

ISSUE BRIEF

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Hensarling Housing Finance Plan: A Welcome Step Toward Solving the Fannie and Freddie Mess

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Representative Jeb Hensarling (R-TX) has released a discussion draft of a proposal, known as the Protecting American Taxpayers and Homeowners (PATH) Act, that would wind down the federally sponsored housing finance agencies Fannie Mae and Freddie Mac and move the U.S. toward a housing finance system that protects both taxpayers and homeowners.

The draft is a marked improvement over the plan earlier proposed by Senators Bob Corker (R-TN) and Mark Warner (D-VA), which would place the secondary mortgage market under the authority of a new government-backed agency.¹ While not perfect, the Hensarling plan provides a good starting point for Congress as it debates housing finance reform.

Importance of Fannie and Freddie Reform.

After nearly five years of federal conservatorship, the U.S. housing finance market is effectively nationalized today: The federal government underwrites more than 90 percent of all new mortgage originations and mortgage securitizations. Because of the explicit backing of the federal government,

government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac have effectively achieved a monopoly share of the mortgage and secondary mortgage market.² Ironically, the same institutions that played a central role in the unraveling of the U.S. mortgage and housing market are now more dominant players than before.³

Fannie Mae and Freddie Mac represent a failed institutional model that shielded them from losses while allowing them to rake in profits during periods of growth. The underwriting record of these housing finance GSEs contains serious and systemic business and policy errors,⁴ and congressional leaders need to recognize the failure of this institutional arrangement. Congressional leaders made the mistakes of creating Fannie Mae and Freddie Mac and subsidizing their activity in the U.S. mortgage and secondary mortgage markets through special access to federal funds and an implicit guarantee of a federal bailout.

Hensarling Housing Finance Reform Plan Winding Down Fannie and Freddie.

The plan provides for the complete dissolution of Fannie Mae and Freddie Mac. The plan would immediately terminate the current federal conservatorship of Fannie and Freddie and set a new five year conservatorship structure, during which the retained portfolios of both entities would be liquidated and all remaining assets of both entities would be sold off.

At the end of this five-year conservatorship period, the two enterprises would be stripped of their government charters, the retained portfolios of both entities would be liquidated, and all remaining assets of both entities would be sold off in federal receivership.

This paper, in its entirety, can be found at <http://report.heritage.org/ib3995>

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National Mortgage Market Utility. Within six months of enactment of the PATH Act, the director of the Federal Housing Finance Agency (FHFA) would choose a method of valuing a proprietary common securitization infrastructure (CSI) for residential mortgage-backed securities currently being developed by the FHFA.⁵ The FHFA would transfer ownership of the CSI within one year to the National Mortgage Market Utility (NMMU), a new nongovernment, not-for-profit cooperative.

The NMMU would then facilitate the origination, servicing, pooling, and securitizing of mortgages and serve as a public securitization outlet to match mortgage loan originators to investors in residential mortgage-backed securities. The new entity would not receive any federal government guarantees and would be barred from issuing securities. Participation in the NMMU would be voluntary.

Covered Bond Financing Structure. In addition to the open-access securitization platform operated by the NMMU, the Hensarling plan would establish a framework in U.S. financial markets for the issuance of covered bonds as an alternative mortgage financing structure to securitization and portfolio lending. Denmark and Germany, for example, rely on broad use of covered bonds in their housing finance markets.⁶ Banks in these systems essentially assume the credit risk, and investors receive a bank guarantee and mortgage collateral as protection against losses.

Federal Housing Administration. The reform plan would also directly address the role of the Federal Housing Administration (FHA) in the

housing finance system. The FHA program has expanded significantly beyond its original mission of providing lending opportunities to first-time and low- and moderate-income homebuyers.⁷ The Hensarling reform would establish the FHA as an independent government agency separate from the Department of Housing and Urban Development and require it to operate a self-sufficient book of business.

