NATIONAL TAXPAYERS UNION

CITIZENS AGAINST GOVERNMENT WASTE

Issue Brief

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The Taxpayer's Perspective: An Analysis of the Administration's Housing Finance Reform Proposal

Background

In 2008, after years of purchasing risky loans, government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac imploded and played a leading role in worsening the Great Recession. Instead of reforming or constructing alternatives to these behemoths, Congress handed the GSEs the largest taxpayer-funded bailout in American history and placed them into conservatorship.

What was supposed to be a temporary patch to the financial crisis has metastasized into 11 years of inaction toward a long-term solution, abusive GSE expansion, and a constant threat of another massive taxpayer-funded bailout. Since being placed into conservatorship, Fannie Mae and Freddie Mac have become the primary buyers in the secondary mortgage market, financing nearly 90 percent of all U.S. mortgages, and have received more than $190 billion from taxpayers, including a $3.7 billion request on February 15, 2018 for a drawdown from the Treasury.

Key Facts:

Taxpayers guarantee $5.6 trillion in mortgages, nearly half the mortgage market.

The administration's proposal aims to build a more resilient housing finance system that protects taxpayers.

Without comprehensive reform, taxpayers are likely to bail out the GSEs again in the future.

The GSEs remain in this untenable position today, with taxpayers potentially on the hook for $6.3 trillion in mortgages. An August 7, 2018 Federal Housing Finance Agency (FHFA) stress test report found that the GSEs could require up to $78 billion in new bailout money if there is another severe global recession. This flawed system forces taxpayers to shoulder a growing burden of risk while the government's outsized role distorts the housing market.

Over the past decade, think tanks, members of Congress, trade associations, and other stakeholders have authored proposals to reform the GSEs. None of the comprehensive overhauls of the housing finance market have been enacted. While minor progress has been made to promote private capital and disperse risk into other avenues, the GSEs are in a more entrenched, leveraged position than ever before. Fannie and Freddie have expanded far beyond their core mission, increasing risk for the entire housing finance system and, in the words of former House Financial Services Committee Chairman Jeb Hensarling (R-Texas), keeping intact "an increasingly dangerous status quo."

Fortunately, housing finance reform is finally receiving the attention it deserves. On April 4, 2019, Mark Calabria, former chief economist for Vice President Mike Pence and former Senior Professional Staff on the Senate Banking committee was confirmed to serve as the next FHFA director. In a speech at the 2019 Ginnie Mae Summit, Director Calabria reaffirmed former Chairman Hensarling's warning, stating, "The status quo is fundamentally unstable, unfair, and unacceptable."

On March 27, 2019, the White House directed the Departments of the Treasury and Housing and Urban Development (HUD) to develop reform plans for the housing finance market with the goal of prudently ending the GSEs' conservatorships. On September 5, 2019, Treasury and HUD released their blueprint, which features administrative and legislative measures that they believe will provide the GSEs with a sustainable path out of conservatorship, shield taxpayers from the risk of another bailout, and ensure the long-term stability of the housing finance system.

After analyzing recommendations from the report, the National Taxpayers Union and Citizens Against Government Waste believe that GSE reform should be guided by the following principles:

- Creating a sustainable, cautious path to recapitalization and release that minimizes systemic risk;
- Protecting taxpayers through stringent capital backstops and liquidity requirements; and
- Restricting mission creep and promoting private-sector competition.

Explicit Government Guarantee

The government guarantee, either explicit or implicit, has long been at the center of debate of post-conservatorship GSE reform. A guarantee is implicit when private investors believe the government will intervene to avoid default because failure to do so may lead to catastrophic economic consequences. This was true in the years preceding the financial crisis, as many investors operated on the assumption that the federal government would not allow Fannie and Freddie to fail. A guarantee is explicit when the circumstances that warrant government intervention are spelled out in legislation or other expression of policy. The government's explicit guarantee makes clear to all market participants that their investment is 100 percent underwritten by the public, which from a taxpayer perspective, is extremely problematic, as it leads to private gains and socialized losses.

One of the more controversial portions of the Trump Administration plan is for Congress to authorize an explicit guarantee for all qualifying mortgage-backed securities. The blueprint notes, "although Treasury does not believe a Government guarantee is required, Treasury would support legislation that authorizes

an explicit, paid-for guarantee backed by the full faith and credit of the Federal Government that is limited to the timely payment of principal and interest on qualifying MBS."

