Testimony of

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"A Failure to Act: How a Decade Without GSE Reform Has Once Again Put Taxpayers at Risk"

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Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify on the subject of GSE Reform. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a senior fellow with the Milken Institute's Center for Financial Markets. I was Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Housing finance reform remains the notable unfinished legislative task of the financial crisis. Indeed, when Fannie Mae and Freddie Mac were taken into conservatorship ten years ago—while I was at the Treasury Department—it was scarcely imagined that the two Government Sponsored Enterprises would remain in government control a decade later and that the vast majority of mortgages in the United States would be guaranteed by taxpayers.

Housing finance reform is still needed. While the housing finance system seems to work well for many Americans, access to mortgage financing remains crimped for many families even as the dominant government role means that taxpayers are taking on too much risk and consumers are missing out on potentially beneficial innovation. In other words, the current housing finance system should satisfy neither those who care most about considerations of taxpayer safety and healthy markets, nor those for whom concerns over affordability and access are paramount.

Housing finance reform can mean a better system in several dimensions:

1. Better taxpayer protection and diminished systemic risk of another financial crisis;
2. Improved access to mortgage financing for families who still face difficulty getting loans;
3. Better targeted and more effective subsidies for affordable housing;
4. Increased transparency in the expenditure of public resources for those subsidies;
5. A more innovative housing finance system with a well-defined role for the government.

Importantly, reform can do better on both taxpayer protection/efficiency and affordability/access.

The Flawed System Before the Financial Crisis

Understanding the flaws of the pre-crisis housing finance system is helpful to ensure that we avoid them in moving forward with reform, whether future changes come about through legislation or through administrative actions.

The central flaw of the old system was the **implicit guarantee** under which Fannie and Freddie, though private companies, were viewed by market participants as having the financial backing of the U.S. government. As David Scharfstein and I explain in a recent overview paper,[1] this implicit guarantee allowed Fannie and Freddie to fund themselves at lower rates than otherwise would have been the case given their modest capital ratios, earning a spread between the yield on the MBS they held in portfolio and their artificially low debt financing costs. The implicit guarantee meant that Agency MBS (mortgage backed securities guaranteed by Fannie and Freddie) traded as if they were free of credit risk even though the two firms were **woefully undercapitalized**; the two firms were required to fund themselves with only 40 bps of capital (four-tenths of one percent) for each $100 of single family mortgages they insured.

In retrospect, given the incredibly favorable situations enjoyed by Fannie and Freddie, it is astonishing that the two firms put themselves in position to fail.[2] And yet they did, presenting great peril to the U.S. financial system and economy. Indeed, the risks taken by the two firms leading into the crisis embodied the **moral hazard** in the pre-crisis system in which the implicit—and uncompensated—guarantee meant that GSE shareholders and management got the upside in good times, while U.S. taxpayers were left covering the risk in a catastrophe – as happened in 2008. Flaws in securitization and origination of non-Agency lending were the initial driving factors behind the housing bubble and thus the financial crisis, but the actions of the GSEs made the crisis worse.

With the two firms then (and still) the linchpins of the U.S. mortgage system, allowing them to fail would have seriously disrupted the flow of mortgage credit at a time when the U.S. financial system and broader economy were facing considerable challenges. Moreover, with GSE debt held widely in the United States and around the world, allowing the two firms to default on their obligations could have had systemic consequences. Many U.S. financial institutions might have been required to recapitalize or shrink their balance sheets, while foreign investors might have hesitated to provide the capital flows that support U.S. investment and consumption and help finance the U.S. government. The terms of the taxpayer support in September 2008 were stiff but appropriate. Fannie and Freddie shareholders had their stakes diluted through the government's 79.9 percent ownership in each firm, with new senior preferred shares issued ahead of the pre-crisis common and preferred equity and paying a 10 percent coupon (or higher if the dividend was paid in kind). Investors in GSE debt and MBS were bailed out, however—much as had been predicted by those who warned about the dangers of the implicit guarantee.[3] While taxpayers remain on the hook to support the firms indefinitely in conservatorship, the commitment of taxpayer resources achieved its purpose, as mortgage financing remained available throughout the crisis even while many other parts of U.S financial markets exhibited severe strains.