Moreover, the Hensarling reform would require the FHA to set responsible credit requirements for borrowers and increased risk sharing from FHA lenders. The plan would encourage individuals seeking FHA mortgage support to save and, overall, move toward purposeful home equity by increasing the minimum down payment from 3.5 percent to 5 percent, a small step in the right direction.

FHA-approved lenders would also share in the risk that accompanies the loans they originate. The FHA would decrease the loan loss insurance on all loans made by lenders over five years (from enactment of the reform) to 50 percent of the original loan from the current 100 percent. The FHA would also have to set a “take-back” requirement for all FHA lenders, requiring lenders to assume the credit risk on any loan that is more than 60 days delinquent within the first two years of the loan.

Dodd–Frank and Basel III Regulation Relief. The plan would additionally provide relief to banks and mortgages securitized through the NMMU from certain regulations in the Dodd–Frank Act that limit options for consumers and community banks to compete more robustly in the mortgage lending market.⁸ The relief from financial and

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1. See John L. Ligon, “U.S. Mortgage Market Reform: Corker–Warner Bill Misguided,” The Heritage Foundation, *The Foundry*, June 22, 2013, <http://blog.heritage.org/2013/06/22/u-s-mortgage-market-reform-corker-warner-misguided/>.
 2. See John L. Ligon and William W. Beach, “Housing Market Without Fannie Mae and Freddie Mac: Economic Effects of Eliminating Government-Sponsored Enterprises in Housing,” Heritage Foundation *Special Report* No. 127, January 8, 2013, <http://www.heritage.org/research/reports/2013/01/a-housing-market-free-of-fannie-mae-freddie-mac>.
 3. See John L. Ligon, “How Government Housing Policy Led to the Financial Crisis,” The Heritage Foundation, March 11, 2013, <http://www.heritage.org/research/testimony/2013/how-government-housing-policy-failed-homeowners-and-taxpayers-and-led-to-the-financial-crisis>.
 4. *Ibid.*
 5. Federal Housing Finance Agency, “Building a New Infrastructure for the Secondary Mortgage Market,” October 4, 2012, <http://www.fhfa.gov/webfiles/24572/fhfasecuritizationwhitepaper100412final.pdf> (accessed July 17, 2013).
 6. Michael Lea and Anthony B. Sanders, “The Future of Fannie Mae and Freddie Mac,” in *House of Cards: Reforming America’s Housing Finance System* (Fairfax, VA: Mercatus Center, 2012), p. 83, http://mercatus.org/sites/default/files/House_of_Cards_March_2012.pdf (accessed July 18, 2013).
 7. See John Ligon, “Will FHA Require the Next Round of Housing Bailouts from the Taxpayer?,” Heritage Foundation *Issue Brief* No. 3961, <http://www.heritage.org/research/reports/2013/06/will-fha-require-the-next-round-of-housing-bailouts-from-the-taxpayer>.
 8. See Diane Katz and David C. John, “Mortgage Regulation: Is CFPB Qualified?,” Heritage Foundation *Issue Brief* No. 3826, January 14, 2013, <http://www.heritage.org/research/reports/2013/01/mortgage-lending-regulation-is-cfpb-qualified>.
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mortgage-related regulations in the Dodd–Frank Act—and the temporary relief from the capital rules in the Basel III Accord—would provide some level of certainty for private capital to return to U.S. financial markets.

Market-Based Housing Finance Reform

Congressional leaders made the mistake of creating Fannie Mae and Freddie Mac and subsidizing their activity in these markets through special access to federal funds and an implicit federal backing prior to federal conservatorship in 2008.

It is time that these same leaders wind down these enterprises and establish a U.S. housing finance market free of the distortions that this institutional arrangement creates.

The Hensarling draft is a substantial step toward real, market-based reform of housing finance. It should provide a solid basis for congressional consideration of housing finance reforms that would help both homeowners and taxpayers.

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