Solution

Fannie Mae and Freddie Mac and the Need for Reform

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Executive Summary

- After entering into conservatorship following the most recent financial crisis, Fannie Mae and Freddie Mac's capital reserves are required to be wound down to zero by 2018. Without capital, any fluctuation in market conditions could require the GSEs to once again draw on their line of credit at the Treasury.

- Real housing finance reform is tedious, with all the moving pieces, the number of involved actors, and the millions of Americans who rely on mortgages and mortgage guarantees. Policymakers must understand the big picture and focus on a set of principles to guide the reform process.

- The guiding principle of reform is taxpayer protection. With the GSEs at the heart of the biggest taxpayer funded bailout in history, policymakers must ensure this doesn't happen again. Private capital like private mortgage insurance must be introduced to share the risk.

Introduction

Housing finance was at the center of the 2008 financial crisis that placed substantial economic stress on Americans and spawned dramatic government intervention. Yet, over nine years later, the central actors in the crisis and response – Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) – remain essentially unchanged. Now,

entering into their tenth year of conservatorship and as their capital reserves approach zero, the GSEs remain a beacon of systemic risk. The Senate has hinted that GSE reform is a priority this year, and, amid other policy and political distractions, the Senate Banking Committee should remain on course if we are to avoid another crisis rooted in subprime underwriting and taxpayer-sponsored bailouts.

Current State of the GSEs

Fannie Mae's most recent quarterly report showed a net income of $3.2 billion and the payment of a $2.8 billion dividend to Treasury in June 2017. With this most recent dividend payout, Fannie Mae's total dividends sent to Treasury are now equal to $162.7 billion since its initial draw from Treasury in 2008. The report explains, "[a]lthough Fannie Mae expects to remain profitable on an annual basis for the foreseeable future, due to the company's limited and declining capital reserves (which decrease to zero in 2018) and the potential for significant volatility in its financial results, the company could experience a net worth deficit in a future quarter. If Fannie Mae experiences a net worth deficit in a future quarter, the company will be required to draw additional funds from Treasury under the senior preferred stock purchase agreement to avoid being placed into receivership."

Similarly, Freddie Mac's most recent quarterly report showed a net income of $1.7 billion and the payment of a $2 billion dividend to Treasury in June 2017. This brings Freddie Mac's total payments to Treasury to $108.2 billion compared to its total withdrawals of $71.3 billion. And like Fannie Mae, Freddie Mac is legislatively required to wind its capital buffers down to zero by 2018. Freddie Mac's purchase agreement with Treasury also limits the amount of mortgage assets it can own and the amount of debt it can incur.

How Did We Get Here

From a policy perspective, the GSEs were central elements of the 2008 crisis. First, they were part of the securitization process that lowered mortgage credit quality standards. Second, as large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the "too big to fail" problem. Policymakers were unwilling to let them fail because financial institutions around the world bore significant counterparty risk to them through holdings of GSE debt, certain funding markets depended on the value of their debt, and ongoing mortgage market operation depended on their continued existence. They were by far the most expensive institutional failures to the taxpayer.

There is vigorous debate about how big a role these two firms played in securitization relative to private-label securitizers. There is also vigorous debate about why these two firms got involved in the problem. In the end, this debate need not be fully resolved to

recognize that while the GSEs did not by themselves cause the crisis, they contributed significantly in a number of ways.

The mortgage securitization process turned mortgaes into mortgage-backed securities through the GSEs as well as through Countrywide and other private label competitors. The securitization process allows capital to flow from investors to homebuyers. Without it, mortgage lending would be limited to banks and other portfolio lenders, supported by traditional funding sources such as deposits. Securitization allows homeowners access to enormous amounts of additional funding and thereby makes homeownership more affordable. It can also diversify housing risk among different types of lenders. If everything else is working properly, these are good things. But everything else was not working properly.

There were several flaws in the securitization and collateralization process that made things worse. Fannie Mae and Freddie Mac, as well as Countrywide and other private label competitors, lowered the credit quality standards of the mortgages they securitized. A mortgage-backed security was therefore "worse" during the crisis than in the preceding years because the underlying mortgages were generally of poorer quality. This turned a bad mortgage into a worse security. Mortgage originators took advantage of these lower credit quality securitization standards and the easy flow of credit to relax the underwriting discipline in the loans they issued. As long as they could resell a mortgage to the secondary market, they didn't care about quality.

