgage-Backed Securities After GSE Reform

Given the recent adoption of the final LCR rule, passage of a housing finance reform bill into law may complicate financial


\(^{215}\) Finkle, supra note 145.

\(^{216}\) Delaney, Carney, and Himes Introduce Housing Finance Reform Legislation, supra note 212.

\(^{217}\) Finkle, supra note 145.

\(^{218}\) Id.


\(^{221}\) Id. § 305.
institutions’ efforts to comply with the LCR. The issue centers on the LCR’s classification of MBS for HQLA purposes. The LCR’s classification of GSE MBS as Level 2A imposes a capital haircut and portfolio composition caps on these assets. These restrictions make GSE MBS less attractive as a means of complying with the LCR than Level 1 assets such as cash, U.S. Treasury securities, and Ginnie Mae MBS. The Agencies noted that as a government agency Ginnie Mae’s obligations are explicitly guaranteed by the full faith and credit of the U.S. government, whereas the Agencies designated GSE MBS Level 2A assets because they are not explicitly guaranteed by the federal government. In contrast, private label MBS, even AAA rated private label MBS, do not qualify as HQLA and, therefore, do not count towards compliance with the LCR.

The Agencies adopted the LCR in a world where Fannie Mae and Freddie Mac, under government conservatorship but nonetheless without an explicit government guarantee, issue nearly all MBS. The three leading housing finance reform proposals, however, all call for the elimination of Fannie Mae and Freddie Mac. Based on the distinctions drawn in the LCR between MBS with an explicit government guarantee (Ginnie Mae MBS) and those without such a guarantee (GSE MBS and private label MBS), the passage of any housing finance reform legislation requires an assessment of how newly-issued MBS will be classified under a new regime for LCR purposes.

The PATH Act provides the most cut-and-dried example of

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223. See SIMPSON THACHER & BARTLETT LLP, supra note 68, at 5 (“[S]ome categories of assets, such as non-investment-grade corporate debt securities and private label residential mortgage-backed securities, will have no value for purposes of U.S. liquidity requirements.”).


225. Id. at 61456.

226. Id. at 61458 (noting that while the GSEs are under conservatorship they are effectively guaranteed by the full faith and credit of the U.S. government, but not explicitly).

227. See SIMPSON THACHER & BARTLETT LLP, supra note 68, at 1.

228. SEC. INDUS. & FIN. MKTS. ASS’N, supra note 14.

housing finance reform legislation that does not address the conflict it creates with the LCR’s HQLA definitions.\textsuperscript{230} Given that nearly the entire mortgage finance market would be privatized under PATH,\textsuperscript{231} it is safe to say that MBS issued by the national mortgage market utility’s platform would be designated as private label MBS for purposes of the LCR.\textsuperscript{232} Under this system, the only MBS that would qualify as HQLA would be those issued by Ginnie Mae which would still receive a Level 1 designation.\textsuperscript{233}

The public-private hybrid mortgage finance systems proposed by Johnson-Crapo and the Delaney bill are not so black and white. Under Johnson-Crapo, FMIC-backed MBS would come with a full faith and credit guarantee.\textsuperscript{234} However, the 10% private capital first-loss position suggests that these securities might be designated as private label considering Fannie Mae, Freddie Mac, and private mortgage insurers collectively lost less than half that amount as a result of the 2008 financial crisis.\textsuperscript{235} A private capital level that high would “all but eliminat[e] taxpayers’ exposure to risk” because the 2008 financial crisis and housing crash resulted in losses less than half that amount.\textsuperscript{236} Furthermore, the FMIC guarantee could more accurately be called a limited guarantee given the first-loss position of private capital and the high unlikelihood that the full faith and credit guarantee would ever be drawn upon.\textsuperscript{237} Although the Agencies would probably characterize FMIC-backed securities as having an explicit government guarantee and, therefore, Level 1 HQLA, at least one industry group sees enough doubt in such a future classification that it proposed changing Johnson-

