The Last Big Housing Finance Reform

BY HELEN FESSENDEN

In 2008, the Treasury Department took over near-broke Fannie Mae and Freddie Mac with a mandate to stabilize their finances. Seven years later, these two housing finance giants remain in government hands with no immediate prospects of escaping conservatorship. Many economists as well as policymakers in both parties agree the status quo is not a long-term solution and that these two government-sponsored enterprises (GSEs) should be downsized and at least partially privatized, but there is no consensus on how to achieve this. In fact, the share of single-family mortgages owned or backed by the GSEs rose to a high of 47 percent in 2013, up from 40 percent in 2007 and far higher than their 7 percent share in 1981. The enterprises also continue to hold a dominant position in the issuance of mortgage-backed securities (MBS), accounting for 70 percent of all issuances in the first quarter of 2015. The challenge of defining the basic mission and identity of the enterprises — public, private, or something in between — is not a new one, however. It was at the center of the debate the last time Washington tried to reform the GSEs, back in 1992.

On the surface, that year promised real momentum for housing finance reform. Congress had agreed to a costly rescue of the thrift industry three years earlier, and amid the bailout's widespread unpopularity, the George H.W. Bush administration and lawmakers in both parties were eager to prevent future rescues requiring taxpayer dollars. In 1991, Congress followed through with legislation that strengthened regulators' authorities over banks with federal deposit insurance. Then, with a strong push from the Treasury Department, Congress turned to reforming Fannie and Freddie, which were taking on an increasingly important role in providing liquidity to the housing market by buying mortgages from lenders and then issuing MBS backed by those loans.

But this time around, Congress reached a deal that left much of the status quo intact. Most importantly, it left in place the implicit government guarantee that, in the view of investors, backed the enterprises. When such a guarantee is present, investors are likely to underprice the risks the institutions take. And while the 1992 reform was an attempt at addressing this problem by ramping up regulation, many observers argue that it fell short. Among its outcomes were capital requirements far lower than those imposed on banks and thrifts, and a regulator that some say lacked the supervisory and regulatory tools commensurate with the GSEs' size and exposure to risk.

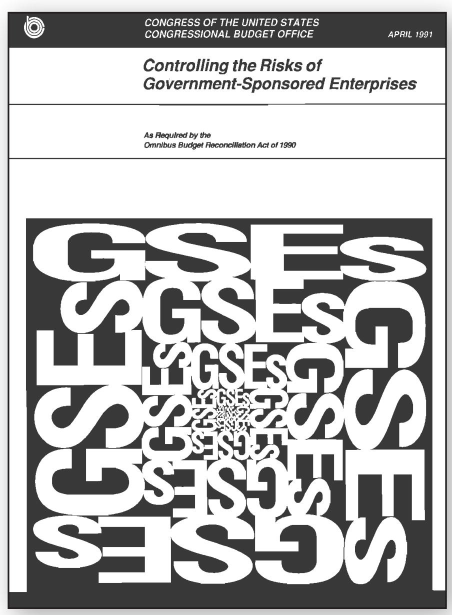
"The fundamental problem in 1992 was that it formalized the hybrid public-private model, which is destined to fail," says economist Scott Frame of the Atlanta Fed, who worked with the Treasury Department on the 2008 GSE rescue. "If you privatize the gains and socialize the losses, you will create excessive risk-taking incentives."

Modest Beginnings

The GSEs' original mission was to buy particular categories of government-insured mortgages, freeing up liquidity for lenders to issue more loans. The Federal National Mortgage Association, or Fannie Mae, was chartered in 1938 and initially bought mortgages that were backed by either the Federal Housing Administration or the Veterans Administration. In 1954, Congress converted it from a government agency to a mixed-ownership entity and granted it certain tax advantages. Another step occurred in 1968, when Congress took Fannie off the federal budget and turned it into a publicly traded company. Meanwhile, the Federal Home Loan Mortgage Association, or Freddie Mac, was chartered in 1970 and targeted its business toward buying mortgages from

Policymakers concerned over the future of Fannie Mae and Freddie Mac may find a cautionary tale in the last time policymakers sought to reform the enterprises more than two decades ago

The Congressional Budget Office issued a report in April 1991 that outlined suggestions for improved oversight of Fannie Mae and Freddie Mac.



COURTESY OF CONGRESSIONAL BUDGET OFFICE

thrifts. In 1971, Freddie issued its first mortgage-backed securities, and it proceeded to grow its MBS business while Fannie tended to keep its mortgage purchases on its books. As a result, Freddie was better able to handle the interest rate volatility in the late 1970s and early 1980s, because it had transferred interest-rate risk to MBS investors. In contrast, Fannie struggled to stay afloat as many of the mortgages it bought and held in its portfolio lost value to inflation.

