AN ERA OF TRANSFORMATION

Ginnie Mae
Our Guaranty Matters

September 2014

ABOUT GINNIE MAE

The Government National Mortgage Association (Ginnie Mae) was established in 1968, and issued the first mortgage-backed security (MBS) in 1970. The mission of Ginnie Mae is to bring global capital into the U.S. housing market while minimizing risk to the American taxpayer. Our MBS program provides access to global capital for our issuers and supports the federal mortgage insurance programs.

ABOUT THIS PAPER

"An Era of Transformation" began when employees in the Office of Issuer and Portfolio Management determined that Ginnie Mae needed to assess how to deal with the rapid, substantial increase in the presence of non-depository institutions. This paper seeks to explain that trend, and sets forth Ginnie Mae's approach to effectively managing this new issuer base.

AUTHORSHIP

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FOREWORD

For more than 40 years the Ginnie Mae mortgage-backed securities (MBS) program has fulfilled its mission of attracting capital into the U.S. housing finance system by providing for the conversion of pools of government-insured mortgage loans made by private sector lenders into homogenous securities that, because they are guaranteed by the full faith and credit of the United States government, are highly sought all over the globe. The value of the Ginnie Mae program was never more evident than in the period following the 2007-08 financial crisis, when total securities outstanding more than doubled (from June 2007 to May 2014) as government-backed MBS programs became virtually the only means of financing residential real estate.

But the aftermath of the crisis set in motion a transformation that today poses challenges to which Ginnie Mae will need to adapt if it is to maintain its successful record. The retreat of commercial banks from mortgage lending and servicing, and the replacement of this capacity by non-depository institutions with more complex financial and operational structures, represents a significantly different operating environment than that for which the program was originally designed.

This paper outlines Ginnie Mae's positions on the issues presented by this transformation and describes the steps it will take to maintain the utility and relevance of the MBS program. These positions are driven by Ginnie Mae's identity as a modestly-sized government guarantor with a substantially narrower scope of concern – and staff – than Fannie Mae and Freddie Mac. The Ginnie Mae model is a public-private partnership that depends upon private sector firms as well as a strong and liquid market for activities related to mortgage servicing.

Ginnie Mae's positions on the key questions of this transformational era:

1. It is important that policymakers give proper weight to the preservation of residential mortgage servicing as an economically viable activity, and mortgage servicing rights (MSRs) as an attractive asset class.
2. Ginnie Mae will make appropriate modifications to its MBS program to support the evolution of the residential finance marketplace, including the increasing role of non-depository lenders. It will also seek ways to broaden access to its program through non-traditional structures.
3. To meet the changing risk profile of this evolution, Ginnie Mae will upgrade its ability to assess and promote the financial and operating capability of its issuers, with a focus on liquidity, MSR valuations, and information-driven operational benchmarks.
4. Ginnie Mae's strategic efforts will focus on providing for market liquidity, with an emphasis on providing liquidity in servicing–related activities and the marketplace for mortgage servicing rights.

5. To preserve the integrity and sound administration of its MBS program, Ginnie Mae will act assertively to maintain program compliance, and – in cases of issuer failure – will seek to relocate MSR portfolios to alternative approved issuers rather than seize and manage them itself.

By balancing the modification of the MBS program to meet changing conditions and maintaining the key principles and features that have contributed to its long-term success, Ginnie Mae will assure that its contribution to the health of the U.S. residential finance market will continue for many years to come.

Ted Tozer
President, Ginnie Mae

AN ERA OF TRANSFORMATION

The depth and impact of the 2007-08 financial crisis, rooted in residential finance, have been apparent for some time. There has never been doubt that its aftermath would transform the way mortgage lending operates in the United States.

Though some aspects of the transformation are far from clear even now – most notably how housing finance will be restructured statutorily – one has crystalized: the retreat of commercial banks from home lending and servicing. This was not a pre-ordained event; at the height of the crisis, it would have been reasonable to envision a future state in which mortgage lending was regulated in such a way that it would become even more exclusively the province of traditional banking institutions. But this is not what has developed. Instead, banks have weighed the costs and benefits of these business lines and concluded that less exposure is the more prudent course.

This retreat has occurred in a time of ample stocks of private investment capital, and opportunistic replacements for the retreating banks have emerged. However, the terms under which the replacement capital can be deployed will result in a substantially more risky and complex landscape.

Various governmental entities that have oversight or stewardship responsibilities in the mortgage finance arena, including Ginnie Mae, are considering the implications of this transformation. As will be discussed herein, the Ginnie Mae mortgage-backed security (MBS) program was developed with a business model in mind that did not contemplate the complexities presented by the current evolving environment. Given the substantial growth in its share of outstanding agency mortgage backed securities, Ginnie Mae must decide what level of evolution in its MBS program and platform is necessary to maintain its successful record into a future that may be very different from the past.

This paper outlines Ginnie Mae's approach to the major issues presented by the transformation of mortgage lending. The intention is to make it easier for Ginnie Mae approved lenders/servicers ("issuers") and other stakeholders to plan and conduct their activities that relate to the Ginnie Mae MBS program, thereby ensuring that the agency's mission of attracting capital into the U.S. housing finance system will continue unabatedly.