\begin{itemize}
\item \textsuperscript{230} See H.R. 2767 § 110 et seq.
\item \textsuperscript{231} ZANDI & DERITIS, supra note 193, at 1.
\item \textsuperscript{233} See id. (defining “[a] security that is issued by, or unconditionally guaranteed as to the timely payment of principal and interest by, a U.S. government agency . . . whose obligations are fully and explicitly guaranteed by the full faith and credit of the U.S. government” as a Level 1 asset); see also GINNIE MAE, supra note 103 (stating that Ginnie Mae is a “wholly-owned government corporation within the U.S. Department of Housing and Urban Development (HUD)” that issues MBS explicitly guaranteed by the U.S. government).
\item \textsuperscript{234} S. 1217 § 303(d)(9).
\item \textsuperscript{235} ZANDI & DERITIS, supra note 150, at 2 (stating that a 10% private capital buffer would “all but eliminat[e] taxpayers’ exposure to risk”).
\item \textsuperscript{236} Id.
\item \textsuperscript{237} Martinez & Mitchell, supra note 162.
\end{itemize}
Crapo’s text to classify such securities as Level 1 HQLA.238

The housing finance system called for by the Delaney bill makes a stronger case for having an explicit government guarantee. MBS issued under that bill’s Ginnie Mae public-private insurance sharing scheme would have an explicit government guarantee for 95% of the MBS face value—the portion that Ginnie Mae would be responsible for insuring.239 Under this proposal, the private capital first-loss position is only 5%240 compared with 10% under Johnson-Crapo.241 However, whether MBS issued under the Delaney legislative regime would qualify as HQLA under the LCR is uncertain without further regulatory or legislative guidance.

The adoption of the final LCR rule and the various housing finance reform legislative proposals currently before Congress raise the question of whether MBS in the future will be treated more like Level 1 Ginnie Mae MBS or more like private label MBS. Whether or to what degree MBS qualify as HQLA after housing finance reform has significant implications for the housing market because the LCR provides an incentive for financial institutions to prefer HQLA over non-HQLA like private label MBS.242 If housing finance reform legislation creates a system where the vast majority of MBS are defined as private label non-HQLA, then financial institutions will have less incentive to hold these assets on their balance sheets.243

V. MAINTAINING CAPITAL IN THE HOUSING MARKET AFTER HOUSING FINANCE REFORM

The current housing finance system needs to be reformed.244 The status of Fannie Mae and Freddie Mac as wards of the state is

240. Id.
241. Finkle & Borak, supra note 177.
242. See, e.g., Comment Letter from Christopher B. Killian, supra note 18, at 10.
243. See, e.g., id.
unsustainable, but any meaningful GSE reform requires comprehensive action by Congress. The need for reform is made even stronger by the importance of the housing market to the U.S. economy. However, all housing finance reform plans will raise mortgage rates and negatively impact the housing market and the national economy. For this reason, it is critical that any reform legislation minimizes the costs to the housing market and maintains adequate capital in the secondary mortgage market.

The exclusion of private label MBS from HQLA in the final LCR rule may decrease liquidity in the secondary mortgage market as financial institutions shift their capital to other assets. Under the current housing finance system, the Agencies found that excluding private label MBS would not cause any liquidity issues because financial institutions would not be deterred from investing in these securities despite the regulatory disincentives. However, the passage of housing finance reform legislation combined with the final LCR definitions of HQLA may create a significant deterrent effect resulting in an unintended capital shortage in the secondary mortgage market.

During the public comment period for the LCR, nearly every financial institution expressed their concern that the classification of GSE MBS as Level 2A assets and the exclusion of private label mortgage-backed securities would shift banks’ balance sheets away from these assets. Such a shift in assets, they argued, would decrease the funding available for mortgages and raise mortgage interest rates,


248. *Zandi & DeRitis*, supra note 244, at 5.

249. *See, e.g.*, Comment Letter from Christopher B. Killian, supra note 18, at 10.


251. *See supra* Part IV.B.

