

Reforming Fannie Mae and Freddie Mac? Don't Hold Your Breath

September 6, 2016 will mark the eighth anniversary of the conservatorship of Fannie Mae and Freddie Mac (collectively referred to as government-sponsored enterprises, or GSEs). In the midst of the financial crisis in 2008, the GSEs' large losses caused investors to question their solvency. The Treasury Department intervened with a capital infusion sufficient to ensure investors that the GSEs would not be allowed to fail, thus avoiding a run on the GSEs that would have severely impacted the flow of capital to housing and aggravated an almost uncontrollable financial crisis. This was conceived as a temporary "time out" to stabilize the GSEs and give Congress the chance to develop a more durable housing finance system.

While the former has indeed happened – conservatorship gave the GSEs the time and guidance needed to stabilize – the latter has not. Over the past eight years, while there have been many proposals to reform the US housing finance system, none have gotten far in Congress. Meanwhile, the GSEs' regulator and conservator, the Federal Housing Finance Agency (FHFA), has implemented several administrative reforms that have altered the GSE business model. We believe these administrative reforms have substantially reshaped the GSE landscape, and that when GSE reform finally comes, it will be grounded in these administrative reforms.

There are a number of reasons why there has been little legislative progress, and none of these factors are likely to change in the short run. Most important, there is no easy answer to what the new housing finance system should look like. There is general (although not complete) consensus on the principles that should guide a new system: the 30-year fixed-rate mortgage should be preserved, private capital should take the first loss, a catastrophic government guarantee is necessary, small and large lenders need to be able to access the market, and some provision to ensure wide credit availability is necessary. However, there is sharp disagreement on the structure of a new system and how to get there. What form should the private capital take? How will the guarantee be administered and priced? How will excessive market and political power (which the GSEs were perceived to have) be avoided? And how can the system be made to expand availability of affordable, responsible mortgage lending in a market in which private capital comes first and risk-based pricing is inevitable?

Another reason for the lack of significant movement is the lack of a sense of urgency. Bipartisan action requires champions, and most legislators believe they have something to lose – and little to gain – by investing their precious resources in fixing a system they see as functioning at least passably well. Compounding this is a remarkably divisive political environment in which very little is getting done. In an environment in which Congress cannot even advance policy proposals that are simple and necessary, the prospects that it can advance one that is astoundingly complicated and not obviously necessary are dim at best.

Meanwhile, the FHFA has mandated a large number of reforms. Taken together, these reforms go most of the way toward addressing the consensus principles outlined above, further reducing the pressure on Congress to move quickly. Under conservatorship, the 30-year mortgage is implicitly preserved, and with the GSEs' large line of credit, the US government essentially provides the catastrophic guarantee. Lenders large and small have access to the system. The FHFA has required the GSEs to introduce and expand credit risk-sharing transactions, in which the GSEs are laying off their credit risk, thus bringing additional private capital into the system. The 2016 GSE scorecard requires that each GSE lay off the risk on 90% of new acquisitions on a targeted book of business (the overwhelming majority of their 30-year fixed-rate loans). The FHFA has also mandated that the GSEs develop a common securitization platform – a shared infrastructure for Fannie and Freddie with standard underwriting disclosures and pooling and ser-

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ving agreements. The structure will be designed such that other entities which might emerge from GSE reform use the platform as well.

The FHFA and the GSEs have also taken multiple steps to increase credit availability, more thoughtfully implementing legislative housing goals for underserved borrowers and communities, expanding cross-subsidization in their book of business and encouraging lending to a broader credit box by giving lenders certainty that they are responsible only for manufacturing defects, not subsequent performance. The FHFA has also finally implemented 2008 legislation that requires a contribution of 4.2 basis points of GSE purchases each year to two funds that support low income rental housing and financing for affordable housing and community development. Finally, the FHFA is in the process of finalizing the “duty to serve” rules, mandated by 2008 legislation, which require the GSEs to make explicit how they will fulfill their duty to serve very low, low and moderate income borrowers in three especially hard-to-serve markets: manufactured housing, affordable housing preservation and rural housing.

With these efforts, we are seeing the outlines of a strong framework for a new housing finance system, and that the needed change could be evolutionary rather than revolutionary. Under the developing framework, the new system would have one or two large, heavily regulated entities, backed by a government guarantee against catastrophic losses to investors. These entities would lay off most of their risk on the private markets through various types of credit risk transfer transactions. While there is a debate about who should own the entity or entities – should it be a government corporation, a mutual owned by originators or a utility owned by shareholders with a regulated return structure? – the range of alternatives has been narrowed, and all of these structures would allow for cross-subsidization. Moreover, the policies related to credit availability already put in place could easily be continued.

However, even with the FHFA actions and the developing framework, legislative reform is not imminent. Some have argued that one of two possible sparks will serve as an impetus for GSE reform, but I believe that neither is sufficient in the near term.

The first possible spark is a Treasury draw by one of the GSEs. Freddie has lost money in two of the last three quarters, due largely to a requirement under GAAP accounting that they mark to market their hedges but not the positions they are hedging, creating an accounting-driven volatility in their reported earnings. As has been widely reported, under the Amended Preferred Stock Purchase Agreement between each GSE and the Treasury Department, the capital of the GSEs is declining and will reach zero by the start of 2018. Left without any insulation against the accounting volatility, at some point one of the GSEs is likely to be forced to take a draw. What has been much less reported, however, is that under the terms of the same agreement, the GSEs are shrinking their portfolios as well, which means that the positions they are hedging will decline, along with the accounting volatility that comes with those hedges. So while the risk of a draw will go up, the size of any draw over the near term will be quite small, certainly not enough to have any impact on investor confidence. The risk that such a draw triggers congressional action is low.

The second potential spark is a victory for one of the groups of shareholders that are suing the US government for its sweep of GSE profits under the Agreement. While the ultimate resolution of these high-stakes legal battles could certainly motivate reform, the inevitable appeals that will follow the first stage of decisions will delay this for years.

Of course, if the housing market stumbles we will see larger draws, providing a reminder that the current system is not built to sustain a crisis. This could prompt Congress to act. And if the new administration makes housing finance reform a priority as part of another round of financial reform, this too could put GSE reform on the front-burner. However, neither of these are likely near-term events. In short: don't hold your breath for GSE reform.