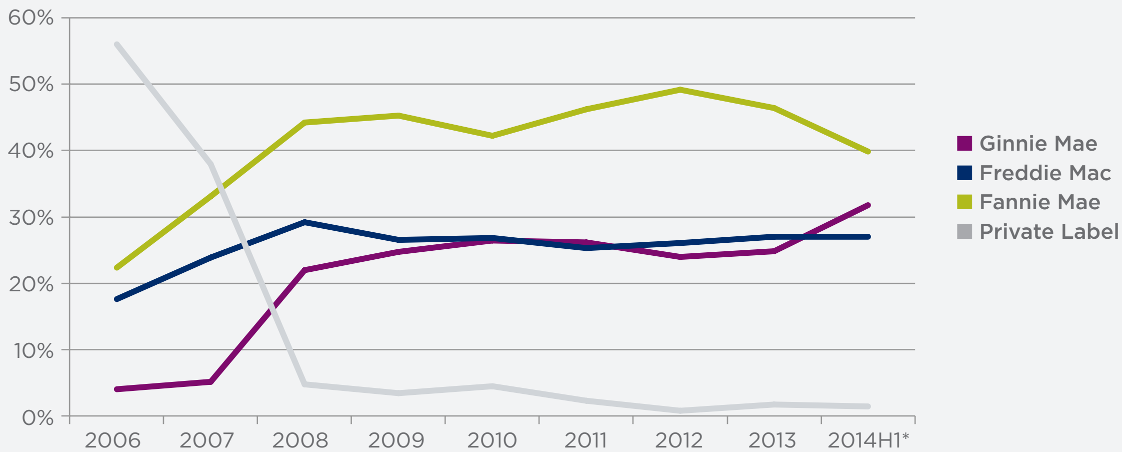
The paper will highlight five ***Strategic Views*** that explain Ginnie Mae's focus, in terms of both the perspectives that will drive its actions and the specific initiatives that will shape its future.

ABOUT GINNIE MAE

Ginnie Mae's creation was an outgrowth of the U.S. government's intervention into the housing markets as a result of the Great Depression, in particular the chartering of Fannie Mae in 1938 for the purpose of creating a secondary market for Federal Housing Administration (FHA) and later Veterans Affairs (VA) insured loans. The Fair Housing Act of 1968 split Fannie Mae into two components: one to continue the purchase of non-government-insured ("conventional") mortgages, and a new agency, Ginnie Mae, to pursue the creation of an MBS market for government-insured loans. Ginnie Mae successfully introduced the first MBS in 1970. Fannie Mae and its eventual sister "government-sponsored entity" (GSE), Freddie Mac, later followed suit with their own MBS programs. As shown below, Ginnie Mae, Fannie Mae and Freddie Mac are the dominant conduits of capital into the U.S. housing finance system. There are no alternatives on the horizon that appear ready to challenge this existing state of affairs.

Under its MBS program, Ginnie Mae guarantees to the owner of the MBS that it will receive all principal and interest payments it is due. In return, Ginnie Mae charges the lender/issuer administering the process a guaranty fee to cover the cost of any failures that would necessitate exercising the Ginnie Mae guaranty.

GINNIE, FREDDIE, FANNIE & PRIVATE LABEL SECURITIES PERCENTAGE OF SINGLE-FAMILY MBS ISSUANCE



*January - June 2014

The model, as originally conceived, has been successful in every respect. The original, statutorily capped price of the government guaranty is readily accepted by the market and has been more than sufficient compensation for losses, including through the massive stress test of the recent financial crisis. Ginnie Mae's MBS program has never posted an annual loss and the securities it guarantees are in high demand across the globe.

However, the success of the MBS program from a capital markets standpoint breeds a critical dependency. For every pool of mortgages that has been securitized and guaranteed by Ginnie Mae, there must be an institution willing to take full responsibility for the servicing, remitting and reporting activities that are essential to the overall construct. These institutions – Ginnie Mae's issuers – are required to make contractually-required payments to security holders even on delinquent loans for which payments have not been received.

It is the marketplace of such institutions that is changing so rapidly today, and is the subject of this paper.

GINNIE MAE AND THE GSEs

In several ways, Ginnie Mae is similar to Fannie Mae and Freddie Mac, which oversee conventional (non-government-insured) securitization and purchase programs. Both provide for the conversion of individual mortgage loans into guaranteed securities that are readily absorbed into the global capital market.

But there are important distinctions between Ginnie Mae and the GSEs, central to the basis for Ginnie Mae's particular view of the transformation underway in the nation's housing finance system.

In a July 2014 commentary, the Urban Institute posited that there are three primary distinctions between Ginnie Mae and the GSEs:

1. Ginnie Mae securities consist exclusively of loans that are backed by the federal government.
2. Ginnie Mae guarantees only the pass-through payments to security-holders, not the credit performance of the underlying loans.
3. Ginnie Mae securities enjoy the explicit full faith and credit guarantee of the United States Government.

