GSE "Black Boxes" and Reps/Warrants Must Change - MBA

By: Jann Swanson | Thu, Jun 20 2013, 11:19 AM

The Mortgage Bankers Association released the fourth of five planned concept papers which recommend **immediate steps** the Federal Housing Finance Agency (**FHFA**) and Fannie Mae and Freddie Mac (the **GSEs**) can take to ease the transition to a new secondary mortgage market. *Keys to Expanding Credit Access: A Common Credit Box And Clearer Representations and Warranties* outlines steps to ensure lenders have the confidence to lend to the full range of qualified borrowers. Aligning the GSEs' underwriting standards and creating clear standards for representations and warranties, is essential for a smooth transition to a sustainable secondary market operating with an explicit, limited government guarantee.

MBA says that the two separate automated underwriting systems (AUS) developed by Fannie Mae and Freddie Mac continue to be "**black boxes**," masking their underwriting standards from their customers. Fannie Mae's Desktop Underwriter (DU) and Freddie Mac"s Loan Prospector (LP) are the primary tools used to establish credit standards for the companies and determine whether loans are eligible for their purchase or financing.

Competition between the two GSEs often took the form of "underwriting variances" with their larger customers. Fannie Mae positioned itself as more lenient on credit scores, documentation, and promoted product types such as Alt-A and high loan-to-value loans with minimum mortgage insurance. Freddie Mac negotiated other types of variances.

This made standards even more opaque, and these variances masked the real risks the GSEs were taking from regulators and Congress. Despite being in government conservatorship the two are still not transparent about their AUS credit standards. This situation needs to change in order to create a path to a new and more **competitive secondary mortgage market**.

Even though the GSE are no longer competing and have no capital base or a way of increasing capital over time, they and their regulator continue to pursue policies that unintentionally **undermine** the health of the mortgage market. This includes pursuing repurchases and indemnifications from lenders on old mortgages where there is only a tenuous connection between underwriting and default. Thus a common standard for representations and warranties is also needed.

The GSEs are not betting with their own money, they are betting with **taxpayer money** and it does not make sense to have multiple credit models from GSEs competing in the same market. There is no reason to have two different government-backed black box underwriting systems.

The Federal Housing Finance Agency should set the parameters for **acceptable underwriting criteria** for both GSES and then allow them to offer credit terms within their outer boundary. The Ability to Repay and Qualified Mortgage rules promulgated by the Consumer Financial Protection Agency is a step in this direction but FHFA should consider extending these rules since the GSEs are interpreting the standards to mean that investor property loans will not have any restrictions on credit.

Next the two GSEs should be required to synchronize their underwriting engines by year end which would eliminate unnecessary differences and level the playing field for all lenders who deliver loans to either GSE. Without an identical match across all variables, there would be adverse selection as lenders seek to exploit whichever GSE has weaker standards.

Alternatively, FHFA could turn off one of the underwriting systems and embed both sets of parameters within a single system. By utilizing the same underwriting engine credit variances would become more transparent which would facilitate credit access.

In fact, this type of approach could include credit scorecards from other guarantors and may provide a good model for a future credit system which would clearly indicate the available choices for lenders and consumers and break the black box. The Qualified Mortgage definition would still demarcate the outer boundaries of the credit box.

Credit differences lead to differences in prepay speeds and aligning underwriting standards will help to resolve this problem. Also some investors have been reluctant to move to a common security because of credit differences between the GSEs. A common security is critical to increasing liquidity in the market and saving money for taxpayers.

Finally, FHFA needs to implement additional clarifications and refinements to the **reps and warrants framework**. While FHFA has made some progress with its recent alignment initiative, more work needs to be done to develop a framework that would:

1. Hold lenders responsible for what they control, that is origination and servicing practices.

2. Clearly define material underwriting breaches.
3. Require a causal link between the breach and a default.
4. Establish a performance benchmark after which reps and warrants are extinguished.

With clear standards for defining material defects and a common understanding of when such defects have a causal link to default, lenders will be more comfortable with eliminating credit overlays and lending closer to the edges of the common credit box.

"Confusion and uncertainty around representations and warranties standards continues to cause lenders to add their own overlays to the existing GSE credit standards," said **Bill Cosgrove**, CMB, MBA's Vice Chairman. "As a result, lenders are only offering mortgages to those with the most pristine credit for fear that any borrower default will trigger costly repurchase requests. This is a major contributor to the tight credit environment that is holding back the housing recovery."

In the weeks ahead, MBA will release its final concept paper which will address FHFA's Common Securitization Platform initiative.

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