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GSEs and Housing Finance Reform

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GSE History

Affordable housing has been a goal of the US Government since the Depression. Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) were created to lower the cost of, and make financing more available for Americans to purchase a home. The GSEs developed a secondary market for mortgages, which further reduced financing costs and expanded credit availability.

Prior to 2008 the GSEs were publicly traded shareholder corporations which had the advantage of carrying an implicit guarantee from the federal government. Both GSEs had a line of credit with the US Treasury Department, and both were exempt from state and local income tax on corporate earnings. The GSEs were the only two Fortune 500 companies exempt from regulation by the Securities and Exchange Commission. Because of implicit government backing, Fannie Mae Discount Notes became the second largest short-term notes issued.

In a nutshell, the GSEs made money by borrowing at low rates, and lending at higher rates. They borrowed in the debt markets by issuing discount notes, and provided liquidity to mortgage originators by purchasing whole loans which were packaged into mortgage backed securities (MBS). The GSEs either retained or sold the MBS created. The GSEs were highly profitable—because of the implied government guarantee, they could borrow at very low rates—thus creating a large gap between borrowing and lending rates.

The GSEs also earned a significant income from guaranty fees they received as compensation for assuming the credit risk on the mortgage loans underlying MBS and on the single-family mortgage loans held in their retained portfolios.

In the early 2000s, housing prices rose at an unprecedented pace—as a result of an aggressive government affordable housing stance, a growing and more complicated secondary market and extremely liberal lending policies in the private sector. By mid-2006, housing prices started to decline, resulting in mortgage defaults. Homeowners, investors, and financial institutions (including the GSEs) did not have enough capital supporting their investments to absorb the resulting losses. As a result, in 2008, credit markets froze and the GSEs were rendered insolvent.

In September of 2008, the federal government placed Fannie Mae and Freddie Mac in conservatorship. The Treasury Department pumped $187.5 billion dollars into the agencies to support their mortgage guarantee obligations. In addition to the housing price decline, the following trends contributed to large losses at the GSEs: lessening loan standards to compete with the private market, increased holdings of risky mortgages on balance sheet, low capital requirements to absorb losses, and lack of federal government oversight.

Since 2008, the housing market has rebounded, improving the finances of the GSEs. They are back in the black and, to date, have paid dividends to the federal government of $213.1 billion.

GSE Reform

Going forward, to avoid tax payer liability in housing finance, Republicans have been advocating to completely privatize the mortgage market, while Democrats push for nationalization. The most recent proposed bi-partisan legislation falls between these two extremes.

Senate Chairman Tim Johnson (D-SD) and ranking member Mike Crapo (R-ID) have drafted the latest bill which attempts to reform housing finance. The goal of their bill is to protect taxpayers from liability, while promoting affordable mortgage financing. A key consideration in the bill is to "provide equal access for lenders of all sizes to the secondary market; and facilitate broad availability of mortgage credit for all eligible borrowers in all areas and for single-family and multifamily housing types."[1]

The bill proposes to eliminate the GSEs and replace them with a new agency called the Federal Mortgage Insurance Corporation (FMIC). The FMIC, patterned after the FDIC, would be explicitly backed by the full faith and credit of the United States, and would only guarantee mortgage securities in which the private market holds at least a ten percent first loss position. The FMIC will be governed by an independent, bi-partisan 5 member board appointed by the President and approved by the Senate.

The draft specifically eliminates affordable housing goals. Instead, an average 10 basis points is charged on each loan guaranteed through the new system to support affordable housing. The fee can be adjusted up or down based upon an institution's demonstration of its record of meeting community needs.

The bill establishes a secondary market for mortgages where private insurance guarantees investors for a 10% first loss with an explicit government backstop behind the private insurance. The secondary market process is described as follows:

- Originators will lend under "qualified mortgage" guidelines (standard established by the Consumer Financial Protection Bureau) and sell mortgages into the secondary market.[2]

- Aggregators (entities that pool mortgages which they originated or purchased) obtain a guarantee from a private guarantor (or other credit enhancement) and deliver the pool to a Securitization Platform (a vehicle jointly owned by entities eligible to sell loans into the FMIC System and would provide standard forms and contracts for securitization). This MBS will be issued with a FMIC-backed government guarantee.

- Guarantors will hold 10% capital against the value of the MBS and provide a guarantee on the MBS. The FMIC backstop only applies when the guarantor fails.

- Investors have the benefit of fully funded first loss positions of at least 10% of the MBS value, putting private capital in front of the government guarantee.

The bill contains provisions to help small lenders such as community banks and credit unions have direct access the secondary market. Rural and tribal housing needs are addressed as well. Conforming loans limits will be higher in areas where home price averages are higher.

To protect US tax payers, the following provisions are proposed:

- The FMIC reinsurance is contingent on a private first loss position of at least 10%.

- MBS guarantees will come from the private sector and those guarantors will be required to hold a minimum of 10% private capital. The bill prohibits bailing out these private institutions if they fail.

- Qualified Mortgage definition will be enforced for all mortgages securitized on the Securitization Platform.

- The FMIC's guarantee would be backed by a Mortgage Insurance Fund. This fund would be maintained by current GSE premiums (until they are wound down) and then the burden would be shifted to participating private companies.

Proponents of the bill say the new system protects taxpayers and levels the playing field for all creditworthy borrowers, includes strong, market-based incentives for lenders to support the housing market in underserved communities, and provides certainty to investors and homeowners through standardization and transparency.

The bill faces stiff opposition from six key democrats including Elizabeth Warren (D-MA), Chuck Schumer (D-NY), Sherrod Brown (D-OH), Jeff Merkley (D-OR), Robert Menendez (D-NJ) and Jack Reed (D-RI). "This bill does not do enough for housing market needs of middle class America," said U.S. Sen. Elizabeth Warren, D-Mass. "It is harder to get a Freddie or Fannie mortgage than at any time in history. (Johnson-Crapo) would cut the pool of qualified borrowers by 20%. Think about that, one in five families who would be eligible today would not be."[3]

Policy analyst Isaac Boltansky told Bloomberg that Johnson and Crapo's bill is effectively dead, at least until 2015. "The Johnson-Crapo package will still likely clear the committee, but without any of the six targeted Democrats signing on it is highly doubtful that the measure will get a floor vote," Boltansky said.[4]

"It's exceedingly unlikely that the Senate Majority Leader, Harry Reid, will allow the bill to the floor given the narrow margin by which the bill was approved in committee, especially so because the most liberal members of the key Banking Committee are in opposition," said Rick Lazio, former U.S. Representative from New York.[5]

As of now, it seems unlikely that any reform will take place in 2014.

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About the Author

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