In addition to feeding poorly originated mortgages into the system, the GSEs proved to be so deeply interconnected with the broader financial system that policymakers were forced to step in to prevent their failure. In September 2008, the Federal Housing Finance Agency (FHFA) put Fannie Mae and Freddie Mac into conservatorship. Policymakers in effect promised that "the line would be drawn between debt and equity," such that equity holders were wiped out, but GSE debt would be worth 100 cents on the dollar.

They made this decision because banking regulators (and others) treated the GSEs' debt as equivalent to Treasuries. A bank cannot hold all of its assets in debt issued by General Electric or AT&T, but it can hold it all in Fannie or Freddie debt. The same is true for many other investors in the United States and around the world. These investors assumed GSE debt was perfectly safe, and, as a result, they weighted it too heavily in their portfolios. Policymakers were convinced that this counterparty risk faced by many financial institutions meant that any write-down of GSE debt would trigger a chain of failures through the financial system. In addition, GSE debt was used as collateral in short-term lending markets, and, by extension, their failure would have led to a sudden, massive, contraction of credit beyond what actually occurred. Finally, mortgage markets depended so heavily on the GSEs

for securitization that policymakers concluded their sudden failure would effectively halt the creation of new mortgages. All three reasons led policymakers to conclude that Fannie and Freddie were too interconnected with the system to be permitted to fail.

When Congress placed Fannie and Freddie into conservatorship in 2008, their charters contained four main points: 1) they would be regulated by the Department of Housing and Urban Development (HUD) and FHFA; 2) they would both be exempt from state and local taxes; 3) the current president would be allowed to appoint five of the 18 members of each company's board, and 4) the Treasury secretary would be authorized to purchase up to $2.25 billion in securities from each company. It is in the purchase agreements between Treasury and the GSEs that the requirements for dividend payments and capital reserves were set – the subject of much debate.

What Should Be Done

How to fix the GSEs is the million (trillion?) dollar question, and there is not one correct answer. A combination of guiding principles and specific ideas for systemic fixes should be considered as Congress takes up GSE reform. First and foremost, priority should be put on action and on truly reforming the system. Over nine years after the financial crisis, the housing finance system in the United States remains essentially unchanged. Moreover, in the aftermath of the mortgage meltdown, the government continues to back a large majority of new mortgages. Restoring the role of the private sector is overdue.

Second, the bailouts of Fannie and Freddie were at the heart of the largest taxpayer-funded bailout in history. Reform of the system should focus on protecting taxpayers and ensuring that such a bailout does not happen in the future. One way of protecting taxpayers is to increase the amount of private capital in the system to help absorb losses. Currently, the GSEs participate in credit risk transfer (CRT) programs which shift a portion of risk to the private market. Unfortunately, they are only transferring about 1 percent of the GSEs over all portfolios, and the credit risk they are retaining on their balance sheets is the most risky, the most likely to default, and the most likely to need another bailout. This indicates that while the housing market may have recovered since the financial crisis, the GSEs are debatably worse off than ever – especially when their undercapitalization quickly approaching zero is taken into consideration.

One way the GSEs can de-risk their portfolios is through the increased use of private mortgage insurance (PMI) to transfer the risk. PMI has traditionally been used to reduce the possibility of loss on low downpayment mortgages to get them to the same level of risk as a 20 percent or greater downpaymnet mortgage. The GSEs could use PMI to absorb even more of those potential losses so that, in a worst case scenario, they wouldn't even have to

cover 80 percent losses on the mortgage. Rather they would cover 50 or 60 percent. As a result there is more private capital behind these mortgages, the GSEs' exposure to losses is lower, and the risk of a taxpayer bailout of Fannie and Freddie is greatly reduced.

Third, the GSEs themselves should not be the only targets of reform. Rather, reform of the Federal Housing Administration (FHA), and FHFA should be on the table. Good reform should consider the full range of federal backing of housing finance and ensure that regulators and their regulations strike a balance in proper oversight while retaining sufficient liquidity of the market, especially during times of severe economic stress. Further, any new housing finance system that is put in place as a result of transformative reform must consider the transition period and how to move smoothly from one system to the next. Specifically, policymakers must ensure that the market remains stable and liquid while overhauling operations within the GSEs, the regulators, and the private market.