[1] David Scharfstein and Phillip Swagel, 2016. "Legislative Approaches to Housing Finance Reform," in *Principles of Housing Finance Reform*, Edited by Susan M. Wachter and Joseph Tracy, University of Pennsylvania Press.
[2] An account of the misjudgments at Freddie Mac can be found in Susan Gates, *Days of Slaughter: Inside the Fall of Freddie Mac and Why It Could Happen Again*, Johns Hopkins University Press (2017), while Timothy Howard, *The Mortgage Wars: Inside Fannie Mae, Big-Money Politics, and the Collapse of the American Dream*, McGraw-Hill (2013) discusses missteps at Fannie Mae.
[3] See, for example, N. Gregory Mankiw, "Remarks at the Conference of State Bank Supervisors, State Banking Summit and Leadership Conference," November 6, 2003. http://scholar.harvard.edu/files/mankiw/files/stbank.pdf

Ten years later, the problems of the pre-crisis GSE system remain in place: we still have two undercapitalized firms that are too important to be allowed to fail. In short, we have failed to address a problem that long has been in front of us.

In addressing these dangers, housing finance reform should clarify the roles of the private sector and the government, making clear what would happen in the event that Fannie, Freddie or any future competitors in securitization and guaranty face collapse. Ensuring that these firms, once they exit conservatorship, fund themselves with more capital will reduce the likelihood of another failure. But if firms remain too important to be allowed to fail, then simply stating that there will not be another bailout is not credible—indeed, a return to a duopoly of private firms such as with "recap and release" would reconstitute the implicit guarantee that was the most problematic aspect of the pre-crisis system. This would be the case even in a recap and release approach that increased the amount of capital over the meager amount required in the pre-crisis system. More capital is important, but not enough: simply adding capital to the model that failed in the crisis does not enough address its structural problems. Reform should make the GSEs and any successor or competitor firms safer and also foster more competition outside of the now-dominant government-guaranteed sector of the mortgage market.

The Housing Finance System since the Crisis

While the current situation with the GSEs is not satisfactory, considerable progress has been made in addressing some problems of the old system.

Most importantly, there is now private capital taking on housing credit risk in the GSEs' single-family guaranty business through a variety of risk transfer transactions (the GSEs' multi-family businesses already shared risk with private capital). The Federal Housing Finance Agency under the leadership of Director DeMarco and Director Watt deserves praise for moving forward with this initiative, as do the people involved at both Freddie and Fannie. While having private capital at risk provides welcome protection ahead of the government, with a duopoly, taxpayers are still on the hook to ensure the continued operations of the two firms. Addressing this latter concern is a key objective of reform – to arrive at a system in which there are sufficient competitors in securitization and guaranty that one or more of them can be allowed to fail without posing a risk to the financial system or the economy. Reform further would usefully increase the share of non-guaranteed origination.

The retained portfolios of MBS have shrunk at the two firms, reducing a way in which the GSEs posed a systemic risk by their massive issuance of debt to fund the portfolios. There is no need for Fannie and Freddie to act as "buyers of last resort" to support demand for mortgages—a rationale sometimes put forward for having massive retained portfolios—since the Federal Reserve can purchase MBS again in the future if needed to support the broad economy as it did during the financial crisis. Indeed, reform should leave the Federal Reserve and the Treasury Department and not the housing finance regulator as the policymakers responsible for responding to macroeconomic threats.

Other steps taken with the GSEs in conservatorship likewise have improved the housing finance system. The Private Mortgage Insurer Eligibility Requirements (PMIERS) that establish capital standards for private mortgage insurers reduce the chance of problems among these firms as happened during the crisis. The development of a common security for GSE MBS will improve liquidity by unifying the pools in

which Fannie and Freddie MBS trade, ultimately reducing mortgage interest rates. More could be done to turn this initiative into a vehicle for longer term reform by opening the architecture of the common securitization platform to allow additional firms to compete with Fannie and Freddie in the securitization of MBS with a government guarantee.

Future Reforms

Even with this progress, the housing finance market will remain in limbo absent legislation to move to a better system. Importantly, the current situation imposes a cost in lost activity—we do not see what we are missing in terms of foregone investment and innovation by people who are standing on the sidelines because they are unsure about the structure of the future housing finance system. Legislation would be preferable, but in the meantime, it would be useful for the next FHFA Director to consider administrative measures to push forward with aspects of a reform agenda within the bounds of the Agency's legal authority. I first discuss aspects of legislative reform and then consider administrative steps.