252. *See, e.g.*, Comment Letter from Paul Ackerman, supra note 91, at 21–22 (“These limitations are likely to incentivize banks to reduce their holdings of GSE MBS, thereby resulting in an increase in mortgage loan interest rates to consumers and a negative effect on the housing market and the broader economy generally.”).
thereby making it much more difficult and expensive for consumers to obtain mortgage financing.253

This problem of shifting capital away from GSE and private label MBS to more liquid assets would only be exacerbated by housing finance legislation that eliminates the GSEs without replacing them with an entity to issue MBS with comparable HQLA treatment or providing a means for private label MBS to qualify as HQLA.254 Under a fully privatized mortgage finance market like the one called for by PATH, all MBS would be private label MBS255 and, therefore, excluded from HQLA.256 In such a system, banks would have less incentive to hold MBS on their balance sheets.257 The secondary mortgage markets would feel the pinch as banks sell off their existing MBS holdings and redirect capital into other assets that qualify for inclusion in the LCR.258

A shift by financial institutions away from investment in mortgage securities would be economically significant. U.S. depository institutions hold $951.4 billion worth of GSE MBS, $136.6 billion worth of private label MBS, as well as $193.4 billion worth of GSE debt.259 In comparison, U.S. depository institutions only hold $345.5 billion worth of U.S. Treasury securities.260 Housing reform proposals that eliminate GSE MBS could unintentionally cause banks to reallocate their MBS holdings to Level 1 assets like U.S. Treasuries.261 Such a move would have profound ripple effects throughout the entire economy beyond the impacts felt in the housing market.262

253. Id.
254. See supra Part IV.B
255. See supra Part IV.A.2.
257. See, e.g., SIMPSON THACHER & BARTLETT LLP, supra note 68, at 3 (“[S]ome categories of assets, such as non-investment-grade corporate debt securities and private label residential mortgage-backed securities, will have no value for purposes of U.S. liquidity requirements.”).
258. BUEHLER ET AL., supra note 99, at 18–19 (explaining how banks can meet LCR requirements and optimize profitability by shifting their holdings between Level 1 and Level 2 assets in response to price signals).
259. FDIC STATISTICS, supra note 107.
260. Id.
261. BUEHLER ET AL., supra note 99, at 18–19.
262. ZANDI & DERITIS, supra note 244, at 5 (describing a “vicious cycle” of weakened housing demand and a weakened economy due to much higher mortgage rates and decreased stability of mortgage funding caused by a privatized mortgage finance system as envisioned by the PATH Act with no MBS comparable to current GSE MBS).
For these reasons, passage of any housing finance reform legislation must take into account the necessity of a robust MBS market. If Congress ultimately moves forward with a system similar to those proposed by Johnson-Crapo and the Delaney bill, the drafters of the legislation would be prudent to include a provision that specifically deals with the LCR. The Structured Finance Industry Group proposed a clause be included in Johnson-Crapo mandating that FMIC-backed securities qualify as Level 1 HQLA for purposes of the LCR.263 The Agencies could also accomplish the same result through new rulemaking in response to housing finance reform legislation.

A housing finance reform proposal creating a privatized mortgage system similar to PATH would require a different solution as there would be no explicit government-guaranteed MBS like under Johnson-Crapo.264 However, the Agencies or Congress could leverage the Consumer Financial Protection Bureau’s Qualified Mortgage rule265 as well as independent credit ratings to create a class of high-quality MBS with sufficient liquidity to warrant classification as HQLA.

The final LCR rule and current proposals for housing finance reform legislation create the potential for an unintended shift of capital out of the secondary mortgage market.266 This potential shift would be a response to the regulatory incentives in the LCR for financial institutions to hold assets that will help them to comply with the LCR.267 Congress and federal banking regulators should be conscious of the potential for a liquidity pinch in the secondary mortgage market as they draft housing finance reform legislation and its accompanying regulations.

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263. STRUCTURED FIN. INDUS. GRP., supra note 238, at 15.
264. See supra Part IV.
265. Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 75215 (proposed Jan. 30, 2013) (to be codified at 12 C.F.R. pt. 1026) (explaining that mortgage loans conforming with the rule represent a better credit risk as a borrower’s ability to repay must be taken into consideration along with other uniform underwriting standards).
266. See, e.g., Comment Letter from Christopher B. Killian, supra note 18, at 10.