Fourth, housing reform must remove barriers to entry for competition in the primary and secondary mortgage markets, especially as those barriers relate to lower-income communities. Take, for example, the qualified mortgage (QM) rules in Dodd-Frank. A recent analysis of mortgage data by the Federal Reserve found that 22 percent of borrowers in 2010 had debt-to-income ratios above the 43-percent threshold set by the QM rules, and 70 percent of borrowers above that threshold had loans from FHA, the VA, or Rural Housing Service-insured loans. Under Dodd-Frank's regulatory regime it will be either costly or impossible for private capital to back high loan-to-value (LTV) or non-QM lending to fill the government's role.

AAF has previously estimated that the bottom line effects of Dodd-Frank and Basel III regulations may result in 20 percent fewer loans resulting in 600,000 fewer home sales. Real housing finance reform must take into account how all applicable regulations affect affordability and barriers to entry, especially from private capital, and must make every effort to reduce any negative, unintended consequences as much as possible.

Fifth, policymakers must ensure that history does not repeat itself in the housing finance market. More specifically, reform should promote best practices within FHFA and should work to bolster a strong, competitive primary market. Just two years ago, nearly seven years after the GSEs went into conservatorship, the FHFA reported that the two were still engaging in risky behavior that could put taxpayers and the economy at risk. Let's not forget that between 1998 and 2004, the Office of Federal Housing Enterprise Oversight (OFHEO) – then the regulator of the GSEs – found that Enron-style accounting at Fannie Mae had resulted in $10.6 billion in losses. More recently, FHFA reported that Fannie Mae hired an employee unqualified to be its chief auditor, and FHFA failed to act. At the same time, FHFA was directing both Fannie and Freddie to do more to make credit available by

backing low downpayment mortgages while filling the coffers of the affordable housing trust fund, further putting taxpayers at risk. Reform should ensure that history does not repeat itself, and should provide for a dynamic primary market, properly overseen, with guidance to accept properly underwritten mortgages.

What Shouldn't Be Done

Despite the $188 billion bailout and the widespread belief that GSE reform would be an immediate post crisis priority, little has been done. Recently, there has been a growing movement to recapitalize the GSEs and release them from conservatorship. This is a bad idea that fails to address the fundamental flaws in the GSEs' business model, and it could lead to another financial collapse.

Those who support a "recap and release" model forget that Fannie and Freddie are the very embodiment of "crony capitalism" or "too big to fail" with their government charters, presidential board appointments, seemingly endless lines of credit at the Treasury, tax exemptions, and minimal capital requirements, all while they continued to accumulate large, undiversified portfolios. In short, Fannie and Freddie were allowed to borrow cheaply while pretending to be independent of the federal government. As a result, taxpayers bore the brunt of the collapse of a rigged system.

Recapping and releasing the GSEs does nothing to change their business model. The GSEs are unable to compete as fully private enterprises. If they were, they either would have done so already, or the private sector would have jumped into the monoline-housing hedge fund business by now. What's left of a potential revenue stream is the collection of fees in exchange for the GSEs' guarantee. But with their existing book of mortgages, they would have to charge much higher fees to accumulate capital to appropriately back the new guarantees. Those higher fees would immediately be undercut by any new competitor entering the mortgage guarantee business.

Conclusion

As Fannie and Freddie move toward zero retained capital and a heightened possibility of another draw on the Treasury, it is more important than ever that real, substantive reforms be made to the GSEs. As one of the most complex issues affecting the lives of almost every American – whether a homebuyer or simply a taxpayer on the hook for the GSEs' shortcomings – policymakers should have a clear set of principles guiding their reform proposals.

Among the most important of these priciples, as detailed above are: 1) Take action – we can't afford to continue to do nothing; 2) Protect taxpayers – create a system that provides

for the needs of homebuyers without subjecting taxpayers to substantial risk; 3) Keep the market stable and liquid – reform should also include the oversight agencies and ensure there is sufficient liquidity even in times of economic stress; 4) Allow competition to flourish – remove regulatory barriers to entry to allow private actors a chance to fill gaps in the market that the GSEs currently cannot serve efficiently; and 5) Do not let history repeat itself – any reform should lay the groundwork for a dynamic primary market. It won't be easy, but it will become necessary very soon.