Insight

A Busy Week for Housing Finance Reform

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Executive Summary

- The Trump Administration has directed Treasury and the Department of Housing and Urban Development to produce sweeping reform plans to the housing finance market.
- The presidential memo has significant policy implications, focusing on increasing the soundness of Fannie Mae and Freddie Mac and increasing competition in the secondary mortgage market. The memo, however, also sets out quite low requirements for ending the conservatorship of Fannie and Freddie, indicating that the administration favors the "recap and release" approach to reform for the mortgage giants.
- As indicated in two days of Senate hearings this week, Congress has been able to make positive but minor steps towards reform. Appearances suggest that for the needed reforms to occur, the administration will need to take the initiative—and this memo indicates that it is doing so.

Context

Hot on the heels of two days of hearings in the Senate Committee on Banking, Housing, and Urban Affairs, the Trump Administration released a presidential memo directing primarily Treasury Secretary Steve Mnuchin to develop a plan for comprehensive housing finance reform.

Few industry watchers were expecting the presidential memo; even fewer expected its scope and detail, as it covers not just Fannie Mae and Freddie Mac, the housing finance government-sponsored enterprises (GSEs), but also the Federal Housing Authority (FHA), Ginnie Mae, and the broader market. Further, the memo comes when not all of the primary policymakers for this issue are in place. While the memo tasks the Treasury Secretary with the bulk of reform, any change will require significant input from the Director of the Federal Housing Finance Agency (FHFA)—yet the administration's nominee, Mark Calabria, has not yet been confirmed by the Senate.

The Presidential Memo

The presidential memo opens by recognizing the urgency of reform, noting the role of Fannie Mae and Freddie Mac in the 2008 financial crisis and that lack of reform "has left taxpayers potentially exposed to future bailouts." The memo, however, goes one step further by noting that, even were the system perfect and taxpayers safe, the GSEs "lack real competitors." Competition in the secondary mortgage market will necessarily expand the options, decrease the cost, and enhance the strength and range of products available to U.S. consumers.

The presidential memo contains two major sections detailing policy goals and specific objectives for the reform of, first, the GSEs, and second, the Department of Housing and Urban Development, the FHA, and Ginnie Mae.

The first section, relating to the "Treasury Housing Reform Plan," has as its stated goals: ending the conservatorship of the GSEs; facilitating competition in the housing finance market; new safety and soundness regulation for the GSEs; and appropriate compensation for the federal government for any implicit or explicit support it provides. The memo also notes that any reform must, among other objectives: preserve the 30-year fixed-rate mortgage; establish capital and liquidity requirements for the GSEs; and mitigate risks undertaken by the GSEs. The first section of the memo concludes with the conditions that must be satisfied for the termination of the GSE conservatorships, which must include: full compensation to the federal government for the explicit or implicit guarantees the federal government provided; a restriction in the GSEs' portfolio and footprint; and heightened prudential regulation.

The second section, relating to the "HUD Reform Plan," has as its stated goals: FHA and Ginnie Mae assuming responsibility for housing finance support to low- and moderate-income families; a reduction in taxpayer exposure; and modernizing operations and technology at FHA and Ginnie Mae.

Both plans must specify whether any reform is "legislative" (and thus requires congressional action) or "administrative" (in that it could be implemented without congressional action).

Analysis

Shortcomings of the Memo

Much of the focus going forward will be on the three requirements for terminating the conservatorship of the GSEs. Although the reforms required (most notably heightened prudential regulation) are welcome, this is not as exacting a standard as we would hope. Crucially, none of the three requirements seem to require congressional action—ostensibly providing a route for ending GSE conservatorship without act of Congress.

The presidential memo therefore clearly leaves a path for "recap and release," the reform strategy that would release the GSEs back into the market without necessarily requiring the presence of robust competition or accounting for the decade of government-backed support. There is a degree of cognitive dissonance in a proposal that can simultaneously require, in multiple places, a market with clear competition to the GSEs while at the same time making it relatively easy for the GSEs to maintain their crushing market dominance.

This path also runs counter to the increasingly accepted narrative that "recap and release" is not the desirable route forward for the GSEs. Of particular note in the two days of hearings held by the Senate Committee on Banking, Housing, and Urban Affairs was how many witnesses and senators spoke against "recap and release," most noticeably Republican Senator Mike Rounds and Democratic Senator Mark Warner.

Omissions from the Memo

Equally noticeable in such a comprehensive document is the lack of two key aspects that will dictate the future of the GSEs: an explicit guarantee on mortgage-backed securities, and the removal from statute of the GSEs' charter. By remaining silent on the nature of any explicit or implicit guarantee, the administration has seemingly taken a pass on the key philosophical question of this debate – the degree to which the federal government is prepared to back artificially the secondary mortgage market. This absence is made more confusing by the strong commitment to the 30-year fixed-rate mortgage, a goal only made possible, some contend, by an explicit guarantee on mortgage-backed securities.

The president's memo also does not contain reference to the GSE charter; in fact, few of its stated objectives would seemingly require the involvement of Congress. Despite the wide-ranging powers of the FHFA Director, congressional action on GSE reform is still needed, most notably to change the GSEs' charter and relationship with the government. By asking specifically for both reform plans to call out "legislative" and "administrative" reforms, the president is indicating that he will require Treasury and FHFA to initiate as wide-ranging reform as possible without congressional action.

Provisions to Watch

Senate Democrats used the two days of hearings to argue at length for affordable housing specifically to be considered in any regulatory reform efforts. It is interesting, then, that the presidential memo specifically makes provision for affordable housing issues by placing responsibility for housing finance support to low- and moderate-income families with the FHA and Ginnie Mae. Such an explicit provision indicates a potential point of alignment between the administration and congressional Democrats, promising that affordable housing will remain a focus of housing finance reform.

The language of "heightened prudential regulation" itself is intriguing, as it appears to reference the language of the Financial Stability Oversight Council (FSOC) and the designation of systemically important financial institutions (SIFIs). Were the GSEs to be privatized, their size and role in the housing market would require they be deemed SIFIs, rendering them the only non-bank SIFIs. Prudential was recently de-designated a SIFI, and this has sparked ongoing discussion around the role of FSOC in regulating non-bank SIFIs that a privatized Fannie Mae and Freddie Mac would vastly complicate.

Conclusions

AAF writers have long noted that the primary and fundamental requirement for wide-scale housing finance reform—other than decreasing the footprint of the GSEs—is a clearly articulated position on the appropriate role of the government in housing finance. Even failing that, 10 years of positive but extremely minor advancements in congressional debate indicate that change must be led and even to a significant degree implemented by the administration. The presidential memo, even without an explicit or implicit guarantee on mortgage-backed securities, represents the most significant policy development in the decade since the GSEs were put into conservatorship. Although reform will be a challenging and lengthy process, this administration has taken the welcome step of not only indicating that the matter is a priority but also informing the direction of policy development.