These broad differences, in turn, give rise to other more-nuanced distinctions that lead Ginnie Mae toward the strategic view and direction discussed herein. The common element of these distinctions is the vastly narrower scope of Ginnie Mae's concern, capability and responsibility relative to the GSEs. This narrower scope results from differences in legal roles: the GSEs are issuer, master servicer and guarantor of their securities. Ginnie Mae is only the guarantor of its securities. Therefore:

1. Ginnie Mae's potential for losses occurs almost entirely at the point where a given issuer fails to fulfill its responsibilities under the program and forces Ginnie Mae to step in and exercise its guaranty. From a practical standpoint, such a failure would almost certainly involve the failure of the firm itself. Ginnie Mae is not exposed to loan level losses that fall short of triggering an issuer failure. Such losses are covered by the applicable insuring agency (FHA, VA, USDA or HUD PIH) and any shortfall in the coverage is absorbed by the issuer. While the GSEs similarly stand to lose money as the result of servicer failure, this risk is relatively insignificant compared to that of credit loss on individual loans, which they bear in full (subject to the ability to require sellers to repurchase loans that have been adjudged to have deficiencies).
2. Ginnie Mae does not use its balance sheet to make a market, nor does it purchase loans or securities. The GSEs historically have made a market in loans and securities, using their vastly larger, leveraged balance sheets.

3. Ginnie Mae has a limited ability to oversee servicing of assets (such as might be acquired through an issuer default) or manage servicing assets generally, due to its modest level of resources. By contrast, the GSEs employ sizable staffs to establish and enforce servicing standards, and otherwise oversee the servicing operations of the seller/servicers who are operating on their behalf.

The preceding points lead to a perspective on the part of Ginnie Mae that is subtly but crucially different from those of Fannie Mae and Freddie Mac. The GSEs need to, and are able to, manage the portfolios of mortgage servicing rights (MSR) assets from the outstanding securities they have issued as their own assets. They are responsible for the full spectrum of risk, from the acquisition of an individual loan to the potential failure of a seller/servicer. They are security guarantors as a byproduct of their broader role as asset gatherers and managers.

Though it similarly administers a securitization system, Ginnie Mae's primary role is that of a guarantor. The individual issuers of Ginnie Mae securities are the responsible entities where the servicing assets are concerned, as the insuring agencies are for the loan level credit risk. (The insuring agencies also establish and enforce the servicing standards for the purpose of protecting their loan guaranty.)

The difference in scope means that Ginnie Mae has a heightened sensitivity to the health and liquidity of the overall market for agency MSRs. Its risk is concentrated at the point of its counterparties' ultimate failure or non-failure, which places a premium on the existence of a broad universe of high-quality counterparties that are willing and able to administer the MSR assets that underlie the securities Ginnie Mae guarantees. And as will be discussed further below, Ginnie Mae has extremely limited ability to operate in the MSR market, to the point of preferring that portfolios from failed issuers be absorbed by other issuers rather than acquired by itself. For these reasons, Ginnie Mae is highly desirous that the servicing/MSR market as a whole be an attractive and viable commercial prospect, and that all aspects of it function smoothly.

Ginnie Mae's historic operating framework, characterized by modest levels of permanent staff and utilization of private firms to provide transactional and support services on a contractual basis, is of particular relevance here. Although Ginnie Mae's staff levels are undergoing a substantial increase in percentage terms (reflecting the recognition of and need to correct a long trend of underinvestment), the agency administers a sizable function and portfolio with a remarkably small employee base. The skillful management of relationships with commercial business partners will continue to be an important part of Ginnie Mae's approach, and a valuable means of leveraging the small base of governmental staff to deliver substantial benefits to U.S. homeowners.

NUMBER OF EMPLOYEES AT GINNIE MAE AND THE GSEs

YEAR	GINNIE MAE EMPLOYEES	FANNIE MAE EMPLOYEES[2]	FREDDIE MAC EMPLOYEES[3]
2006	66	6,600	N/A
2007	65	5,700	5,281
2008	64	5,800	4,927
2009	59	6,000	5,323
2010	67	7,300	5,231
2011	78	7,000	4,859
2012	89	7,200	4,961
2013	108	7,400	5,053

Ginnie Mae's unique model results in an acutely market-oriented perspective. Its ability to fulfill its mission is heavily dependent in several crucial ways on the presence, interest and capability of private market firms mostly operating within a heavily-regulated (and sizable) segment of the U.S. economy.

BANK RETREAT

As noted earlier, the retreat of banking institutions from mortgage lending is one of the clear defining developments of the post-crisis era. The Ginnie Mae ***Strategic Views*** articulated in this paper all derive from this trend.