While an explicit federal guarantee ought to be unnecessary in promoting a sustainable housing finance system, such a proposal would only be viable and worth considering in a more comprehensive reform package that, at a minimum, includes the following guardrails:

- A hard statutory cap under which the federal government will cover certain plainly-defined unexpected losses, creating a clear catastrophic loss position,
- A significant level of first loss private capital, and
- An accurately-priced commitment fee that should be placed into a lockbox, only to be used for specific instances.

These safeguards would require carefully drafted statutory language, with mechanisms such as supermajority vote requirements and points of order to prevent Congress from furtively weakening them.

Ending the Net Worth Sweep

In 2012, the net worth sweep was implemented for the GSEs to repay $190 billion in bailout money. The net worth sweep was a decision by the Obama administration to skim the profits of the GSEs and send them directly to the Treasury. This misguided approach has left the GSEs in a precarious position with less reserve capital -- in turn leaving taxpayers exposed to further bailouts at their expense. While the GSEs have paid nearly $300 billion to the Treasury since 2008, Fannie Mae and Freddie Mac remain severely leveraged, leaving taxpayers exposed to further bailouts.

On September 30, 2019, FHFA released its agreement with Treasury to increase capital retention for the GSEs. Prior to that decision, the GSEs were each allowed to retain $3 billion in capital, with the rest swept away by Treasury, representing 80 percent of the GSEs' stock, along with a guaranteed 10 percent dividend. But, for two mortgage giants that provide $6.3 trillion in funding for the housing market, this buffer is completely inadequate. The new agreement allows Fannie to keep $25 billion and Freddie to keep $20 billion in capital reserves, a significant step toward practical reform.

The Treasury plan does not call for a complete end to the net worth sweep, nor does it provide any clear plan for raising capital. The report does, however, say that FHFA should "consider adjusting" the sweep and the GSEs' capital should be rebuilt, with the new financial structure putting private capital in a "significant first-loss position." This means that in the event of an economic downturn, shareholders and creditors would bear the losses, rather than the taxpayers.

Regulatory Changes

Fannie Mae and Freddie Mac have long been exempt from many of the capital, enhanced supervision, and other regulatory requirements with which large banking and other financial institutions have to comply. One of the drivers of the GSEs' recent growth has been a regulatory framework that is biased in favor of GSE-supported mortgage lending. Since the GSEs are free from many of the extra costs associated with regulatory compliance or holding a certain threshold of capital, they have a competitive edge over the private sector.

As explained in the Treasury/HUD report, Congress should repeal the statutory definitions that restrict FHFA from setting strict, risk-based capital and liquidity requirements for the GSEs. This would require them to build sufficient capital that is buffered by private shareholders and follow a "simple, transparent

leverage restriction" that would allow FHFA to assess the GSEs on their progress toward implementing the new capital rules.

FHFA should also require stricter underwriting standards. To reach affordable housing goals in the 1990s, Fannie and Freddie made riskier and riskier loans. The initial 1992 low- and moderate- income (LMI) annual quota was set at 30 percent of all mortgages. By 2008, the quota had skyrocketed to 56 percent and instead of finding borrowers that could make a 10 percent down payment, banks were routinely handing out loans with 3 percent down and, in some circumstances, zero percent down. While underwriting has improved since the crisis, there is no guarantee that the GSEs will not return to their riskier practices once again. As Treasury recommends, "FHFA should conduct an assessment of the credit and other risks posed by the GSEs' underwriting parameters." Revisiting underwriting criteria does not mean that affordable housing goals should be left behind. On the contrary, as Treasury noted, Congress should find a way to provide a more "efficient, transparent, and accountable mechanism for delivering tailored support to first-time homebuyers and underserved borrowers."

Another regulatory reform to consider would be for the Consumer Financial Protection Bureau (CFPB) to allow the current Qualified Mortgage (QM) Rule, known as the "GSE patch," to be replaced by more transparent and consistent rules that apply across the industry. Outside the GSE space, other market participants have developed prudent, risk-managed practices, while GSEs continue to lag. The QM patch allows Freddie Mac and Fannie Mae to exceed the QM 43 percent debt-to-income test and be exempt from some requirements of the CFPB's "Ability to Repay/Qualified Mortgage Rule" that sets underwriting standards for home loans.

For far too long, rules and regulations have benefited government entities at the expense of the private sector. As the Administration notes, "to achieve a level playing field between the GSEs and other private sector competition, the regulatory frameworks governing the GSEs and other market participants should be harmonized."

