Insight

Housing Finance Reform under FHFA Director Calabria

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Executive Summary

- Despite congressional action on the government-sponsored enterprises Fannie Mae and Freddie Mac appearing as unlikely as ever, 2019 has seen significant administrative housing finance reform under Federal Housing Finance Agency (FHFA) Director Mark Calabria.
- These reforms appear to have derisked Fannie Mae and Freddie Mac from a leverage ratio of 1,000-1 earlier in the year to 500-1, and are therefore necessarily a step in the right direction.
- Nevertheless, substantial housing finance reform is still required: Although the FHFA's focus on rebuilding capital at Fannie and Freddie is laudable, it cannot be the only tool in the FHFA's toolbox for considering the future of housing in the United States.

Introduction

In early September – and one day before the 11-year anniversary of Fannie Mae and Freddie Mac entering federal conservatorship – the Departments of Treasury and Housing and Urban Development (HUD) published their recommendations for widescale reform to the housing finance market. These recommendations expanded on at least one major theme in response to the presidential memo earlier this year and divided reform into two kinds of recommendation: congressional (requiring an act of Congress) and administrative (requiring only actions by the executive departments of government).

This division has come to be a useful framing for housing finance reform conversations. Although all actors in this conversation are keen to stress that congressional activity is preferable, after 11 years there has been no legislation out of Congress reforming Fannie

Mae and Freddie Mac, the government sponsored enterprises (GSEs). This fairly alarming oversight, leaving unaddressed what are seen by many as the most significant factors in the 2007-2008 financial crisis, is as unlikely as ever to be resolved by a divided Congress in the year before an election.

Conversely, this administration is the first since the financial crisis to test in a serious way the scope of its authority to pursue housing finance reform without Congress. The starting point for this effort seems to be the appointment of Federal Housing Finance Agency (FHFA) Director Mark Calabria, confirmed by the Senate in April of 2019.

As we consider the path forward for housing finance reform in 2020, it is perhaps time for a retrospective to consider the real efforts to rein in the GSEs that the administration, and most particularly FHFA, have undertaken since Director Calabria's appointment. But by what criteria should these developments be judged?

Comprehensive housing finance reform should include consideration of several questions.

- What is the role of government in the provision of housing, and how must the FHFA be expanded and modernized to be the world-class regulator the industry requires?
- What is the future of the GSEs? Ideally the GSEs would not play a part in the future of housing finance at all, but assuming that is not possible, what should their role be? Their structure? The conditions (and the method) for ending their conservatorship? Their regulatory status post conservatorship?
- Of those conditions, capital is perhaps the most fundamental. How will the GSEs be recapitalized? Will the net-worth sweep (which governs the profits the GSEs must return to Treasury) be amended? Will there be some form of public offering?
- Separately, what steps will be taken to decrease the role the GSEs currently play in the secondary mortgage market? How will the GSE "footprint" or scope be decreased?
- More broadly, how will the risk that the GSEs pose to economic safety and soundness, both in and out of conservatorship, be mitigated?
- Finally, how will private industry be incentivized and enabled to provide real competition to the GSEs? Only the involvement of private actors will lessen the risk the GSEs represent to Treasury.

Effective reform must seek to address these questions and reassure the taxpayer that the GSEs will not be released from conservatorship without addressing the systemic reasons that required the federal government to take over them in the first place.

Steps Toward Reform: A Timeline

April

On April 4 the Senate confirmed Mark Calabria 52-44 as Director of the FHFA, replacing acting director Comptroller of the Currency Joseph Otting and the previous director, Mel Watt. Director Watt oversaw a period of expansion in the footprint of the GSEs, most obviously through an expansion of its pilot programs. These programs, usually not subject to formal notice or public comment periods, expanded the role of the GSEs in the secondary mortgage market and actually increased the risk posed to the financial system writ large. Prior to his confirmation, Director Calabria indicated his commitment to ending the conservatorship of the GSEs.

May

In his first public remarks as Director, Calabria confirmed his view that it is fully within his power as FHFA Director to end the conservatorships of the GSEs, drawing a specific analogy to the rights of the Federal Deposit Insurance Corporation (FDIC) to end banking conservatorships. Director Calabria indicated that he was willing to end the conservatorships himself if Congress was not willing to act. Director Calabria also began to make clear that his and the FHFA's priority was to rebuild capital at the GSEs, considered by him a necessary step before releasing them from their current state, and that he would begin discussions with Treasury to amend the net-worth sweep, the agreement that governs the capital that the GSEs must return quarterly to Treasury. Director Calabria also indicated that sufficiently capitalized GSEs might not require a government guarantee (the $258 billion line of credit to Treasury), either explicit or implicit. Director Calabria also spoke about his commitment to a "level playing field," picking up the theme of competition to the GSEs that was introduced with perhaps surprising force by the March presidential memo.