The chart below illustrates the transition of issuance volume and MSR concentrations by top 25 participants over several key time periods:

GINNIE MAE SINGLE FAMILY MBS ISSUANCE & OUTSTANDING PORTFOLIO (TOP 25)

	SINGLE-FAMILY GINNIE MAE MBS ISSUANCES			SINGLE-FAMILY GINNIE MAE OUTSTANDING PORTFOLIO		
YEAR	TOTAL (BILLIONS)	DEPOSITORY SHARE	NON-DEPOSITORY SHARE	TOTAL (BILLIONS)	DEPOSITORY SHARE	NON-DEPOSITORY SHARE
Pre-bubble: 2001	$141	83%	17%	$468	80%	20%
Bubble: 2006	$72	74%	26%	$352	81%	19%
Post-crisis: 2011	$281	87%	13%	$1,075	91%	9%
Today: June 2014 YTD	$113	56%	44%	$1,155	75%	25%

2. Fannie Mae numbers are gathered from the company's annual 10-k filings with the SEC. Totals include full-time, part-time, term and on-leave employees.
3. Freddie Mac numbers are gathered from the company's annual 10-k filings with the SEC. Only full-time numbers are included. However, part-time employees make up only approximately 1%-2% of their staff for the years reported.

Three factors can be considered as primary drivers of the post-crisis retreat of the banks:

1. The impending imposition of capital standards (via the Basel III standard) that could have the effect of penalizing the ownership of MSRs.
2. A recognition that the servicing organizations that banks had constructed over time were inadequate to the current era of high numbers of defaulted loans and more onerous regulatory standards. And additionally, an accompanying unwillingness to invest in the re-engineering that would be necessary to change this.
3. The incurrence of enormous retroactive costs, in the form of settlements and penalties that have made mortgage servicing appear to be a much more challenging and economically uncertain business line than had been believed to be the case.

From Ginnie Mae's perspective, the third of these driving forces seems by far the most significant and likely to have the longest lasting impact. The possibility of continuing unpredictable government-driven costs from a variety of sources will constrain the appetite for participation on the part of the banks that have borne the brunt of them to this point, facilitating the inevitable rise of costs to the consumer.

Ginnie Mae's MBS program is not based on any fundamental distinction between bank and non-bank issuers. The program has always been open to any and all entities that can demonstrate that they meet stipulated qualifications.

Nonetheless, in light of Ginnie Mae's dependence on a sufficient supply of capable and willing private market firms to support the mortgage backed securities it guarantees, decreased levels of participatory interest of some of the largest and strongest residential finance firms is not a welcome development. Ideally, these institutions would regard mortgage servicing, and particularly government-insured mortgages, as an attractive business proposition.

STRATEGIC VIEW I. Policy-makers should be concerned with the retreat of banks holistically; that is, not just with respect to the trend's most direct result (the rise of non-depositories), but also to its causes and long-term significance for the mortgage credit market.

Ginnie Mae will advocate for an environment in which the importance of preserving residential mortgage servicing as an economically viable activity, and mortgage servicing rights as an attractive asset class, is recognized.

REPLACING THE BANKS

As noted earlier, the recent retreat of banks from mortgage lending activity has occurred at a time when investment capital is plentiful. Non-bank institutions—many of them relatively new—have risen to take the place of banks, though the speed and scale of the transition is giving interested governmental entities pause.

A comparison of Ginnie Mae's top ten issuers by unpaid principal balance (UPB) lists from June 2011 and June 2014 gives a flavor for the transformation:

TOP 10 ISSUERS BY OUTSTANDING SERVICING AS OF JUNE 2011				TOP 10 ISSUERS BY OUTSTANDING SERVICING AS OF JUNE 2014			
ISSUER RANK	ISSUER NAME	UPB	% OF PORTFOLIO UPB	ISSUER RANK	ISSUER NAME	UPB	% OF PORTFOLIO UPB
1	WELLS FARGO BANK, N.A.	$320,280,614,950	29.55%	1	WELLS FARGO BANK, N.A.	$418,363,523,365	30.60%
2	BANK OF AMERICA, N.A.	$307,667,701,851	28.38%	2	JP MORGAN CHASE BANK N.A.	$151,908,589,204	11.10%
3	JP MORGAN CHASE BANK N.A.	$110,944,770,913	10.24%	3	BANK OF AMERICA, N.A.	$111,958,890,639	8.60%
4	GMAC MORTGAGE LLC	$46,868,260,324	4.32%	4	U.S. BANK, N.A.	$52,841,656,251	3.90%
5	CITIMORT-GAGE, INC	$42,519,634,964	3.92%	5	NATIONSTAR MORTGAGE, LLC	$45,657,725,630	3.30%
6	U. S. BANK, N.A.	$37,512,106,275	3.46%	6	PENNYMAC LOAN SERVICES, LLC	$38,071,414,508	2.80%
7	PHH MORT-GAGE CORPO-RATION	$24,149,268,284	2.23%	7	FREEDOM MORTGAGE CORP.	$34,284,593,139	2.50%
8	FLAGSTAR BANK, F.S.B.	$18,846,291,764	1.74%	8	LAKEVIEW LOAN SERVICING, LLC	$32,198,111,979	2.40%
9	PNC BANK, N.A.	$18,564,503,025	1.71%	9	QUICKEN LOANS INC.	$30,538,066,447	2.20%
10	SUNTRUST MORTGAGE, INC.	$17,951,812,492	1.66%	10	OCWEN LOAN SERVICING, LLC	$27,832,982,745	2.00%
	Total Top 10 Issuers	$945,304,964,842	87.21%		Total Top 10 Issuers	$948,921,847,329	69.39%
	Total Ginnie Mae Single-Family Portfolio:	$1,083,947,747,620			Total Ginnie Mae Single-Family Portfolio:	$1,367,439,115,046	

