Housing Finance Reform: The Basic Economics of Auto Repair

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Summary Points

- ***Problem wasn't the function of the GSEs, it was reckless and leveraged growth without appropriate capital and oversight.***

- ***Most causes of the failures of the GSEs were fixed in 2008, too late to prevent their failures.***

- ***The legislative and administrative proposals for mortgage finance are unworkable and poor options proposed by large financial institutions seeking a broad government backstop and expanded safety-net.***

- ***The "secondary mortgage market" was and should be a countercyclical utility intended to provide liquidity only when private markets become discontinuous.***

For Two Decades We Knew What to Do

- **There is nothing specifically wrong with the existence of entities whose purpose is to support liquidity in the secondary mortgage market. In fact, there is a substantial need for such a function to exist.**
- **We have long known how to properly regulate the GSEs but we failed to do it in the last meaningful reform effort preceding the crisis (1992) and in efforts during 2000-2005.**
  - *Historically, unlike Freddie Mac, who generally securitized their mortgages, Fannie tended to portfolio them.*
  - *Between 1978 & 1984, as rates rose, Fannie (unlike Freddie) had a negative net worth on a mark to market basis.*
  - *While GSE capital requirements weren't as rigorous as other institutions they were able to access markets because of an implied government guarantee.*
  - Still, during that time, underwriting standards were generally strong.
- The problem was the use of these quasi-private/quasi-public institutions as tools of social policy for the purpose of delivering housing subsidies to the public, through a perverse off-balance-sheet scheme that was arbitraged by private market participants. The problem was not inherent to the GSEs themselves.

GSEs – No Controversy Until S&L Crisis

– In 1989, as a result of the failure of the S&L industry the government began to reconsider the oversight of the GSEs.

- The House Ways & Means Committee held the first comprehensive GSE oversight hearing in 30 years and required reports by departments and federal agencies.
- **In 1991 the US Treasury Report noted:**
  - ***"Financial safety and soundness regulation of GSEs must be the primary statutory goal of regulators, or regulatory conflict in the existing structure may compromise effective safety and soundness regulation.***
  - ***In times of economic stress, a regulator with unclear or dual statutory objectives (safety and soundness versus promotion of another public policy goal) may decide to subordinate its safety and soundness responsibility in favor of the achievement of other public policy goals…***
  - ***…unless a regulator has an explicit primary statutory mission to ensure safety and soundness, the Government may be exposed to excessive risk";***
  - ***"the regulator must have sufficient stature to avoid capture by the GSEs or special interests.***
  - ***To be effective and avoid capture, the regulator must have strong statutory powers and highly qualified staff."***

GSE Reform Efforts: 1992 & 2000-2006

1992: Rather than creating a world class regulatory regime, the1992 Act created a neutered safety & soundness standard with a weak primary regulator. This is detailed in great length in *Reckless Endangerment: How Outsized Ambition, Greed and Corruption Led to Economic Armageddon*.

- *OFHEO didn't have free reign to raise & lower capital requirements as appropriate. The capital standards were defined by Congress, were a static snapshot of an evolving market, took a decade to implement and were interfered with by lobbying and Congress;*

- *GSE mortgage securities received lower relative risk weightings than private mortgages even though GSE capital standards were lower than other financial firms;*

- *The regulator had no explicit authority over enterprise leverage or portfolio growth;*

- *Safety and soundness received no priority over housing goals and public mission;*

- *Regulator had no "bright line language" to prevent mission creep;*

- *The regulator was neutered by the politics of appropriation;*

- *The 1992 Act left in place a $2.25 billion line of credit for the GSEs. While nominal these lines, nonetheless, supported an implicit government guarantee.*

- *With the President selecting half the members of the GSEs boards, they were political.*

Both Private Markets & GSEs Caused Crisis

While many Democrats blame weak regulation of private markets and unbridled greed, many Republicans blame government policies that attempted to deliver social subsidies through the off-balance sheet, quasi-public and quasi-private, Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac. Attempts to assign blame have prevented policy-makers from embracing the structural mortgage finance reforms that would address weaknesses which brought the economy to the precipice of collapse and have therefore failed to reduce these economic, market, social or political risks.