Once interest rates stabilized, both GSEs dramatically expanded their business, including issuance of MBS. In 1983, the two issued a combined $35 billion in MBS; by 1992, it was almost $675 billion. The number of mortgages held on their books also expanded, from a combined $49 billion purchased in 1983 to $443 billion in 1992. This rapid rate of growth far outpaced the rise in the value of the single-family mortgage market over the same period, from $202 billion to $894 billion.

These numbers would rise even more dramatically in the years that followed. But it was that rise in exposure in the 1980s and early 1990s, combined with the woes in the banking and thrift sectors, that compelled the Bush administration to turn to reforming Fannie and Freddie. Some in the administration became concerned that the GSEs could pose a long-term risk to taxpayers as long as their status as public-private hybrids remained unresolved. Multiple government agencies, including the Treasury Department and the Congressional Budget Office, addressed these worries in reports in the spring of 1991, and they concluded that Fannie and Freddie needed formal capital requirements and stronger government oversight, even though they were not in imminent danger of failing and had high credit ratings. The CBO report, for example, argued that the GSEs had developed more comprehensive ways to manage credit- and interest-rate risks, but the feature of the implicit government guarantee meant that formal capital requirements would be needed to serve as a buffer against taxpayer liability.

The House acted first, passing a bill in the fall of 1991 to establish a new GSE overseer within the Department of Housing and Urban Development: the Office of Federal Housing Enterprise Oversight, or OFHEO. Notably, this office would be funded from dedicated fees, like the Securities and Exchange Commission, rather than annual appropriations, which tend to be less predictable and more politicized. The bill also set a 2.5 percent capital requirement for the GSEs' balance-sheet assets (the loans it held on its books) and 0.45 percent for off-balance-sheet assets (the MBS). (By comparison, banks had a requirement of 4 percent for home loans they held and 1.6 percent for GSE MBS.) Finally, the bill authorized OFHEO to impose stress tests to see if higher capital requirements were necessary; if the GSEs failed those tests, they could face cease-and-desist orders and fines. As soon as the bill headed to the Senate, however, Fannie's senior management warned it would drop its support due to those two provisions, according to media accounts at the time. This move could have spelled trouble for the bill's prospects in the Democratic-controlled Congress, which had at the time liberal constituencies that also were close to the GSEs.

Negotiators released a new draft the following spring, this time making it easier for the GSEs to challenge regulatory findings and making it harder for OFHEO to set fines. Another provision established an affordable housing mandate, under which a certain percentage of loans and MBS on the GSEs' books had to come from home purchases in underserved communities. Backed by fair housing groups, the provision was intended to make borrowing easier and cheaper for low-income and minority homebuyers.

In the fall of 1992, the bill was finally close to passage when Fannie sent another unexpected warning: It still opposed the bill because, in its view, OFHEO had too much say over risk-based capital standards given that it lacked the necessary expertise to understand them, and it ultimately could cause a nationwide credit crunch if it compelled the GSEs to raise capital. According to press reports, a deal was struck in which OFHEO's funding was moved over to the appropriations process, and the capital-standards provision stayed. Congress finally sent the legislation, formally titled the Federal Housing Enterprises Safety and Soundness Act, to President Bush to sign in October.

The Legacy of Reform

One of the most important legacies of the 1992 reform is what it did *not* do: namely, resolve the question of whether the government would come to the GSEs' aid if they became distressed. On one hand, they were chartered by Congress, had access to a $2.25 billion line of credit with the Treasury Department, and were granted special tax and regulatory exemptions on account of their unique status. They were also entrusted with a public mission to enhance liquidity in the housing market and, after 1992, to meet affordable housing goals.

This was the "government" part of their acronym, and collectively, these provisions cemented the belief among investors that the GSEs enjoyed implicit support from Treasury. For this reason, the securities issued by Fannie and Freddie carried a lower interest rate than those issued by the private sector, reflecting the assumption that their debt was ultrasafe. At the same time, the GSEs had a private shareholder structure and New York Stock Exchange (NYSE) listings. This model worked well for them in the 1990s; the GSEs' combined net income in 1992, more than $2.2 billion, rose to $14 billion in 2002.

The 1992 reform did include language stating that the government would not come to the GSEs' aid if they were distressed. But the law left all of their quasi-governmental advantages untouched, thereby preserving the implicit government guarantee that was so central to their growth. As Thomas Stanton, a Washington lawyer who was involved with the legislation, points out, the proof of the durability of the implicit guarantee was in how markets treated GSE securities.