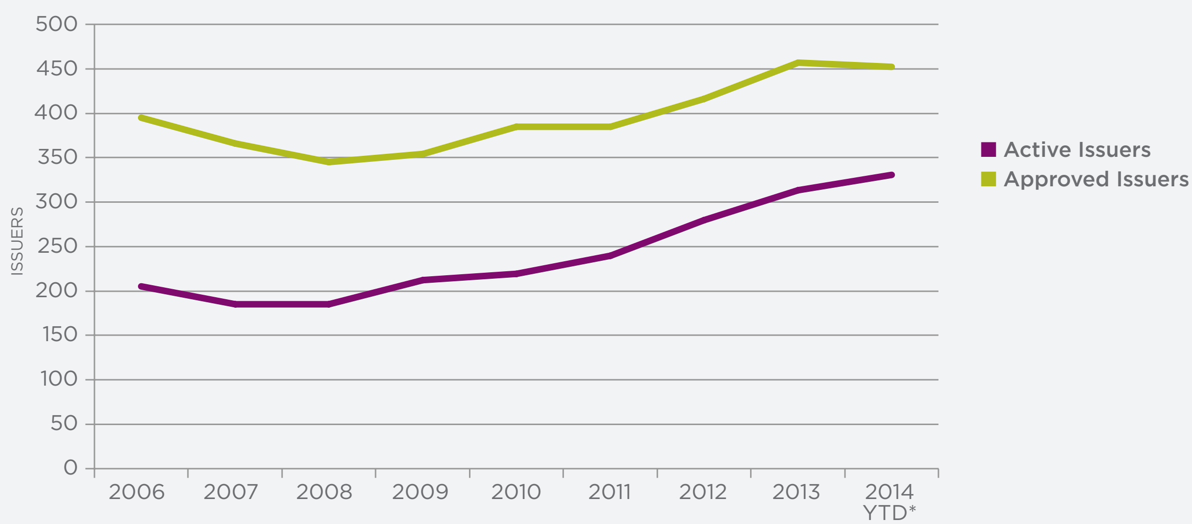
RED = DEPOSITORY

The emerging non-depositories of size are of two principal types. One type consists of established firms that conduct mortgage banking activities through traditional means and see an opportunity in the post-crisis era to expand their exposure to MSRs on attractive terms.

The far more significant type, however, consists of firms whose development and structure has occurred largely or entirely in the post-crisis era. A subset of the new entrants that bear particular mention are those with profiles characteristic of a networked entity more so than a full-scale mortgage banker. Such firms are structured to link funds of capital with operating platforms for the primary (or even exclusive) purpose of overseeing MSR investments. They do not aspire to become broad-based mortgage bankers along traditional lines.

Change among the ranks of smaller mortgage bankers has significantly impacted Ginnie Mae. These firms had become heavily reliant on the banks as their conduits to the capital market. As the banks modified their business approach in the wake of the crisis, smaller mortgage bankers perceived a vulnerability that led them to seek, in substantially greater numbers than had been the norm, direct access to the capital market – such as that afforded by participation in the Ginnie Mae MBS program. This has led to heightened demand for Ginnie Mae approval and a network of Ginnie Mae counterparties that stand to increase markedly for at least the next several years.

ACTIVE VERSUS APPROVED ISSUERS



*YTD = as of August 2014

Although the expansion in the aspirations of the smaller, traditional firms does not show up in top ten lists, it does carry important implications for Ginnie Mae. At a minimum, it will be necessary for the agency to manage a significantly larger number of counterparties than in previous years. At the same time, resources are being applied to exploring innovative approaches that might open the door to broader access to the MBS program through non-traditional "gateway" issuers. These might be "new breed" entities in a further stage of development or entirely different entities altogether. An initial example of the latter is Ginnie Mae's partnership with the Federal Home Loan Bank of Chicago, under which member banks without Ginnie Mae approval may participate in the MBS program with the Federal Home Loan Bank of Chicago acting as the issuer.

STRATEGIC VIEW II. The rising prominence of non-depository firms, and the accompanying trend toward specialization and networked firms, represents a natural market response to prevailing factors, such as the pressures on legacy bank servicers. Though there are legitimate concerns about accompanying risks, there is also value in the diversity and innovation that such firms can bring.

Ginnie Mae is supportive of a responsible evolution of the residential finance marketplace and is willing to explore making appropriate modifications to its MBS program and securitization platform to reflect such evolution.

This evolution should include arrangements to more efficiently broaden access to the MBS program through non-traditional structures, such as the recently announced partnership with the Federal Home Loan Bank of Chicago.