What Washington seems not to understand is precisely what many private citizens understand, that these are not mutually exclusive explanations. In fact, it was the interplay between poorly considered government policies, weak regulatory oversight, the lobbying power of industry players, unrestrained profit seeking behaviors of issuers of private label mortgage backed securities, structural changes in the business and oversight of the GSEs and a lack of prudent economic activities of borrower

"…we excused and even embraced an ethic of greed…we encouraged a winner-take-all, anything-goes environment …instead of establishing a 21st century regulatory framework, we simply dismantled the old one." **– Barack Obama**

GSEs Seasoned Market but Were not the only Culprits

1993, Clinton administration decided that among the "available Federal resources", ***"capital investments for housing and community development" could be driven "through Fannie Mae, Freddie Mac, FHA, and HUD/USDA programs"***

- **"National Homeownership Strategy"**: Goal was "reaching all-time high national homeownership levels by the end of the century"

    - ***"Can be done almost entirely off-budget-through creative leadership and partnerships HUD, FHA, Fannie Mae, Freddie Mac, FHLBS, CDFls, the private mortgage and insurance companies, and the banks and thrifts".***

    - It could be achieved by ***"making homeownership more affordable, expanding creative financing, simplifying the home buying process, reducing transaction costs, changing conventional methods of design and building less expensive houses, among other means"***

    - *It was unprecedented for regulators to partner this closely with those that they have been charged to regulate*.

- **"National Partners in Homeownership"**: HUD, Federal Deposit Insurance Company, Fannie Mae, Freddie Mac, the Mortgage Bankers Association, the American Institute of Architects, America's Community Bankers, the U.S. Dept. of Treasury and the National Association of Realtors.

GSEs Seasoned Market
but Were not the only Culprits

1998 risks were understood, stated but ignored:

- In an internal memorandum from Secretary of the Treasury Robert Rubin regarding **“increasing lending to the most ‘at risk’ borrowers”:**
  - ***“Lowering the down payment requirement is likely to reduce saving among low-income people who would like to be home owners”***;
  - ***“We may not want to encourage poor people especially those who cannot save, to purchase their homes. In an economic downturn, these home owners may be more vulnerable and more likely to lose their homes”***; and
  - ***“It is not clear that home ownership causes the effects attributed to homeowners”.***

GSEs Seasoned Market but Were not the only Culprits

In 2001, lobbying by Federal Reserve, banks and investment banks led **the Basel Committee to determine that “AAA” and “AA” rated private label securities should carry the same risk weightings as correspondingly rated GSE products.**

- As a result the *PLS market took off*
  - *Investment banks and their third-party mortgage origination partners created more and more risky products, including many negative amortization products*
  - *Credit rating agencies conflicted analysis of MBS led to development of derivative CDO market*
  - *Strong investor demand for these relatively higher yielding debt securities led to PLS issuers taking significant market share from the GSEs.*
  - *Negative amortization and hybrid products emerged to take advantage of falling interest rates to refinance existing homebuyers, to encourage cash out refinancing and to encourage speculation in second homes and investment properties.*

For the first few years, the GSEs avoided direct and aggressive competition with the looser standards of these lenders and instead, increasingly used their portfolios to become the largest purchasers of private label securities. By 2004, Freddie Mac decided to expand its direct exposure to Alt-A lending.

Why did Fannie & Freddie Fail?