In contemplating the future housing finance system, it is important to keep in mind that taxpayers are now on the hook for housing credit risk, both explicitly through the terms of the Treasury support for Fannie and Freddie and implicitly because the two firms remain too important to the housing finance system and to the broader economy to be allowed to fail. A reduction in taxpayer exposure would be brought about through a reform that involves an explicit guarantee on specified MBS protected by an ample cushion of private capital. The guarantee and taxpayer exposure already exist. Reform that recognizes this risk would improve taxpayer protection and make the government role transparent rather than implied. Reform can also usefully separate the critical infrastructure of the housing finance system such as the common securitization platform from the firms that serve as guarantors or credit enhancers, among whom there can be competition for the benefit of borrowers and the overall economy.

Legislation

There are important dimensions of agreement among the various legislative proposals for housing finance reform, including 1) the key role for private capital in taking credit risk ahead of a government guarantee; 2) the secondary government guarantee covering MBS and not the firms such as Fannie and Freddie involved in securitization and guaranty; 3) support for affordable housing to be made explicit, transparent, and more effective; and 4) provisions to ensure that smaller originators have equal access to the processes by which mortgages receive government backing. I would add a fifth principle: the importance of fostering competition within the mortgage finance system.[4]

This approach would open the business of guaranty and securitization to multiple private firms that would compete with the existing GSEs. This could be done in various ways, including along the lines of

[4] See Susan Gates, Ann Schnare, and Phillip Swagel, "Privatize Fannie and Freddie, yes. But be pragmatic," March 2017. https://www.rhsmith.umd.edu/files/Documents/Centers/CFP/research/swagel_march_2017.pdf

the PATH Act; as proposed by Ed DeMarco and Michael Bright[5] or by Jim Parrott et al;[6] or following the approach in the Senate Banking Committee with the Crapo-Johnson and Corker-Warner proposals. In the latter approach, firms that purchase the secondary government guarantee on their MBS would be required to fund themselves with considerable private capital that would be extinguished ahead of the taxpayer obligation. MBS would be guaranteed but the firms undertaking securitization and guaranty would not; with sufficient entry, one or more of the private guarantors could fail without posing a systemic risk. In the event of a broad crisis that threatens the collapse of all guarantors, there is little doubt that the federal government would step in, but this is the case with any system. Indeed, legislation should contemplate this possibility and include a resolution regime that ensures that the private shareholders are wiped out ahead of such federal support. Even so, the essential – and I think achievable – goal of reform is to ensure more capital and instill more competition and market discipline to avoid another catastrophic failure in the first place.

The amount of capital and the pricing of the secondary government guarantee are crucial decisions.[7] The key insight remains that ample private capital is essential both to shield taxpayers and to provide the private sector firms with an incentive for prudence. Policymakers should look skeptically at the suggestion that ensuring appropriate capital levels will have an especially large impact in pricing people out of mortgages. After all, if a specified amount of capital is enough to protect taxpayers against all but the most catastrophic housing credit risk, then incremental capital past this point would hardly be at risk and therefore cannot be expensive. It cannot be the case that taxpayers are safe and yet incremental capital has a large impact on mortgage interest rates—if adding capital is expensive, then taxpayers are not safe and the capital requirement is insufficient.[8] A recent CBO report, for example, indicates that a structure for the secondary mortgage market along the lines of the 2014 cost estimate for the Crapo-Johnson proposal (*S.1217)* would result in a small impact of 10 to 20 basis points on mortgage interest rates – and this modest impact easily could be offset with better targeted subsidies to improve affordability for low- and moderate-income borrowers.[9]

The proposal by Representatives Carney, Delaney, and Himes provides an example of an innovative approach by which to price the government guarantee. In their setup, five percent private capital would be required in the first-loss position, and then 10 percent of the mortgage credit risk of the remaining 95 percent of the securitization would sold to private investors *pari passu* to the government exposure. The pricing of this 9.5 percentage points of capital would be used to set the price of the secondary government insurance. The precise details of a pricing mechanism would have to be worked out, but the

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[5] Ed DeMarco and Michael Bright, "Toward a New Secondary Mortgage Market," September 29, 2016. https://www.milkeninstitute.org/publications/view/823

[6] Jim Parrott, Lewis Ranieri, Gene Sperling, Mark Zandi, and Barry Zigas, "A More Promising Road to GSE Reform," March 2016. https://www.economy.com/mark-zandi/documents/2016-03-22-A-More-Promising-Road-To-GSE-Reform.pdf