Also in May, Treasury counselor Craig Phillips noted that the taxpayer had been "repaid" since the government intervened in Fannie Mae and Freddie Mac.

June

In June the FHFA released its 2018 *Report to Congress*, meeting an FHFA statutory requirement since 1992. In this report Director Calabria made his first of what would be many formal requests that Congress take legislative action on housing finance reform but also requested that Congress invest in the FHFA the power to charter additional competitors to the GSEs, reducing the impact of the quasi-governmental duopoly's control on the market. Director Calabria noted that to give the FHFA this authority would be in line with the other federal safety and soundness regulators. One of Director Calabria's themes –

that prior to any drastic reform the FHFA must be reshaped first into a world-class regulator – begins to become clear at this point. Congress has not yet given the FHFA this authority.

In early June Director Calabria also noted that he was reviewing a capital framework proposed under then-Director Watt that would govern the capital that the GSEs would have to hold were they to be released from conservatorship. Results of this review are still outstanding, but some communication is expected before the end of the year.

July

The Consumer Finance Protection Bureau (CFPB) announced that it would allow the Qualified Mortgage (QM) patch to expire. The CFPB's QM rules require lenders to determine their borrower's ability to repay; any borrower with a debt-to-income (DTI) ratio exceeding 43 percent cannot obtain a loan – except via the GSEs, because of the QM patch. By allowing the QM patch to expire, the CFPB is signaling that it will no longer allow the GSEs to extend loans to those at the greatest risk of not being able to repay them (for further analysis see here). This shift will necessarily decrease the risk that the GSEs hold.

August

The FHFA issued a final rule covering the treatment of the GSEs' credit-score models. The rule, a requirement of 2018's Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155), codifies the process by which the GSEs validate and approve credit models, with four distinct phases each with identified time frames. Industry welcomed a move that sought to bring transparent requirements to a system that president of the National Association of Realtors John Smaby noted was nearly two decades out of date. The move was widely seen as healthy to the promotion of systemic competition.

Later that month the FHFA provided the 2019 GSE stress test results, a requirement of Dodd-Frank. The stress test results indicated that comprehensive losses for 2019 had declined for 2019 compared to 2018, a decrease the FHFA attributed to both the housing market and to an "improvement in the credit profile of the GSEs' books of business."

September

In keeping with federal law and internal policy in place since 2012, the FHFA confirmed in September that no GSE base salaries exceeded $600,000. During Director Watt's tenure this salary cap was avoided by executive reshuffling, and base salaries for GSE executives were determined to be many times this amount, with the Inspector General finding that Fannie was paying $4.2 million to two executives performing duties previously performed by a

single officer for $600,000.

On September 5 Treasury and HUD released their long-awaited housing finance reform plans (for more detail please see this previous analysis). The plans, helpfully divided into both congressional and administrative reform recommendations, were broad in scope but perhaps lighter in detail than hoped, posing all the right questions but seeking to answer few of them, particularly those questions relating to recapitalizing the GSEs. We did learn, however, that the backstop would remain in place and that the immediate path forward was one of recapitalization, although Treasury declined to identify a preferred approach or amount. The report also goes into some detail as to how it would seek to empower private industry to restart competition between the GSEs and the private sector in securitizing mortgages. The report calls for the Financial Services Oversight Council (FSOC) to be involved – suggesting, as seems only appropriate, that post-conservatorship the GSEs will be considered systemically important and regulated as such.

Shortly after, in an important win in the fight against "scope creep" at the GSEs, the FHFA announced that it would revise the multifamily loan purchase caps to $100 billion per Enterprise over a five quarter period. Although the FHFA's stated goal was to address a shortage in affordable housing, this development represents a welcome limit in the GSEs multifamily portfolio which expanded from 36 percent of the available annual supply in in 2015 to 49 percent in 2017.