- **Their failures had nothing to do with their core activities or specifically the TBA market.**
  - **The use of their portfolios** to invest in assets that were outside of their core activities, provided liquidity to parts of the market that was outside their core mission and created highly leveraged bets for little purpose beyond generating shareholder returns and larger bonus pools to benefit senior executives of the agencies;
  - By the year 2000, the GSEs had employed the use of novel automated underwriting and automated appraisal systems that were not sufficiently stress-tested by their regulator, OFHEO. Even if they had been stress tested, OFHEO was too politically compromised to limit their activities. As a result, Fannie Mae and Freddie Mac **expanded their credit underwriting standards without proper oversight**;
  - Beginning in the mid-1990's, in competition for market share, GSEs offered significant discounts on G-fees for large volume customers. As a result **those insurance fees didn't reflect underlying, loan-level, mortgage credit risk**. This underpricing of risk was allowed without appropriate capital cushions; and
  - **By 2007, seven private mortgage insurers with combined capital base of $40 billion insured about 17% (roughly $400BB) of GSEs' book. Nobody questioned the ability to absorb first loss exposures**. The failure of private mortgage insurers to properly assess the risks they insured, on those portions of mortgage loans above an 80% loan-to-value ratio, left the PMI's with inadequate capital to meet their obligations and further imperiling the GSEs.
  - **The GSEs' regulator did not have the authority to adjust their required capital** to recognize the GSEs' increases in their on-balance-sheet operational, credit and interest-rate risk profiles. Moreover, the regulator was not able to require they maintain appropriate levels of capital in support of their off balance sheet liabilities.

Legislative Attempts To Date

In considering reform proposals it is an imperative to ask:

- Is it an improvement?
- Does it protect the public?
- Does it improve market discipline?
- Does it reduce systemic risks posed by central players?
- Does it create a strong divide between the utility-like function of the secondary mortgage market and the primary (private) mortgage origination market?

- ***The answers are clear: "No!".***

If you look the leading legislative and administrative proposals, the standard setters and securitization entity would be owned by industry. Whose interests are being served?

Legislative Attempts To Date

The GSEs, in or out of Conservatorship, are among the largest companies in the world with assets of $5 trillion and liabilities of $5 trillion. These assets and liabilities cannot be modified willy-nilly without serious collateral damage to both investors and home borrowers who need to get mortgages delivered to them.

- **The leading bills in both the House (PATH Act) & Senate (Crapo Johnson) recreate a dangerous system in which:**
  - The line between primary and secondary market players creates the risk of excess liquidity in good times and withdrawal of liquidity in bad times.
  - Legislators seek to deliver public subsidies through shareholder owned and private companies without appropriate regulation.

- **Their approaches are dangerous, create new systemic risks and support several false myths.**

Legislative Attempts To Date

Imagine a car getting rear-ended by another car as it is stopped at a stoplight. The damage is significant but repairable.

- **There are three obvious choices:**
  - Firstly, the owner can choose to bring the car to an auto repair shop and have it fixed. This seems to be the most rational economic choice as it retains most of the value of the vehicle and also provides real benefits given the limited downtime;
  - Secondly, Leave the car unrepaired with an understanding that its resale value will suffer not only because of the damage but also its future rust and other degenerations;
  - Thirdly, even though the car is mechanically sound and the damage is just cosmetic, the owner could nonetheless opt to junk the car. This would obviously appear to be an uneconomic choice. Not only would it be a total loss of value but also given the necessary downtime of raising funds to purchase a new car would be costly.

leading legislative proposals, and administrative proposals being recommended, have found a fourth choice – Build a new auto assembly plant to produce a new car.

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False Myth #1 – Private Capital can Replace GSEs

While I agree this is a noble goal it is important to ask in what form that capital will be committed and not flee in periods of market dislocations.

- **To replace the GSEs and attract enough private capital to insure the top 10% of a future market roughly the size of their current books, or roughly $5 trillion, the industry will need to attract close to $500 billion of capital, before even considering the capital risk weighting of assets.**
- *The PMI industry, which was intended to reduce losses to the GSEs by insuring any portion of an agency mortgage above 80 LTV, remains thinly capitalized with only $8 billion of capital, less than the $11 billion in 2007.*
- *There is currently no private securitization market because neither regulators nor industry participants fixed it or created standards that would revive it. If one looks at the share of agency and non-agency MBS issuance it is clear that private capital is not returning to the market.*
- *The seizure of shareholder owned companies, without regard for the contractual rights of preferred or equity holders and in violation of capital priority rights promulgated by the FHFA & authorized by HERA substantially reduces the likelihood of substantial private capital.*
    - **While some argue the GSEs prevent private markets from working. With the average agency mortgage FICO score above 740 there should be plenty of opportunity for private lenders. So, with only 2.5% of securitizations PLS, why aren’t the large players there?**