Credit Risk Transfer Programs

Despite the failure by Congress to enact comprehensive housing finance reform, FHFA has taken some action to mitigate the risk that Fannie and Freddie pose to taxpayers while in conservatorship. Using authority granted to FHFA by Congress, in July 2013, the GSEs initiated new credit risk transfer (CRT) programs to share a portion of the credit risk linked to their guaranteed single-family mortgages with the private sector. Since the start of the CRT programs through the end of June 2018, the GSEs have transferred a portion of credit risk on approximately $2.8 trillion of unpaid principal balance, thereby decreasing taxpayer exposure.

The bulk of these risk transfers, which are called Structured Agency Credit Risk (STACR) at Freddie Mac and Connecticut Avenue Securities (CAS) at Fannie Mae, are purchased by an array of investors from across the globe. These arrangements to buy securities backed by the agencies' loans that are subject to write-downs if homebuyers default. The credit risk therefore is being dispersed broadly throughout the entire global financial system.

Reinsurance and other "loss-sharing agreements" are also innovative and effective tools to limit GSE losses. If and when the GSEs leave conservatorship, they would have to hold large amounts of capital as a private entity so these risk-sharing agreements would considerably lower the amount of capital the two firms have to hold.

While CRT can be an important tool for risk mitigation, they should not be considered a silver bullet in the absence of housing reform. While the GSEs offload the mortgages that carry some of the most

risk of default (Loan-to-Value ratios above 60 percent), they are also the most expensive for the GSEs to insure. Since private investors must be compensated at market interest rates for assuming that risk, they effectively charge more than the GSEs do to bear the risk. According to FHFA, the GSEs pay more to the private sector to assume credit risk relative to what they collect in guarantee fees from borrowers, and the GSEs have not raised their guarantee-fees to cover the costs of those transactions.

Additionally, the Congressional Budget Office believes the GSEs' CRT transactions have so far not reduced short-term costs to the government. In return for transferring some of their risk, the GSEs effectively give up some of their income from guarantee fees to private investors who buy credit-risk notes. Another disadvantage of CRT transactions is that they could attract few investors during a financial crisis and thus can be very limited and expensive at such a time.

The Administration's blueprint rightly highlights the benefits of a vibrant CRT market, noting "the GSEs' CRT programs enhance taxpayer protection and foster price discovery and market discipline, and in light of these features, FHFA should continue to support efforts to expand these programs." The Administration and Congress should continue to focus on expanding these programs to diversify risk.

Pilot Programs

In the 11 years since conservatorship began, Fannie Mae and Freddie Mac have both dramatically expanded their operations by offering new products and services beyond the secondary mortgage market. These pilot programs and products serve a varying number of functions but have mostly added to the level of risk exposure to taxpayers.

Given the unique position and size of the GSEs, developments to broaden the government's leverage in the mortgage market raises serious questions. There is little to no transparency or accountability in the development and implementation of pilot programs. The GSEs' expansion into nontraditional businesses includes credit enhancement, single-family rentals, and financing mortgage servicing rights. In many cases these pilot programs were implemented in direct competition against private sector companies.

Unsurprisingly, many of these pilot programs failed to achieve their desired impact. For example, on August 21, 2018, Fannie and Freddie announced that they were pulling the plug on their single-family rental pilot program, belatedly recognizing that the private sector has had no trouble backing the purchases of such homes and there was no need for government intervention. Had this been recognized at the outset during a pre-implementation comment period, taxpayer dollars would not have been wasted. This is exactly the type of unnecessary dabbling the former regulator should have put a stop to before it got off the ground.

Under the leadership of Director Calabria, FHFA is conducting a thorough review of the GSEs' pilots to ensure their activities comply with their congressional charters. On September 18, 2019, FHFA announced the end of the GSEs' Mortgage Servicing Rights (MSR) pilot program. Established in 2018, the pilot was intended to provide liquidity to non-bank servicers. While both GSEs were approved for the program, only Freddie went ahead. In his press release explaining the termination of the MSR program, Director Calabria stated, "The MSR market is already served by a wide assortment of highly competitive private sources of capital and financing. Going forward, the Enterprises should focus on activities that are core to the guaranty business, mitigate risk, and are essential to end the conservatorships."

FHFA should apply this incisive logic to any other pilots that allow the GSEs to push into markets that are already thriving. For example, Freddie Mac's Integrated Mortgage Insurance and Fannie Mae's Enterprise-Paid Mortgage Insurance pilot programs unfairly give preference to some lenders over others who sell low down payment mortgages to the GSEs. These programs represent a significant blurring of the bright line separation between primary market and secondary market activities.

