Insight

Where are the GSEs 10 Years After the Financial Crisis?

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Executive Summary

- Ten years after the start of the financial crisis, Congress has done little to reform the housing finance system in the United States, especially the government-sponsored enterprises (GSEs) that stood at the heart of the crisis.
- The GSEs have a range of problems – from little accountability and oversight to loosened credit standards, profligate spending, and opaque internal proceedings – that Congress should address in a housing-finance reform package.
- While legislation to reform the housing-finance system is difficult and thus unlikely, Congress should turn to its oversight powers to shine a light on the GSEs' missteps.

Introduction

It's been just over 10 years since the Federal Reserve bailed out Bear Stearns, the failure of which helped fuel the financial crisis and the ensuing collapse of Fannie Mae and Freddie Mac (the government sponsored enterprises, or GSEs). Shortly thereafter, the Federal Housing Finance Agency (FHFA) took the GSEs into conservatorship, and most housing-finance experts expected a broad reform of the entire system soon to follow.

During the crisis it became apparent that a combination of what was essentially the GSEs' hedge fund and the GSEs' implicit government guarantee led to their demise. In an ideal world the first item of business for Congress would be to fix those two things. While Congress did eliminate the hedge fund, the implicit government guarantee stuck around, and, in fact, continued to expand over the years.

Unfortunately, 10 years later, the GSEs are still in conservatorship, Congress has passed no

major legislation to overhaul the GSEs or the housing-finance system as a whole, and Fannie and Freddie are returning to some of the dangerous activity that led to the last crisis. Even five years ago *The Wall Street Journal* said that fixing the GSEs was the "largest single piece of unfinished business from the financial crisis."

It is time for lawmakers to prioritize real housing-finance reform. To see clearly what this reform should look like, policymakers must understand what changes have, in fact, been made over the last decade, and consider the current problems at the GSEs.

What has happened over the last 10 years?

While no sweeping reform has passed Congress, some smaller housing finance policies have been enacted over the last 10 years.

FHFA introduced the Home Affordable Refinance Program (HARP) in 2009 to allow homeowners with decreased property values to refinance their homes into better terms. In other words, HARP allows homeowners to keep the same amount of default risk on the books of the GSEs – risk backed by the taxpayers – but pay less interest into the program. That's not exactly a step in the right direction. HARP's sibling, the Home Affordable Modification Program (HAMP), also introduced in 2009, does essentially the same thing, but, instead of a full refinance, the loan terms are modified to suit the homeowners' ability to repay.

Then there are the qualified mortgage (QM) and qualified residential mortgage (QRM) rules created by the Consumer Financial Protection Bureau after its own creation in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The QM rule effectively requires a lender, before approving a loan, to certify that a borrower can repay it through tools like maximum debt-to-income (DTI) ratios and a limit on points and fees. The QRM rule, on the other hand, requires securitizers to retain 5 percent of the credit risk of their mortgage-backed securities for loans that don't "qualify" per the above QM rules, with some additional requirements. While these rules sought to make lending safer – for both consumers and the financial system as a whole – they have driven up costs for borrowers and levied steep compliance burdens on financial institutions, especially struggling community banks.

Major Problems at the GSEs

These changes have sought to help borrowers and discourage irresponsible loans. While these programs have inherent flaws, there are numerous other issues with the GSEs that Congress has not addressed. In fact, depending on what metrics are applied, the GSEs are arguably even worse than before. Below are several areas where the GSEs face significant

problems.

Loosening Credit Standards and Lax Oversight

Despite rules like QM and QRM, the credit standards that were tightened in the immediate aftermath of the crisis have begun to slip back to dangerous levels in the last few years. Take, for example, the DTI requirement in the QM rule. While QM requires a 43 percent maximum DTI ratio, loans purchased by Fannie Mae and Freddie Mac were not required to meet this "prudent underwriting" threshold. In fact, not only was a 43 percent DTI not high enough for them, they have continually expanded their credit box, recently even up to a 50 percent DTI ratio – a dangerous policy change that Congress did not pass, but, rather, that the GSEs implemented unilaterally.

To be sure, an arbitrary 43 percent DTI is likely not the most effectively way to prevent another housing crisis, but more stringent lending standards are a good place to start. Lax underwriting will just put the housing market back in a position to crash again.

The fact that the GSEs enacted this shift in the DTI on their own highlights the need for greater oversight and accountability. If the GSEs are under federal conservatorship and backed implicitly by the taxpayer, they should not be able to threaten the stability of the U.S. economy with unilateral policy changes.

IMAGIN Pilot Program

Earlier this year Freddie Mac announced the launch of the Integrated Mortgage Insurance (IMAGIN) pilot program to test a new type of risk sharing with the goal of increasing the attractiveness to investors of low down-payment mortgages. The program runs the risk of making these already risky mortgages even riskier. If the program is expanded beyond the pilot phase, it essentially will remove the permanent private capital from private mortgage insurance and will replace it with untested capital that can more easily leave the market.

Further, by removing the role of private mortgage insurance in issuing loans, IMAGIN removes what is essentially a second look at the underwriting on the mortgage by the private insurers. Circumventing traditional private mortgage insurance not only increases the risk on the books of the GSEs – and thus the taxpayers – but it is also inconsistent with the GSEs' charters and the calls of many parties for greater transparency in the underwriting process.

Credit Risk Transfer

Last year, FHFA director Mel Watt spoke about the GSE's credit risk transfer (CRT)

programs at the American Mortgage Conference. He announced that the GSEs "have transferred a meaningful portion of credit losses on a combined $1.4 trillion in mortgages, with a risk in force of about $49 billion." That total sounds responsible until you realize that the $49 billion in credit risk that the GSEs have successfully transferred is only equal to approximately 1.2 percent of the GSEs' overall portfolios.