[7] See Eric Kaplan, Michael Stegman, Phillip Swagel, and Ted Tozer, "Bringing Housing Finance Reform over the Finish Line," January 2018, Milken Institute. https://www.milkeninstitute.org/publications/view/898

[8] See Scharfstein and Swagel (2016) for an analytic discussion, or the numerical analysis in Jim Parrott, Michael Stegman, Phillip L. Swagel, and Mark M. Zandi, "Access and Affordability in the New Housing Finance System," Urban Institute, February 13, 2018. https://www.urban.org/research/publication/access-and-affordability-new-housing-finance-system

[9] Congressional Budget Office, "Transitioning to Alternative Structures for Housing Finance: An Update," August 23, 2018. https://www.cbo.gov/publication/54218

key insight of the Carney-Delaney-Himes proposal is to harness private incentives to price the government guarantee.

Entry of new firms to compete in securitization and guaranty is useful for two related purposes: to ensure that one or more firm can fail without an undesirably large disruption to the availability of mortgage financing, and to ensure that competition among firms pushes down the costs involved with home loans for the benefit of consumers.[10] A challenge for housing finance reform is thus to ensure that an adequate number of new firms enter to compete. With the annual earnings of Fannie and Freddie together more than $10 billion in recent years, there would seem to be adequate incentive for others to enter into this market. Opening the common securitization platform to entrant firms would ensure that new competitors are not at an initial liquidity disadvantage. And as noted previously, housing finance reform must ensure that smaller lenders are not disadvantaged as was the case in the pre-reform system.

Administrative Measures

While housing finance legislation remains difficult, it would be useful to take administrative measures that move in the direction of an improved housing finance system. Such steps would not foreclose any particular legislative outcome. The broad direction of administrative measures in housing finance reform would be to focus the GSEs' activities while improving their effectiveness.

Ahead of legislation, it is useful that the FHFA in July of this year put forward for comment a proposal for Enterprise Capital Requirements that would apply in the event the GSEs emerge from conservatorship. It is common for the level of capital requirements for the GSEs to be compared to the firms' losses in the financial crisis—for example, to note that the amount of capital implied by the recent capital proposal or by the FHFA's annual stress test would have been enough for Fannie and Freddie to make it through the crisis. This comparison is inapt. The losses of the two firms during the crisis came in the face of massive interventions by the federal government to support the housing market and the economy. Capital requirements should be set so that problems in the housing finance system do not require another TARP, an $800 billion fiscal spending binge, or extraordinary policy actions by the Fed and FDIC. And even then, capital requirements are set to ensure that firms have not just the capital to squeak past a severely stressful environment but to continue operating through the stress. If the future housing finance system involves a duopoly, those two firms must have fortress balance sheets – they will be essentially akin to utilities.

While the duopoly continues in the present, additional competition and innovation in the housing finance system can be fostered by actions that increase the share of non-Agency securitization and thereby reduce the exposure of taxpayers to mortgage risk. An approach in line with the second of the three options in the Obama Administration's white paper on housing finance reform would be to limit the scope of the government guarantee on MBS in normal times when there is little need for it, and expand the availability of the government backstop in periods of financial stress. This is similar to the provisions of the PATH Act, in which a government guarantee is available through the FHA for low-

[10] Evidence on the importance of competition in housing finance is provided by David Scharfstein and Adi Sunderam, "Market Power in Mortgage Lending and the Transmission of Monetary Policy," April 2015. https://www.hbs.edu/faculty/Pages/item.aspx?num=44239

income and first-time homebuyers in normal times, and made widely available in times of stress. Administrative changes to the GSE capital regime and the pricing of GSE insurance premiums could move in this direction.

The expiration of the QM Patch in January 2021 provides a natural opportunity to consider the scope of GSE activities and the broader set of regulations around origination, with the FHFA usefully coordinating with other federal regulators. As noted by Kaul and Goodman (2018), "The non-QM market is small because most lenders are wary of taking on the risk that a borrower in default will sue, citing lender failure to verify ability to repay."[11] The problem is that overly rigid regulation discourages private sector capital from taking on mortgage risk outside the confines of the GSEs. It would be useful to coalesce on one set of standards that avoid favoring the GSE channel—ultimately doing away with the QM patch rather than broadening it to encompass additional lending. FHFA should further examine whether elements of the GSEs' automated underwriting systems represent critical infrastructure in the sense that the favored status of loans approved by those systems poses a barrier to entry. This would lead to consideration of putting those systems into the common securitization platform.