STRENGTHENING STANDARDS

Support for transformation to non-bank lenders with monoline businesses does not imply an indifference to the substantially greater risks associated with this trend. For a government guarantor, a counterparty landscape dominated by enormous banking institutions with substantial resources, diverse lines of business and deep access to low-cost funding is an appealing proposition. Each step away from this state represents a meaningful increase in the possibility of loss to Ginnie Mae. The rising prominence of non-depository institutions in residential finance will require substantial changes to Ginnie Mae's counterparty monitoring and governing practices.

While the advantage in capital and funding sources in particular dramatically favors the risk profile of the banks, the stringent regimen of prudential regulation that undergirds their activities presents an additional advantage. When the MSR portfolio is heavily concentrated in the hands of such regulated institutions, as it had been, Ginnie Mae can consider itself to have outsourced a significant portion of its risk management to banking regulators with a vast experience in attending to the "safety and soundness" of these institutions.

As the allocation among various actors shifts in favor of non-banks, no equivalent entity is playing a similar role to that of banking regulators. Ginnie Mae itself is accustomed to utilizing only a very basic and broad set of financial eligibility standards to address the financial capacity of its approved or prospective issuers.

In addition to financial oversight, the transformation entails a greater need to exercise oversight of areas that relate to operational risk. As mentioned, "new breed" servicers are sometimes characterized by their reliance on networked arrangements, in which financial capacity, origination capacity and servicing capacity are in separate locations. The core function of the primary entity is to manage and oversee the linkage of the separate pieces and ensure that the assembled whole functions smoothly. It stands to reason that there is more room for breakdowns where such constructs are concerned, compared with a long-established bank mega-servicer, in which all requisite pieces are under one roof.

Even with more traditional structures, however, there is a pressing need to ensure that entities have the capacity to handle all aspects of origination, servicing and remitting/reporting in this more demanding post-crisis era.

STRATEGIC VIEW III. Ginnie Mae will upgrade its ability to assess both the financial and operating capacity of its issuers, and the establishment of new measures and standards is likely to result. Three areas will be the subject of particular focus:

- Closer scrutiny of an issuer's liquidity and sources of funding, given the requirement that they remit required payments to security-holders under any eventuality.
- More frequent and detailed MSR portfolio valuations, reflecting that issuer Ginnie Mae MSR portfolios are essentially collateral for the government guaranty that Ginnie Mae has provided on the underlying securities.
- Greater attention to operational capability and dissemination of data-driven operational performance information, recognizing the importance of non-financial factors to the health of the MBS program.

LIQUIDITY

Servicing government-insured mortgage loans is a capital intensive proposition. Market liquidity will be of paramount importance in the years ahead, as residential mortgage finance adjusts to a post-crisis landscape where the institutions and assets have undergone a significant re-allocation.

"Market liquidity" has two primary meanings to Ginnie Mae. The first meaning refers to an adequate supply of funding for mortgage servicing activity and the provision of accessible sources of funding at the point of need. The most critical point, from the standpoint of the Ginnie Mae MBS program, is an issuer's ability to meet the obligation to fund servicing advances to security-holders on loans that are in default.

Toward this end, Ginnie Mae has sought to facilitate borrowing by issuers who maintain Ginnie Mae MSR collateralized financing arrangements. While the lenders under these arrangements can take a pledge of the issuers' Ginnie Mae MSRs without the acknowledgment of Ginnie Mae, there are advantages to entering into an "Acknowledgment Agreement" with Ginnie Mae.

These arrangements lay out the rights and responsibilities of the three parties (financier, issuer and Ginnie Mae) when a Ginnie Mae MSR portfolio is pledged as collateral.

Though the purpose and terms of the financing are always subject to careful review before the use of an Acknowledgment Agreement is approved, Ginnie Mae identifies liquidity added to the overall system from the ability to monetize MSR assets as an additional safeguard against it needing to advance itself funds under its guaranty in case of issuer failure. In recent years, Ginnie Mae has taken steps to allow its Acknowledgment Agreement to be more widely used.