"Banks, pension funds, foreign governments — everyone — kept treating Fannie and Freddie MBS as if they were almost as safe as Treasuries," he says. "So whether you have some language in the bill purporting to prohibit a bailout is really beside the point. And when these enterprises ultimately grow so large and become too big to fail, a government guarantee is inevitable."

Several economists have tried to estimate the size of the subsidy that the guarantee provided to the GSEs. By issuing securities at exceptionally low interest rates reflecting their perceived safety, and then using the money raised to buy higher-yielding mortgage securities from the private sector, the GSEs could count on making money off of this spread. In 2001, the Congressional Budget Office estimated that this differential created a subsidy worth $3.7 billion in 2000 for the GSEs' MBS business, in addition to $1 billion derived from their tax and regulatory exemptions. (That same year, in comparison, Fannie and Freddie reported a combined net income of $8.1 billion.) In another widely cited paper, published four years later, Federal Reserve economists Wayne Passmore and Shane Sherlund and Gillian Burgess of New York University estimated that the GSEs had a debt-funding advantage that ranged from 24 to 40 basis points over long-term, highly rated corporate debt.

The GSEs also earned money in other ways — notably, by securing fees from MBS buyers to guarantee timely payment of interest and principal. These "g-fees" — basically, an insurance premium taken out of the interest payments on the underlying loans — grew steadily until the financial crisis, from a combined $1.8 billion in 1992 to almost $11 billion in 2008. Because these guarantees also put the GSEs on the hook to pay back investors if these securities soured, however, they drove the enterprises' rapid financial deterioration in 2008.

Benefits and Costs

For their part, Fannie and Freddie executives consistently argued that this advantage ultimately benefited homeowners because it led to savings in the form of lower interest rates and the availability of fixed-rate, 30-year mortgages. Research has found those benefits to have been modest, however. In their 2005 paper, Passmore, Sherlund, and Burgess analyzed the difference in rates between conforming mortgages backed by GSEs and those for "jumbo" mortgages (that is, loans too large to qualify under the GSEs' conforming limit). They found not just a narrow spread, but a minimal pass-through effect of the GSE debt-funding advantage to homebuyers. Looking at more than 1 million loans from 1997 to 2003, they calculated a spread of only 15 to 18 basis points between conforming and jumbo loans. As for the savings passed along to homebuyers that resulted from the GSEs' cheaper yields, the researchers calculated that this amounted to about 7 basis points.

Economists argue that another effect of government guarantees that protect investors is to weaken market discipline, resulting in too much risk. In principle, regulation can help offset increased risk-taking, but critics argue that OFHEO had insufficient tools to do that.

"The excessive risk-taking incentives created by this hybrid model need to be countered with a strong regulatory regime," says Frame of the Atlanta Fed. "With the GSEs, you had the facade of regulation but no teeth."

For example, the office lacked the independent authority to bring lawsuits against the GSEs or to replace their executives. In the event the GSEs faced insolvency, OFHEO could opt to keep the enterprises operational (known as conservatorship) but could not close them down (that is, place them in receivership) as the FDIC can with struggling banks.

One of the more important but overlooked aspects of the reform, however, may have been the more esoteric issue of OFHEO's authority to conduct stress tests — one of the key sticking points during the 1991-1992 negotiations. Under the final deal, OFHEO could not set the GSEs' minimum leverage capital requirements by itself, but it was authorized to devise and conduct stress tests to assess the existing risk-based capital requirements for the GSEs. It took a full 10 years, however, to write and implement the rule; moreover, when the stress tests were conducted, up through the crisis, they underestimated the GSEs' losses.

A recent Atlanta Fed working paper that Frame co-authored with Kristopher Gerardi and Paul Willen dissected OFHEO's stress test methodology to find out why it failed. They noted that OFHEO used mortgage data from 1979-1997 to create the statistical model that guided the tests after 2002 — which meant the model did not reflect the many changes in mortgage underwriting practices after 1997. As a sign of how poorly this model worked, the researchers found that actual defaults during the housing bust were four to five times greater than what the OFHEO model predicted. To be sure, many market participants and regulators alike underestimated the extent of losses related to the housing bust. But in the case of OFHEO's stress tests, the researchers found that if the agency had used an alternative model with real-time mortgage loan data, it would have dramatically increased the quality of its forecast of defaults starting in 2005; similarly, if OFHEO had used real-time home price data, its model would have determined as early as late 2006 that the GSEs lacked enough capital to handle the risk of a national housing slump. But instead, the researchers found that OFHEO used an adverse home-price scenario that predicted property values would actually rise for the first 10 quarters of the stress test — contrary to the idea of a stress test, namely, to see how an institution would perform during a period of market turmoil.

