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Fannie and Freddie 2.0: The Senate Does Not Get the Government Out of the Market

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In an effort to reform the nation's housing finance system, Senate Banking Committee Chairman Tim Johnson (D–SD) and ranking member Mike Crapo (R–ID) have announced that they will hold a markup for their bill on April 29, but many details still have to be ironed out.

Given that close to 100 percent of the U.S. mortgage market is now backed by the federal government, it is good that the Senate Banking Committee wants to improve the Johnson–Crapo proposal. However, the approach being taken by Johnson–Crapo and a similar bill by Senators Bob Corker (R–TN) and Mark Warner (D–VA) would ensure that U.S. mortgage markets are slightly remodeled rather than completely reformed. The government would be at least as involved in these markets as it was prior to the 2008 crash.

The Pre-Crisis GSE System. Prior to the 2008 crisis, Fannie Mae and Freddie Mac were referred to as government-sponsored enterprises (GSEs) because they were quasi-private corporations.[1] Though they had the implicit backing of the federal government, they also had private shareholders who stood to lose the capital they had invested in the companies. The GSEs purchased mortgages from banks and then packaged them into mortgage-backed securities (MBS).

The GSEs then provided guarantees of principal and interest payments on these MBS, and markets generally assumed that taxpayers would pick up the tab if the GSEs got into trouble. If only a handful of mortgages backing a Fannie Mae MBS defaulted, Fannie covered investors' losses out of its own profits. On mortgages that had down payments of at least 20 percent, Fannie covered all the losses. For those home loans with less than a 20 percent down payment, however, the GSEs required private mortgage insurance (PMI). PMI companies, in turn, were typically private insurance companies.

In other words, any mortgage with less than 20 percent down in a GSE-issued MBS had at least two sources of private capital to cover losses. The PMI company insured a portion of any mortgage default costs, and the GSEs covered losses not covered by the PMI companies. As long as losses remained "normal" and there was no massive shock to the system, taxpayers were never on the hook for any of these losses.

The 2008 crisis was far from normal, and it proved that the "implied" taxpayer backing was real. The crash also proved that the private capital held in the GSEs was too low to cover those losses. Additionally, many PMI companies had too little capital to cover their losses. Many PMI firms—mostly regulated by state agencies—either failed or were given a reprieve from their capital requirements during the crisis.[2] GSE shareholders lost their capital and are currently embroiled in a legal battle with the U.S. Treasury over the details of the taxpayer bailout.[3]

Post Crisis and the Senate's GSE Reform Approach. Aside from any implications regarding the shareholder lawsuits, the problem with the new approach in the Senate is that it would barely change

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the public–private nature of the pre-crisis GSE system. The Johnson–Crapo bill, for example, requires a "first-loss" position of 10 percent for private "guarantors" of MBS but then waives the requirement in the event of a crisis.

Though there are several roadblocks, even in a crisis, to using taxpayer funds to cover MBS losses, the rules make clear that the federal government will pick up 90 percent of losses if there is a crisis. This arrangement is only nominally different from the old system because taxpayers were never required to cover losses *unless* those shortfalls were catastrophic. The GSEs were effectively "private" guarantors that everyone assumed would be covered in a crisis. The system now envisioned in the Senate would have "private" guarantors that know they are covered in a crisis.

Relative to the old GSE system, it certainly is true that the bills in the Senate would increase the amount of private capital to cover even catastrophic losses. But the GSEs started out with higher capital requirements, too: Fannie started out with a required leverage ratio of 15 to 1 in 1968, and the company was leveraged as much as 200 to 1 in 2008.[4]

The GSEs capital requirements were watered down over the years mainly in the name of expanding their "affordable housing mission." There is absolutely no reason to think that the same thing would not happen again if the Senate's approach is adopted. In fact, the Johnson–Crapo approach would give the guarantors a new safety and soundness regulator that is charged with making sure everyone has "fair access to financial services."

At best, the approach in the Senate would create a series of smaller quasi-private GSEs with higher capital requirements but with the explicit understanding that any catastrophic losses would be covered by taxpayers. The Senate approach goes much further, though, by creating a new government agency and an intricate new regulatory framework.[5]

What Congress Should Do. Congress should:

- Reject the approach being offered in the Senate bills. Both of these bills would 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) Protecting American Taxpayers and Homeowners (PATH) Act and Representative Justin Amash's (R–MI) New Fair Deal Banking and Housing Stability Act.

A Legislative Exercise. The members of the Senate Banking Committee—and especially their staff—deserve credit for taking on such a complex issue. However, the approach being put forward largely recreates the old GSE structure. Why should the nation go through this legislative exercise if the end result will be a system so similar to the one that just imploded? Congress should not leave the government so embedded in the business of housing finance. If lawmakers want to improve the nation's housing finance system, they should get the government out of these markets.

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1. See Norbert J. Michel and John L. 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.
2. See Moody's Investors Service, "U.S. Mortgage Insurers: Negative Outlook," March 7, 2012, http://www.radian.biz/sfc/servlet.shepherd/version/download/068C0000000S1qKIAS (accessed April 14, 2014).
3. See Richard A. Epstein, "Grand Theft Treasury," Hoover Institution, July 16, 2013, http://www.hoover.org/publications/defining-ideas/article/151966 (accessed April 14, 2014).
4. See Michel and Ligon, "Fannie and Freddie: What Record of Success?" Also see Seeking Alpha, "Fannie and Freddie Are Largely Responsible for the Housing Bubble," July 16, 2008, http://seekingalpha.com/article/85249-fannie-and-freddie-are-largely-responsible-for-the-housing-bubble (accessed April 14, 2014).
5. See Norbert J. Michel and John L. Ligon, "U.S. Financial Markets Do Not Need a New Regulator: Senate Misses the Mark," Heritage Foundation *Issue Brief* No. 4191, April 3, 2014, http://www.heritage.org/research/reports/2014/04/us-financial-markets-do-not-need-a-new-regulator-senate-misses-the-mark.