In making changes to capital standards, insurance pricing, and acceptable origination parameters at the GSEs, it would be useful as well to coordinate with the FHA and with the regulators of other lending securitized by Ginnie Mae. The goal is to avoid having borrowers migrate to FHA, presenting a yet greater risk to taxpayers since FHA loans have no private capital at the MBS level and typically modest down payments such as 3.5 percent.

Administrative reforms can also improve the effectiveness with which the housing finance system supports affordable housing. As documented in my February 2018 paper with Parrott, Stegman, and Zandi, the current GSE system provides an estimated $4.1 billion in annual resources to subsidize affordable housing, of which $3.8 billion comes through cross-subsidization that takes place within the pricing structure of the insurance premiums charged by Fannie and Freddie, and another $300 million each year results from the affordable housing fee imposed on the two firms.[12] The $3.8 billion in cross-subsidization comes about because lower risk borrowers pay relatively higher insurance premiums than would be implied by considerations of risk and return, in order to reduce insurance premiums and thus borrowing costs for higher-risk borrowers.

This approach to subsidizing affordable housing is poorly targeted to help low- and moderate-income borrowers who most need assistance to become homeowners, because the measure of risk by which the subsidies are allocated does not correspond to measures of income or need. In the current GSE system, a lower-income family that has prudently accumulated money for a 20 percent down payment on their home and has lived within their means to end up with a high FICO score in effect will subsidize a higher-income or wealthier borrower with a smaller down payment and a lower FICO score. In my February 2018 paper with Parrott, Stegman, and Zandi, we estimate that approximately 23 percent of borrowers receiving a subsidy under the current system are not low- and moderate-income households. We describe an alternative in which the cross-subsidy would go only to low- and moderate-income

[11] Karan Kaul and Laurie Goodman, "What, If Anything, Should Replace the GSE QM Patch?" Urban Institute, August 2018. https://www.urban.org/sites/default/files/publication/98949/qualified_mortgage_rule.pdf

[12] For a discussion of the affordable housing fee and initial review of the uses of the funds, see Michael Stegman and Phillip Swagel, "An Affordable Housing Fee in the Context of GSE Reform," Milken Institute, June 2018. https://www.milkeninstitute.org/publications/view/916

borrowers, providing $4,500 in assistance per borrower, equal to 29 basis points—an amount that would more than offset the impact of higher capital requirements as calculated by the CBO. Restricting affordable housing assistance to new low- and moderate-income homebuyers (rather than those refinancing a loan) would increase the amount of assistance to $6,000 per family and yet more carefully target assistance to those looking to become homeowners.

Administrative measures could take immediate steps to more carefully target affordable housing assistance even ahead of a full-scale revision of the GSE insurance premiums by removing the cross-subsidy from cash-out refinances. It might make sense for a family to borrow against the value of their home, which for many is their largest asset. But there is no need for the federal government to subsidize the use of a home as an ATM when the private sector can do this effectively.

Administrative measures could further improve the targeting of other GSE activities aimed at affordable housing. In this respect, the decisions made during conservatorship merit careful examination. As an example, the FHFA's implementation of the Duty to Serve provisions mandated by the Housing and Economic Recovery Act of 2008 (HERA) provides Fannie and Freddie with credit for financing energy or water-efficiency improvements through provisions that are not mentioned in the statute. As shown in research by a former top economist in the Obama White House, however, for residential energy efficiency investments, "the cost to deploy the efficiency upgrades was about double the energy savings."[13] There is nothing wrong with people deciding to put up solar panels, but federal subsidies for cost-ineffective activities means less support for low- and moderate-income families looking to become homeowners. A similar approach should guide consideration of other GSE activities to ensure that subsidies embodied in the single-family and multi-family activities are effective and well targeted to those who most need assistance to become homeowners or to afford decent housing.

Conclusion

Housing finance reform remains necessary ten years after Fannie Mae and Freddie Mac were taken into conservatorship. Not moving forward with housing finance reform leaves too many families still facing difficulty obtaining mortgages and taxpayers taking on too much risk. Reform can improve the safety of the housing finance system and better protect taxpayers, and also provide for more access to mortgage financing and better support for affordable housing.

[13] "Energy Efficiency Upgrades Cost Double the Projected Benefits." UChicago News. June 23, 2015. https://news.uchicago.edu/story/energy-efficiency-upgrades-costdouble-projected-benefits-0.