The Atlanta Fed researchers traced these shortcomings back to the 1992 law, which required that OFHEO publish every detail of the model's construction through the federal rule-making process. This is a process that can take years, with multiple rounds of notice-and-comment and interagency clearance, which would make any updating an onerous task. For this reason, it took a decade to finish the first stress test; after that, the researchers argued, OFHEO lacked the time, resources, and political capital to update the model.

A Sudden Collapse

In the 15 years following the reform, the growth of the U.S. housing market bolstered the GSEs' performance as well. The GSEs kept the bulk of their mortgage purchases in relatively high-quality loans, and they kept their capital cushions, on average, higher than the minimum requirement. After 2003, however, they began buying more MBS issued by both bank and nonbank lenders with looser standards, including those backed by "Alt-A" and subprime loans. The GSEs' combined purchases of "private label" MBS rose from about $68 billion in 2002 to almost $300 billion in 2006. Then, when private investors began shedding these securities in 2007 as foreclosures began climbing and devaluing the underlying loans, Fannie and Freddie ramped up their purchases. As a result, their market share in the mortgage securitization business, which had fallen from 50 percent in 2003 to 27 percent in 2006, climbed to 44 percent in late 2007.

At the same time, the quality of the loans underlying the GSEs' MBS fell as their market share expanded. From 2003 to 2007, the percentage of these loans with a loan-to-value ratio over 80 percent (that is, for homes with little or no equity) rose from 12 percent to 23 percent. Some have contended that this shift was driven by the affordable housing mandate, which allowed the GSEs to apply private-label MBS toward their housing goals. Recent research on this topic suggests the impact is less clear-cut, however. For example, three economists at the St. Louis Fed —Ruben Mernandez-Murillo, Andra Ghent, and Michael Owyang — have found no evidence that lenders ramped up subprime loan originations or changed the pricing of their mortgages so that they would conform to the various cutoffs (for example, ensuring that a certain percentage of loans were made to homeowners under an income threshold) that the affordable housing provisions had mandated. As economist Ronel Elul argued in a recent article in the Philadelphia Fed's *Business Review*, profit and desire for market share, rather than the affordable housing provisions, prompted this late drive by the GSEs to buy private-label securities. "They did not significantly contribute to the development of risky lending practices in this sector," he concluded.

In the second half of 2007, the losses began to rise as the GSEs began paying out credit guarantees on bad loans. By summer 2008, the two had lost $14.2 billion over the year, and their combined capital dropped to about 1 percent. In July 2008, Congress established a new overseer for the GSEs, this time with the power of receivership, and Treasury Secretary Henry Paulson ordered a classified review of their finances, concluding that the GSEs no longer had enough capital to cover their obligations. Because the size of their exposure was so vast — $5.2 trillion in held or guaranteed mortgage debt, almost half of the roughly $11 trillion in household mortgage debt outstanding at the time — Paulson decided that only a government takeover could prevent systemic contagion. Treasury then executed the takeover in a surprise operation over the first weekend of September.

Paulson's concern that the GSEs no longer had enough capital to cover their losses was borne out by the numbers. Over the course of the bailout, the two suffered a capital erosion of $232 billion, $181 billion of which was in losses from credit guarantees. The bailout itself cost $187.5 billion.

Still Seeking a Solution

Under the Treasury Department's conservatorship, it offered assistance in the form of stock warrants so that the GSEs could continue to meet their obligations. The enterprises were placed under new leadership and de-listed from the NYSE, and they had to give up their dividends and any future profits to the government. Paulson and other senior administration officials assumed this arrangement would be only a temporary solution, and that Congress would legislate a permanent fix, whether it was a full-scale privatization, a shrunken but well-defined government backstop role, or something in between.

That has yet to happen. To date, the GSEs have yielded about $225.5 billion in their returns to the government, more than the dollar cost of their bailouts. The Treasury Department released a white paper in 2011 that laid out options for winding down or reforming the enterprises, but it did not kick off any sustained legislative action. To date, no proposal for reform has been able to advance in Congress beyond the committee level or gain support in both chambers. At the same time, as noted above, the GSEs back a greater percentage of mortgages than ever before.

Frame, of the Atlanta Fed, says the current impasse over resolving the GSEs' fate still leaves in place significant risks.

"As it stands, the status quo offers benefits in terms of significant control over mortgage credit standards, risk pricing, and generally lower mortgage rates than would otherwise be the case," he says. "But what it does do is generate an enormous contingent liability. That is still the case with Fannie and Freddie." **EF**

Readings

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