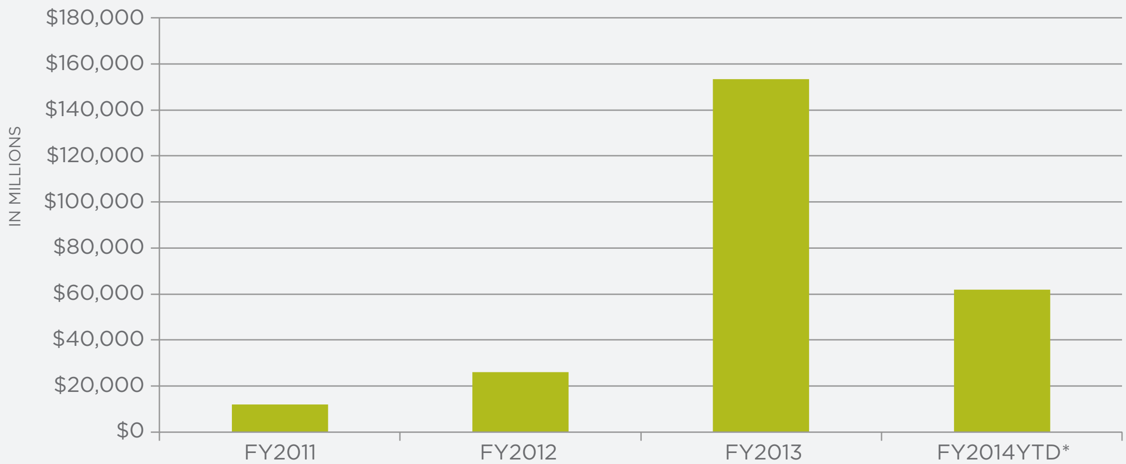
The use of monthly principal and interest advances as collateral presents particular challenges under the Ginnie Mae program, relative to the GSEs. The issue has to do with the separation of loan level credit risk from counterparty failure risk in the Ginnie Mae model. Under the GSE model, the GSEs are liable for reimbursing advances, and are also the master servicer, so a potential separation of the reimbursement from the responsibility to service the MSR is of comparatively little consequence.

Under the Ginnie Mae model it is a third party loan guarantor who is responsible for paying the reimbursement, and—in the case of an issuer default in which ownership of the MSR asset changes hands—the possibility of advance reimbursement going to an entity other than the new servicer is of significant consequence, and might have the impact of inhibiting the marketability of the MSRs and/or increasing Ginnie Mae losses. For this reason, advances on government-insured mortgages are not currently accepted as eligible collateral for financing in the marketplace (advances cannot be separated as collateral from the MSR itself).

A second meaning of “market liquidity” to Ginnie Mae is that a market exists that will permit the ownership of Ginnie Mae MSRs to change hands. Ginnie Mae’s mission to attract global capital into the U.S. housing markets could be thwarted if there were an insufficient supply of institutions ready and willing to service the securities and underlying loans Ginnie Mae guarantees. Perceived difficulty associated with the transfer of servicing responsibilities to other entities should future conditions change could make institutions less willing to invest in these assets. Moreover, as noted, Ginnie Mae has far fewer resources to apply to, and less control over, the servicing of pools and loans as compared to the GSEs, rendering it more reliant on the existence of a deep pool of qualified servicers.

Market liquidity is at the forefront of this transformation. Large actors – both bank and non-bank – are not reducing their footprint merely through adjusting levels of origination via servicing portfolio run-off. Rather, they are opting for accelerated reallocations in the form of MSR transfers. The dramatic increase in Ginnie Mae MSR transactions, as shown in the chart below, illustrates the trend:

MSR TRANSFERS IN GINNIE MAE PROGRAM



*YTD = as of July 2014Y; Fiscal Year = Oct.-Sept.

Ginnie Mae has approval rights over the transfer of the MSRs of securities it guarantees, and it is the guarantor function that drives decisions such as: can the acquiring servicer be confidently expected to fulfill its obligations under the MBS program? Decisions to decline a transfer are likely the result of concern that the proposed transaction presented the possibility of undue risk of losses, which could inure to Ginnie Mae in the event of a future default by an issuer.

This counterparty risk decision, though, is made amidst the backdrop of a larger concern for the maintenance of a liquid market for MSRs – a state of affairs that has great value to Ginnie Mae. This stems from the point made above: Ginnie Mae's mission, achieved through global sales of the securities it guarantees, depends upon a sufficient appetite for investing in MSRs. The perception of MSR illiquidity would dampen this demand, to the potential detriment of housing finance as a whole. Ginnie Mae's actions with respect to servicing transfers are therefore mindful of both counterparty risk at the micro level and market liquidity at the macro level.

Notably, the existing structure of the Ginnie Mae program itself impedes market liquidity in that it is denominated strictly in terms of pools of loans. Ginnie Mae issuers who may wish to transfer servicing of specific loans within a pool are unable to do so today. Upgrading systems to provide for loan level servicing and bond administration is an important strategic initiative for Ginnie Mae.

A final note on liquidity involves MSR strips, the segmentation of cash flows into narrower streams that can be owned by investors completely removed from the operational aspects of producing them. Such streams may be established through private market arrangements or take the form of tradable securities. A plausible future may involve increasing levels of economic ownership of MSRs by passive investors.

Ginnie Mae is generally supportive of developments such as these that make way for additional liquidity into the business of servicing mortgage loans. These cash flow instruments depend on the identification of one stream of cash flow to compensate for the operations of servicing, and another stream to remain available for passive investors. Ginnie Mae remains focused on ensuring that any of its counterparty entities will have the adequate capacity to make all required pass-through payments to security holders, even with a portion of the MSR cash flows being diverted to other parties.

Accordingly, Ginnie Mae will consider MSR strip arrangements, though it has not yet committed to develop a securitized product. The development of loan level servicing capability is a higher priority initiative.