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False Myth #2 – We Need more Competition

- **A key arguments of those who favor either replacing the GSEs or expanding the number of players supporting the secondary mortgage market is that Fannie and Freddie have duopoly power over the market.**
  - ***Monopolies, duopolies and oligopolies are all driven by industry fixing pricing, rather than markets. In properly pricing credit risk, the GSEs do not compete on price.***
  - ***IF G-Fees were priced appropriately to underlying risks, large private players could execute directly to private markets at comparable cost. This would drive down the number of " wrapped" deals, keep primary and secondary market players separate, and reduce the the backstop by transferring risk into private markets while ensuring liquidity exists in bad times.***
  - Yes, they are the only private secondary market firms tasked exclusively with ensuring ongoing liquidity to the primary markets but they are not the only source of long-term mortgage funding:
    - Bank balance sheets;
    - Federal government programs; and,
    - Private label securitizations (before the crisis) all provided (what was intended to be) stable funding.
  - ***Importantly, if we are to strike the proper balance in support of the secondary mortgage market, we should recognize that they provide an essential public service (ongoing availability of secondary mortgage credit) much like the provisioning of water, gas, electricity or sewers that utilities offer.***
  - ***As is true of other utilities, increasing the number of competing firms doesn't improve outcomes. In fact it drives excess liquidity and creates disparate execution prices for all but the largest, leading to deterioration in standards.***

Housing & Economic Recovery Act (HERA) Solved Most of These Issues

- **While the 2008 Act addressed most of the problems embedded in the 1992 Act it was too late prevent the subprime market contagion, which began in 2006, from imperiling the GSEs solvency.**
- **HERA empowered FHFA with authorities to make changes that should be supported by even the staunchest critics of the GSEs.**

  – Provide the supervisor of Fannie Mae and Freddie Mac with the authority to set and adjust the capital requirements for the enterprises in a manner comparable to the capital authority available to the federal banking agencies with respect to insured banks;

  – Establish a clear and credible receivership process for the enterprises; and

  – Limit the size of the retained portfolios of the enterprises by anchoring them to a well-understood public purpose.

"HERA allows the FHFA director to oversee the prudential operations of the GSEs and to ensure that each GSE operates in a safe and sound manner by, among other means, maintaining adequate capital and establishing adequate internal controls."

Is FHFA as Feckless as OFHEO?

- **Contrary to their oft repeated claims that only Congress can fix the GSEs:**
  - *Ensure independence of Conservator* and ability to operate effectively.
  - **FHFA should place the restoration of capital ahead of the PSPA**. As the sole party to that agreement statutorily charged with the restoration of the GSEs' capital, it is in the FHFA Director's power either (a) to stop dividends and to inform the Treasury that now that they have received repayment of all monies provided in support of the GSEs and enter into a new agreement which effectuates the statutorily required process of restoring the GSEs capital or, (b) if he deems the GSEs could not become adequately capitalized according to the capital classifications in HERA, to reorganize the enterprises through receivership by creating a limited life regulated entity (i.e. a good bank) and then selling the capital stock of the LLRE.
  - **Suspend payments to the affordable housing funds which, according to HERA, are disallowed for undercapitalized GSEs.**
  - **Negotiate with Treasury to place Treasury's warrants into the affordable housing fund, ensuring support for affordable housing while contributions are suspended for recapitalization** – Such a fund, as already established by HERA, should not only be acceptable to the public but was proposed by Peter Wallison of AEI in draft GSE reform language offered in 2004. As the companies build capital, improving safety & soundness, it will increase the value of the warrants;
  - **Ensure that capital is assessed based on actual issuance.** Prior to the 1992 Act the capital requirement on unsecured GSE debt to total capital was 15-to-1 but there was no requirement for capital to be held against the agencies' MBS. **If they were forced to retain capital against MBS outstanding, and buffer capital for the institutions in case of operational or other risks they would have been able to withstand financial crisis.**

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Is FHFA as Feckless as OFHEO?