Continuing this theme, in September the FHFA ended the Mortgage Servicing Rights (MSR) financing pilot, designed to allow the GSEs to provide more liquidity to nonbanks, a growing share of the GSEs' portfolio. This pilot represented a particularly notable example of "charter creep," or the GSEs expanding into products and services not permitted under the terms of their charters. In his remarks, Director Calabria noted that the MSR market is already adequately served by the private market.

The FHFA also formally ended the practice of guaranteed fee discounts for high-volume lenders, in an attempt to "level the playing field" for small lenders.

Perhaps the most significant development of the year, however, was the late September joint announcement of the FHFA and Treasury to amend the net-worth sweep and in so doing allow the GSEs to retain a portion (up to an aggregate $45 billion) of their earnings. This step is absolutely fundamental to decreasing the risk the GSEs pose and the first step of an eventual recapitalization and release from conservatorship. But does it go far enough?

October

On October 28 the FHFA released its 2020 scorecard for the GSEs. Structurally different

from previous iterations, the 2020 scorecard directs its focus to ending the conservatorship of the GSEs. The scorecard was accompanied by the FHFA's strategic plan, which gave further insight into the path ahead for reform. Notably, we can expect further revisions to the net-worth sweep in 2020 and a review of the FHFA credit risk transfer (CRT) program, which transfers risk from the GSEs to private industry. Just as notable, the strategic plan is light on detail relating to further reductions in the scope of the GSEs.

Analysis

2019 saw significant reform efforts, and the administration should be commended for more reform initiatives than in the 11 years prior. But how does the reform we have seen match against the ideal criteria we established for comprehensive reform?

At a conceptual level, the desired involvement of government in the housing sector remains unclear. This lack of clarity translates into reform initiatives that will necessarily include, and to an extent preserve, the GSEs as the prime actors in this space. Those hoping that the GSEs be liquidated or turned into the government agencies they *de facto* already are will be disappointed. The relentless focus on expanding the opportunities for competition and the participation of private actors has been heartening, but in a world in which the GSEs remain, achieving true competition remains an uphill battle. Some comfort should be derived, however, from Director Calabria's push to remake the FHFA into a world-class regulator so that when the GSEs are released from conservatorship, they are appropriately monitored and controlled.

Although all signs are currently pointing toward the recapitalize-and-release plan, there is a notable lack of detail regarding the conditions the GSEs must satisfy before exiting conservatorship, or what their legal and regulatory structure will be on exit (although it is comforting that the FHFA envisages the involvement of FSOC). Without expressly removing the Treasury backstop, some level of government guarantee will necessarily remain, be it implicit or explicit.

The focus of the FHFA appears to be on allowing the GSEs to recapitalize. Almost all actors are united in their strong support that key to the safety of the GSEs is a considerable capital buffer. Despite this unity, detail remains scarce on the actual process of recapitalization, with the lack of specificity most notable in the Treasury housing finance reform plan. Although amending the net-worth sweep to allow the GSEs to rebuild capital is a necessary step, an additional $45 billion will not stave off disaster, with concerns that the GSEs will be released with capital at only the minimum statutory requirements rather than levels based on any form of risk-based capital assessment. We are still no closer to identifying what the desirable level of capital should be, although the FHFA is committed to releasing the GSE

capital-requirements plan prior to the end of the year.

Perhaps the most effective reform activities have taken place in derisking and limiting the scope of the GSEs – from allowing the QM patch to expire, to discontinuing certain pilot programs, to caps on multifamily lending. More work must be done, however; although it is commendable that the FHFA has discontinued the MSR pilot program, that program was only one example of charter creep at the GSEs. Perhaps more fundamentally, the GSEs retain the first 10 to 40 basis points of loss on CRT transactions. More must be done to shield taxpayers from risk.

Conclusions

Prior to releasing the GSEs from conservatorship, policymakers must achieve comprehensive reform that prevents the GSEs from needing a government rescue again. Although the FHFA has already taken several significant steps this year, a substantial amount of work remains to be done. The FHFA's focus on capital is a good place to start but cannot be the only tool in their toolbox for considering the future of housing finance in the United States.

Director Calabria noted at the start of his tenure that the GSEs were leveraged (had a debt to income ratio) of 1,000 to 1, where most banks are only allowed a leverage of 10 to 1. In Director Calabria's testimony to the House Financial Services Committee on October 22, he was able to announce that this ratio now stands at 500 to 1. At the very least, anything that decreases the risks the GSEs pose to U.S. and international financial safety and stability must be recognized as steps in the right direction.