Insight

The FHFA and the Future of Housing Finance Reform

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Executive Summary

- Ten years after the financial collapse, statutory housing finance reform remains neglected. Fannie Mae and Freddie Mac linger in government conservatorship, leaving taxpayers on the hook in the event of the next financial crisis.
- While legislative reform is unlikely, the Federal Housing Finance Agency has been, and could continue to be, used as a vehicle for housing finance policy.
- With this administration poised to appoint a new leadership of the agency in January, it is an appropriate time to review the policy stance of the FHFA and put it on track to reduce the risks of Fannie Mae and Freddie Mac before taxpayers are once again required to bail them out.

Introduction

Yesterday the House Financial Services Committee held a hearing entitled "Oversight of the Federal Housing Finance Agency's role as conservator and regulator of the Government Sponsored Enterprises."

The American Action Forum has written at length on the need for large scale housing finance reform and the need to end the conservatorship of Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs) that effectively constitute the secondary mortgage market. To adapt the words of Chairman Hensarling in yesterday's hearing; ten years ago Fannie Mae and Freddie Mac were thinly capitalized, bought loans issued with as little as 3 percent down payments, issued mortgage-backed securities encompassing roughly half of all first mortgages and were embroiled in scandal. Ten years later little has changed. Although some market participants see the potential for legislative reform on the

horizon, it is far from a guarantee.

Congress is, however, not the only actor in determining the scope and direction of the GSEs. A key role is played by the Federal Housing Finance Agency (FHFA), which oversees Fannie and Freddie, and given that the next FHFA director is expected to be appointed in January, the role of the FHFA should be examined in more depth.

The creation of the FHFA

During the midst of the sub-prime mortgage crisis in the summer of 2008, Congress passed the Housing and Economic Recovery Act (HERA) in an attempt to stabilize the housing market. Amongst other things, it consolidated two preexisting federal housing entities, the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board, into one single overarching independent agency – the FHFA.

Under statute the FHFA director is tasked with the duty to "oversee the prudential operations of each regulated entity" – i.e. Fannie and Freddie – and in doing so, gives the director the power "to exercise such incidental powers as may be necessary or appropriate to fulfill the duties and responsibilities of the Director in the supervision and regulation of each regulated entity." These are broad authorities – some would argue *too* broad – but they provide FHFA the ability to pursue housing finance policy.

After failed attempts to recapitalize Fannie and Freddie as the mortgage market continued to grow toxic, the newly formed agency used its broad statutory power to take the two GSEs into conservatorship, becoming the financial managers of the enterprises in exchange for a Senior Preferred Stock Purchase Agreement that would pay back the billions of taxpayer dollars used to ensure their solvency during the crisis. This assumption was initially envisioned as a temporary measure to help the enterprises return to their normal business operations of providing liquidity, stability, and affordability to the housing market, as mandated by their government charter.

The powers of the FHFA and its Director

Conservatorship, never intended to be more than a temporary measure, has exposed the sweeping powers of the FHFA and its director. The director enjoys considerable power to set the direction of the GSEs, from the decision to fund pilot programs potentially up to putting the GSEs into receivership.

Under the directorship of Mel Watt, FHFA has indeed used these powers. Unfortunately, they have often been used to enlarge rather than diminish the role of the GSEs. For example, while FHFA has sought, via various pilot programs, to move risk away from the

taxpayer and onto private balance sheets, these attempts may very well have provided advantageous treatment to some insurers over those already in the market. Such initiatives are usually not subject to a public comment period and exemplify the GSEs' relentless drive to assume more risk. Commentators in the industry have noted the "charter creep" these programs represent.

Citizens Against Government Waste and the National Taxpayers Union commented in a joint letter to Vice President Mike Pence: "Instead of supporting the secondary mortgage marketplace, as originally intended, the GSEs have sought to compete with small lenders, have flirted with ways to extend credit to riskier borrowers, and have attempted to directly conduct business with consumers. This includes the GSEs' purchasing of no-appraisal loans and radically increasing their multifamily lending portfolios, which the American Enterprise Institute has called 'crony welfare and crony capitalism—where profits are privatized but the losses are taken by the taxpayer.'"

The sweeping powers of the FHFA director are under legal challenge. In July 2018, a three-judge panel of the Fifth Circuit Court of Appeals found the structure of FHFA to be unconstitutional given its isolation from executive branch oversight. The ruling detailed just how much power the FHFA director possesses. The panel notes that "the FHFA enjoys sweeping authority over GSE operations," including the power to "take over the assets of and operate the regulated entity with all the powers of the shareholders, the directors, and the officers of the regulated entity and conduct all business of the regulated entity."

Even if the structure of the FHFA must be altered to satisfy constitutional muster, however, the entity will retain its policymaking role and powers. For that reason, it makes sense to review the policies of the FHFA with an eye to reform under the new leadership.

Conclusions

With current FHFA Director Mel Watt's tenure coming to an end in January, the new leadership of the FHFA should use its authority for change, despite the lack of congressional action. In the absence of real GSE reform, a future FHFA should understand the limited role the GSEs were intended to play and act to limit their scope accordingly.