To make matters worse, Director Watt went on to explain how FHFA determines what risk to transfer to private investors. He explained that after experimenting with what amount of expected credit loss investors had an appetite for, FHFA learned that selling the first 50 basis points is difficult and expensive. So FHFA "determined that it is better if Fannie Mae and Freddie Mac retain the first 50 basis points of expected losses in most transactions." It makes sense that investors don't want the first 50 basis points, because that's the credit with the highest risk of loss. But it doesn't make sense that taxpayer-backed entities should voluntarily retain the 50 riskiest basis points of any given pool of mortgages. In sum, not only are FHFA and the GSEs only transferring about 1 percent of the risk in their portfolio, but the risk that they are retaining is the most risky, most likely to default, and most likely to trigger another bailout.

Although the housing market has recovered to some extent since the financial crisis, this risk-transfer policy is yet another example of how the GSEs are arguably worse off than ever, especially now that they are statutorily required to hold zero capital. We are left with undercapitalized yet enormous GSEs (some could argue that they are systemically important financial institutions, which would ordinarily subject them to enhanced oversight) deciding to retain their most risky assets and transferring very little of their credit risk into private hands. We've seen this story before, and it didn't end well.

Overall Lack of Transparency

Beyond the transparency concerns surrounding pilot programs like IMAGIN, there are broader concerns about the lack of transparency within the GSEs in general. In 2015, Senator Grassley sent letters to the Department of Justice and the Department of Treasury asking for more details on the hundreds of billions of dollars being transferred between the GSEs and Treasury. He claims that instead of the transparency expected of a taxpayer-backed entity, "there appears to be an invocation of executive privilege." And when shareholders sued the government over this transfer, arguing it constituted an improper taking of property, the government sought to keep secret as much of the proceedings as possible.

The shareholder concerns are legitimate and plentiful, but the shroud of secrecy within the GSEs is concerning at all levels. Given that Congress recently bailed out these failed

behemoth companies and that they are now under government conservatorship, Fannie and Freddie's lack of transparency about their innerworkings and policymaking should concern Congress deeply.

Spending Issues at the GSEs

Even though the GSEs remain in conservatorship with statutory limitations on the CEOs' salaries, the most recent annual reports for Fannie and Freddie paint a picture of excessive executive pay and an employment payroll that continues to grow. For example, although the CEOs' pay is limited to $600,000 or below, there are other executives making up to $3.25 million per year. In 2017 alone, the GSEs paid out over $24 million to named executives. Similarly, during the height of the crisis in 2008, the GSEs employed a total of 10,812 people. Now, 10 years later, they employ over 13,000 people, and that number grows each year.

Unfortunately the liberal spending goes beyond employee salaries. In a 2017 report from the FHFA's Inspector General, wasteful spending, specifically on the construction of a new headquarters for Fannie Mae, has ballooned out of control. When the project was first proposed in 2015, the estimated costs to Fannie Mae were $115 million, which increased to $171 million in 2016. Now, the report estimates that the new building will cost nearly $800 million once complete, largely due to additions like glass walkways between towers and water features throughout the building. The report also highlights a $250,000 chandelier, a $1.2 million decorative ceiling finishing, and a $2.1 million addition to enhance the natural lighting in the building.

The State of Affordable Housing Programs

The GSEs are not the only threat to the U.S. housing-finance system. The federal government's myriad other housing programs are also worth examining and reforming.

The federal government devotes considerably more resources to affordable housing than to ensuring the long-term stability of the housing market. Federal efforts to promote affordable housing include more than 30 programs within HUD, tax credits and deductions for both corporations and individuals, housing programs for veterans through the Department of Veterans' Affairs, rural housing programs through the Department of Agriculture, the mortgage insurance programs of the Federal Housing Administration, and government corporation Ginnie Mae. Future attempts to overhaul the housing-finance system cannot ignore affordable housing programs and their need for reform as well.

In 2012, the Government Accountability Office (GAO) found that the federal government, through its affordable housing programs, "incurred about $170 billion in obligations for

federal assistance and estimated foregone tax revenue in fiscal year 2010." The GAO further found that housing assistance was fragmented across more than 160 programs and activities. Similarly, the Joint Committee on Taxation estimates that tax expenditures that subsidize housing for individuals and corporations will cost the federal government $787 billion from 2016 to 2020. Many of these credits, deductions, and exemptions favor owner-occupied housing over rental housing, a bias that can and should be addressed.

Such redundancy of federal housing support calls into question the efficiency and effectiveness of government efforts to assist low-income renters and homebuyers and maintain affordability. These affordable housing programs have seen little change since the financial crisis, but for Congress to address affordability, it must both examine how it can improve these programs and seek to support greater job and wage growth.

Conclusion

The GSEs are becoming policymakers on their own, with insufficient oversight, and a lack of transparency. If recent changes indicate the GSEs' trajectory, we may soon find ourselves right back where we were before the financial crisis.

Comprehensive reform to the GSEs is certainly a difficult undertaking politically, as any reform must balance the interests of affordable housing with those of Fannie and Freddie's preferred-stock shareholders and those of taxpayer advocates looking to reduce the risk of another bailout. If Congress will not soon consider legislation to correct the GSEs' missteps, it at least should require more robust oversight to shed light on the current state of affairs in housing finance. The GSEs and FHFA cannot continue to behave so irresponsibly with so much taxpayer money on the line.