The development, approval, and implementation of new products and activities lack meaningful oversight and transparency. Despite the hundreds of millions of dollars affecting the housing finance system, no pilot program has been subject to a public notice and comment period. A public comment process allows market stakeholders, including taxpayers, to provide feedback on the need for a proposed pilot and to identify potential impacts to the market. There are also concerns that the GSEs are purposefully expanding their business activities to further entrench themselves in the housing finance system, which complicates efforts to enact comprehensive reform.

The Trump Administration's reform blueprint rightly recognizes the trouble surrounding these taxpayer-supported pilot programs: "FHFA should specify a policy and process for the approval of new pilot programs and other new activities or products, and that process should ensure that each new program, activity, or product is clearly authorized by the GSE's charter and would not compete with products or services already provided by the private sector, while also contemplating the solicitation of public input on these issues and any related considerations."

These safeguards would ensure that the GSEs are neither crowding out private market competitors nor expanding obligations back-stopped by taxpayers. FHFA should provide the following transparency requirements before providing impetus to new pilot programs, or substantially changing or expanding any existing pilot program:

- Clear reasoning as to why such a program is permitted by the GSEs' charters;
- Clear evidence of a market failure, in which no other suppliers can be expected to provide such services with reasonable effectiveness, scope, and equity;
- A quantitative impact study, including a cost-benefit analysis; and
- A reasonably-timed open comment period for stakeholders.

Transparency For the Roles of FHFA, FHA, and HUD

As reported in the Treasury/HUD reform plan, FHFA and HUD should define the roles of the GSEs and the Federal Housing Administration (FHA) in the housing finance market. Since 2014, the GSEs have increased their purchase of loan-to-value and debt-to-income ratio loans. Similarly, FHA has increased its acquisition of cash-out loans by more than 250 percent since 2013. In order to avoid the overlap of increasingly risky loan acquisitions between these government entities, FHFA and HUD must develop and enforce specific, separate missions for the GSEs and FHA.

Reining In Multi-Family Lending Portfolios

In order for the GSEs to better protect taxpayers and stay within their mission of supporting rentals to underserved consumers, FHFA sought to decrease its multi-family acquisitions by 10 percent in 2013. In 2014, after receiving public input on the portfolio's footprint, FHFA imposed caps on annual multi-family secondary mortgage acquisitions. While the caps help to bolster marketplace liquidity, loopholes, particularly green loans involving energy and water efficiency, were used to circumvent the caps.

These broad exemptions are largely responsible for the substantial growth of multi-family lending. Between 2015 and 2017, the multi-family portfolio grew by 14 percent and GSE loan purchases have grown by 41 percent more than the overall market. Of the GSEs' shares, roughly 50 percent were excluded from the caps, with green loans making up a large portion. The GSEs now hold nearly 40 percent of outstanding multi-family debt, up 15 percentage points from 2008.

Continuing to allow the GSEs to expand beyond their mission to promote affordable housing for low- and medium-income renters and their families keeps taxpayers in a precarious position. Privately-owned multi-family housing units should not be backed by a government guarantee. While such a guarantee does not seem to be going away anytime soon, a radically increasing multi-family portfolio puts taxpayers in a riskier loss position. The American Enterprise Institute has called this "crony welfare and crony capitalism—where profits are privatized but losses are taken by the taxpayer."

Fortunately, under the leadership of Director Calabria, FHFA has already taken steps to rein in the GSEs' runaway multi-family lending. On September 13, 2019 the agency revised the structure for multi-family loans. Although the caps rose from $35 billion to $100 billion for Fannie and Freddie, they now "apply to all multi-family business," eliminating loopholes that discourage private investment and tightening the eligibility requirements for those seeking energy and water efficiency loan exemptions. In order to ensure the GSEs commit to their core mission, the revision also directs the GSEs to maintain at least 37.5 percent of their multi-family business to be "mission-driven, affordable housing." FHFA's decision forces the GSEs to dole out their multi-family loans more responsibly and refocuses them on their core mission to provide affordable housing to low- and medium-income renters.

Conclusion

Conservatorship was never meant to last forever. With a strong economy, a true watchdog director at FHFA, and sincere interest from the Trump Administration, the table is set for real housing finance reform to be implemented. The Administration, Congress, FHFA, Treasury, and HUD should all work together and develop solutions that will rein in the GSEs, unwind the government's dominant role in the nation's mortgage market, and safeguard taxpayers. As Director Calabria said, quoting President John F. Kennedy, "The time to repair the roof is when the sun is shining."

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