- **Contrary to their oft repeated claims that only Congress can fix the GSEs, FHFA should:**
  - Continue development of first loss risk transfer to minimize risk of PMI failures and dispersion of risk;
  - Raise guarantee-fees to market levels;
  - Prevent the deterioration of underwriting standards through both private market mechanisms (greater data disclosure, accurately represented and warrantied mortgages with clear, standardized and enforceable putback remedies) and by better regulation
  - HERA has already mandated the near total elimination of the GSEs portfolios for other than liquidity purposes;
- **A failure to act will create political problems and may create economic problems as interest rates rise and housing, potentially, weakens.**
  - **GSEs have no capital so there will be a political problem as GSEs go back to draw on UST.**
  - **As we saw in the 1960's, as rates rose and bank deposits were withdrawn and placed in Treasuries, there was a reduction in bank willingness to support mortgage lending.**
- **We shouldn't reinvent a wheel that has driven the secondary market successfully for generations. We should repair it well, just as we recognized the need to do after the S&L crisis.**

If FHFA Does Its Job, Legislation Becomes Easier

- **Congress should ensure that the GSEs' regulator places safety and soundness of these companies as primary.**
- **Require minimum capital standards of 3.5-4% to ensure that they never expose the taxpayers to risk again.**
- **Replace the current regulatory oversight with a Public Utility Commission responsible for determining allowable rates of return**
  - *Any income above the minimum capital and that rate of return would go to enhance capital.*
  - *With capped rates of return the GSEs would not have the deep pockets with which to lobby legislators, thus avoiding much of the basis for capture.*
- **Use stringent methods to price guarantees, separate from the GSEs and from political influence.** This would create incentives for increased private market, unwrapped issuances on which investors would be forced to retain the risk (eliminating the broad government guarantee);
- **Sever the government's sponsorship to end the provisioning of an implied government guarantee;**
- **Ensure that GSEs can function in a counter-cyclical environment and that the GSEs are regulated in the same manner as other utilities that are considered to deliver essential public services.**

If FHFA Does Its Job, Legislation & Oversight Becomes Easier

- **Rather than leave the Treasury line of financial support in place, which only supports market perception of an implied government guarantee, the GSEs should be required to pay an annual commitment fee to Treasury for a narrow and explicit catastrophic insurance policy to support TBA.**
  - *With stringent capital standards that incorporate security level requirements, real transfer of first loss and capital stringent capital standards for PMIs or other first loss holders, this should never be called on.*
  - *Such a line would provide a narrow guarantee to allow the ongoing functioning of the TBA market and would be significantly smaller than proposed guarantees in either Crapo Johnson or the PATH Act.*
  - *With capital determined both on the institutions and their guaranteed securities, this would be a backstop guarantee of the institutions so that, in a 100-year crisis, they would still be able to access markets.*
  - *It would also create enhanced supervision and expanded regulatory authorities.*
- **Eliminate the Presidential appointments to the GSE boards.**
- **The FSOC should designate the firms as Systemically Important Financial Institutions (SIFIs).**
  - *This would create the opportunity for other primary financial regulators to oversee the interplay between the GSEs and other market participants.*
  - *The GSEs commitment- fee should be determined by the Financial Stability Oversight Council by reference to market rates for comparable financing and the risk of drawing on that support.*

"I am skeptical that the 'break it up and privatize it' option will prove to be a robust or even viable model of any substantial scale, without some sort of government support or protection. It is difficult to envision a sound, practical, private sector mortgage insurance business of any significant size that does not require large amounts of capital, and consequently generates only a modest return on capital." **– Secretary of the Treasury Henry "Hank" Paulson**

"A public utility model offers one possibility for incorporating private ownership. In such a model, the GSE remains a corporation with shareholders but is overseen by a public board. Beyond simply monitoring safety and soundness, the regulator would also establish pricing and other rules consistent with a promised rate of return to shareholders" **– Federal Reserve Chairman Ben Bernanke**