

ISSUE BRIEF

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U.S. Financial Markets Do Not Need a New Regulator: Senate Misses the Mark

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Senators Tim Johnson (D–SD) and Mike Crapo (R–ID) have released a new housing finance reform bill, and as expected, it is very similar to the bill that Senators Bob Corker (R–TN) and Mark Warner (D–VA) released last June. Both Senate proposals would wind down the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, and both would replace the GSEs with a new government agency.

This new agency, the Federal Mortgage Insurance Corporation (FMIC), receives an even bigger regulatory role in the Johnson–Crapo bill than it would have under the Corker–Warner plan. The Senate’s newest legislation even gives the FMIC the authority to waive the much-touted first-loss provision when approving new companies to operate in the mortgage market.

The Federal Mortgage Insurance Corporation. The centerpiece of the Senate legislation is the FMIC, a new government entity that serves several purposes. One key FMIC function is to administer a special fund to cover losses on mortgage-backed securities (MBS). The FMIC is supposed to take over the insurance function that the current GSEs provide on MBS, and this feature would result in

taxpayers explicitly backing future losses on MBS. The FMIC also acts as a new federal regulator of the mortgage industry designed to monitor the safety and soundness of various financial institutions.

According to the Senate Banking Committee, Johnson–Crapo envisions the FMIC as “a strong regulator with supervision and examination powers” and “the authority to take enforcement actions against approved guarantors, aggregators, and [private mortgage insurers].”¹ It is still unclear which companies will carry out some of these functions, but banks, private mortgage companies, and asset management firms are all candidates.² Banks that decide to stay in the business of mortgage lending could end up dealing with at least six federal regulators because the Johnson–Crapo bill reorganizes the Federal Housing Finance Agency (FHFA) as an independent agency of the FMIC.

The Corker–Warner approach, on the other hand, would *replace* the FHFA, the current regulator of the GSEs, with the FMIC. Given the already expansive list of U.S. financial industry regulators—the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Consumer Financial Protection Bureau (CFPB), the Securities and Exchange Commission, and the Commodity Futures Trading Commission, to name a few—it is a good thing that Section 308 of Johnson–Crapo directs the FMIC to “avoid duplication or conflicts with the regulatory activities of other agencies.”

FMIC Sets Key Standards in “New Housing Finance System.” Johnson–Crapo envisions a “new housing finance system” predicated on explicit government backing for 90 percent of MBS losses. While this idea sounds simple, many of the details,

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such as how the 10 percent first-loss provisions will be created, are still uncertain. The Senate Banking Committee notes that the new securities will be executed as follows:³

1. Originators will underwrite mortgages for homebuyers and sell eligible mortgage loans into the secondary market (mainly to aggregators).
2. Aggregators will then pool the mortgages they purchase (or originate) and obtain some form of guarantee from a guarantor.
3. The mortgage pool will then be “delivered” to a Securitization Platform, and MBS will be issued to investors with an FMIC-backed government guarantee.

The general idea is that private companies will function as guarantors, and they will be required to hold 10 percent capital that has to be depleted before FMIC covers losses. In other words, the FMIC is providing guarantees on MBS so that private companies will provide guarantees on MBS. If the private insurers get into financial trouble, the FMIC will cover losses. While this provision has been touted as a major improvement over the old system, Johnson-Crapo actually gives the FMIC broad authority to develop the details for these so-called risk-sharing mechanisms.

The fact that the exact details of this supposed first-loss requirement will be allowed to evolve makes it highly likely that the actual first-loss position will be less than 10 percent. In fact, Johnson-Crapo already waters down this requirement: Section 302 (4)(A) (ii) allows the FMIC to approve credit-risk-sharing mechanisms that “do not represent the first loss position with respect to single-family covered securities.”

More generally, Johnson-Crapo gives the FMIC broad regulatory powers over companies that take part in the housing finance market.

For example, Section 306 gives the FMIC the power “to prescribe, repeal, and amend or modify, rules, regulations, or requirements governing the manner in which its general business may be conducted.”

Combined with other sections of Title III, the FMIC ends up with the power to decide which firms can function in the mortgage market and to establish capital standards for these companies. Under this authority, the FMIC can force troubled companies to dissolve in much the same manner as the FDIC can.

No Duty to Serve, Only a Mission to Provide. Aside from acting as the safety and soundness regulator, the FMIC is also charged with the political mission of ensuring access to credit for low-income and underserved markets. Specifically, Section 201 requires the FMIC to ensure “fair access to financial services, and fair treatment of customers by the institutions and other persons subject to its jurisdiction.” This section of the bill also charges the FMIC with facilitating the “broad availability of mortgage credit” to (among others) *all eligible borrowers*.

The term “eligible borrower” refers to all borrowers that meet the standards for an eligible mortgage. The FMIC, in turn, is allowed to develop the standards for these mortgages, provided they are “substantially similar” to regulations issued by the CFPB. While the Johnson-Crapo bill does not include explicit affordable housing goals for low-income markets, it clearly charges the FMIC with ensuring access to so-called affordable housing groups. There is a rich history showing exactly why the industry’s safety and soundness regulator should not also be charged with a politically motivated mission to provide housing.⁴

1. Committee on Banking, U.S. Senate, “Summary of Senate Banking Committee Leaders’ Bipartisan Housing Finance Reform Draft,” http://www.banking.senate.gov/public/_files/SummaryoftheBipartisanHousingFinanceReformDraft_update.pdf (accessed March 31, 2014).

2. Shortly after Corker-Warner was introduced, *Politico* reported that BlackRock CEO Larry Fink met with Senators Corker and Warner at a private event in Washington, leading to speculation that the asset management firm was in some way involved in the new legislation. See Ben White, “Spotted: Blackrock Execs Dine With DC Titans,” *Politico*, July 26, 2013, <http://www.politico.com/morningmoney/0713/morningmoney11254.html> (accessed March 31, 2014).

3. Committee on Banking, U.S. Senate, “Summary of Senate Banking Committee Leaders’ Bipartisan Housing Finance Reform Draft.”

4. See Norbert J. Michel and John Ligon, “Fannie and Freddie: What Record of Success?,” Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, <http://www.heritage.org/research/reports/2013/11/fannie-and-freddie-what-record-of-success>.

What Congress Should Do. Congress should:

- Reject both approaches being offered in the Senate bills. Both of these policies provide explicit taxpayer guarantees that are not necessary.
- Avoid establishing yet another federal regulator in U.S. financial markets.
- Adopt a policy that gets the federal government out of the U.S. housing finance market. Two good examples of such a plan are House Financial Services Committee Chairman Jeb Hensarling's (R-TX) Protect Taxpayers and Homeowners (PATH) Act and Representative Justin Amash's (R-MI) New Fair Deal Banking and Housing Stability Act.

Misguided Policy. The Johnson-Crapo bill, like Corker-Warner, contains policies that are misguided for numerous reasons. Johnson-Crapo

would create a new government entity with an ill-defined affordable housing mandate and the explicit authority to protect MBS investors in the event of a financial crisis.

It is bad enough that some Senators want to impose yet another federal regulator on financial markets, but this newest legislation would even give the FMIC the authority to waive the much-touted first-loss provisions when approving new companies to operate in the market. The Senate bills would not help people to buy homes; they would only protect investors and special interests at taxpayers' expense.

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