STRATEGIC VIEW IV. Much of Ginnie Mae's strategic efforts over the near future will be directed at providing for market liquidity:

- Enhanced standards for issuer liquidity and increased attention to MSR valuations and markets.
- Continued provision of liquidity through the recognition of MSRs as collateral (via the Acknowledgment Agreement).
- Recognition of the importance of entities that finance servicing activities and incorporation of that role into the standards and procedures that govern the execution of the MBS program.
- Continued exploration of how advance financing can be provided for in the realm of government-insured loan servicing.
- Development of the ability to support loan level servicing, so that Ginnie Mae issuers are no longer constrained by the need to service or transfer an entire pool.
- Attention to the development of MSRs as an alternative asset class, divorced from servicing operations, and consideration of program modifications that might appropriately support this trend

ISSUER FAILURE

Ginnie Mae must consider, as one implication of the transition to a markedly larger universe of active Ginnie Mae non-bank issuers, the possibility of an increase in instances of issuer failures. In charting its strategic direction for the foreseeable period ahead, Ginnie Mae has given consideration to the posture it will take toward issuer infractions under the program, as well as the even more grave issue of addressing issuers that prove unfit for participation or demonstrate outright failure. As future market conditions and participants are likely to differ from the recent past's, Ginnie Mae has begun to adapt its approach to issuer non-compliance.

As stated in earlier passages, the narrowly-defined nature of Ginnie Mae's responsibility is a driver of its perspective on this subject. Ginnie Mae's primary function is to administer a government guaranty. In the context of this paper's focus on the changing face of the residential finance industry, the most serious threat to this function would be a spate of issuer failures sufficient to introduce doubt surrounding the long-term rationale for and soundness of the MBS program (such as have become a normal part of the conversation where the GSEs and even the Federal Housing Administration are concerned).

At the same time, this narrowly-defined responsibility has the advantage of making it possible to describe with succinctness what is most essential on the part of issuers: they must report accurate and timely data about their securitized pools, and manage and pass-through funds on behalf of security holders. Ginnie Mae securities represent an obligation of the U.S. government to security-holders that must be met absolutely without fail. Tolerance of issuer failures to meet these essential requirements – particularly in a climate of increasing numbers of new issuers, many of them small with limited capitalization – could lead to a "slippery slope" in which incidences of non-compliance strain Ginnie Mae's ability to manage its risk.

The ultimate failure, of course, is the inability of an issuer to pass through payments to security-holders or to otherwise demonstrate a lack of compliance so significant as to render it unfit to maintain its nominal ownership of the MSRs. Historically, such failures have resulted in Ginnie Mae's declaration of a default, with the accompanying extinguishment of an issuer's rights to the MSRs and termination of approval status. In such cases, the MSRs become government property and are serviced on behalf of Ginnie Mae by a third party subservicer.

The long aftermath of the 2009 failure of Taylor, Bean & Whitaker (which resulted in the confiscation of a $26 billion government MSR portfolio by Ginnie Mae) has demonstrated the inherent difficulties of making a small government agency designed to administer a security guaranty program also an asset manager, particularly when the need to enter into and perform asset management functions is almost completely unpredictable in terms of timing and scale.

Mindful of these inherent difficulties, while also mindful of the future possibility of the failure of similarly large or even larger institutions, Ginnie Mae's strategic direction will be toward fostering the maximum possible potential for MSRs from failed institutions to be absorbed by other private market firms, without requiring administration by the government.

This strategic approach is another manifestation of Ginnie Mae's need to focus on the mortgage finance marketplace and the institutions that participate within it.

STRATEGIC VIEW V. Because a spiraling series of compliance failures could pose a threat to the continued viability of the MBS program, institutions that clearly demonstrate difficulty complying with essential program terms will be deemed unacceptable risks and will be removed from the MBS program.

In situations where issuer failure necessitates the transfer of MSRs elsewhere, Ginnie Mae's preferred course of action will be to place such MSR assets in the hands of a more suitable Ginnie Mae-approved private sector owner, rather than to seize and manage them itself.

CONCLUSION

Ginnie Mae's central challenge – adapting to changing circumstances, while preserving the integrity and strength of its MBS program – must be performed as a delicate balancing act in an increasingly complex environment. As described herein, the organization's particular makeup, including its compact size, limited scope of operation and unique position as a guarantor only, leads it toward a notably market-focused and private sector-oriented approach.

This paper lays out areas in which Ginnie Mae will be aggressive about changing its program and infrastructure to meet the evolving needs of the market. It also points to areas where the organization will be increasingly vigilant about upgrading standards and practices to meet the challenges posed by today's evolving market presents.

In this balancing act, Ginnie Mae's overriding goal will be to protect and preserve the utility, relevance and remarkably successful track record of the Ginnie Mae MBS program. The agency has held a pioneering role in the creation of a securities market for mortgage loans, its ability in the ensuing period to refine the MBS program as needed to maintain its currency and, especially, its maintenance of an unblemished record of profitable operation over four decades of market change and disruption. This record of accomplishment is testament to the power of a well-conceived and executed government effort to support the healthy functioning of a sizable and critical private sector function.

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