# CONGRESSIONAL TESTIMONY

## The Bipartisan Housing Finance Reform Act of 2018

## Does Not Protect Taxpayers

### Testimony before the Committee on Financial Services

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It has been 10 years since the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, failed and were placed into government conservatorship. Yet, Congress has failed to enact legislation that would reform the housing finance market and adequately protect taxpayers. It now appears that the next Congress may adopt a solution similar to the one proposed in the Bipartisan Housing Finance Reform Act of 2018 (the Act), but this type of solution is harmful because it perpetuates the worst parts of the existing housing finance system. Given the spectacular implosion of this system in 2008, it is nearly inconceivable that Congress would even contemplate this type of legislation.

Broadly, a major problem with the approach in the Act is that it tries to intricately design a housing finance system rather than simply provide a strong legal framework for the private market. More narrowly, the Act takes the wrong approach because it continues the long-running trend of increasing government intervention in financial and housing markets. In particular, the Act provides explicit taxpayer guarantees for privately issued securities, a feature that will weaken the incentives for investors to remain vigilant and skeptical of the underlying risks in these securities. This course has repeatedly made housing less affordable for the typical American and destabilized housing and financial markets. Congress should reject this approach in favor of one that moves the U.S. further toward a market-based housing finance system.

**Background**

Robust homeownership was established in the U.S. long before the government became heavily involved in the housing finance market. For instance, from 1949 to 1968, the year that Fannie Mae was allowed to purchase non-government-insured mortgages, government backed

mortgages failed to account for more than 6 percent of the market in any given year.[1] Yet the homeownership rate was 64 percent in 1968, virtually identical to the current rate. Then, in the 1990s, the U.S. housing finance system morphed into one that was heavily dependent on implied taxpayer guarantees. From 1990 to 2003, Fannie Mae and Freddie Mac went from holding 5 percent of the nation's mortgages ($136 billion) to more than 20 percent ($1.6 trillion).[2]

Critics have argued that, rather than a problem caused by the GSEs and affordable housing goals, private-label mortgage backed securities (PMBS) were the problem.[3] However, in 1995 the Department of Housing and Urban Development (HUD) ruled that the GSEs could get affordable housing goal credit for buying PMBS that contained mortgages to low/moderate income buyers.[4] Between 1997 and 2007, the GSEs purchased more than $700 billion in subprime PMBS and an additional $154 billion in Alt-A PMBS, amounts that represented approximately 30 percent and 13 percent of the total issued, respectively.[5] In the years leading into the crisis, the GSEs (combined) held approximately 70 percent of all the PMBS issued.[6]

Investors who purchased Fannie and Freddie's bonds and mortgage-backed securities (MBS) – ultimately helping to fund these PMBS purchases as well – enjoyed implicit government backing. The GSEs charged a guarantee fee and, in return, promised investors they would make good on all principal and interest payments for their MBS. However, it was common knowledge that taxpayers would make good on promised cash flows if either Fannie or Freddie were to ever fail financially. This feature led to more risky lending than would have taken place without such guarantees because it allowed investors to ignore the true financial risks of those underlying mortgages and securities.[7] Though it is often forgotten, a key part of this GSE system was that Fannie and Freddie required all borrowers with less than a 20 percent downpayment to purchase private mortgage insurance. Put differently, private capital at both the private mortgage insurance companies and the GSEs was "in front" of any losses that the taxpayers would have to absorb if the GSEs failed.

In this GSE system, as long as losses remained "normal," meaning the absence of a massive shock to the system, taxpayers were never expected to cover any losses. Of course, the 2008 crisis was abnormal, and the "implied" taxpayer backing was proven quite real. The crisis also demonstrated that the private capital held in the GSEs (and in many of the private mortgage insurance companies) was too low to cover the catastrophic losses realized at that time. There has

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[1] Norbert J. Michel and John Ligon, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation *Backgrounder* No. 2877, February 7, 2014, p. 6, https://www.heritage.org/housing/report/gse-reform-the-economic-effects-eliminating-government-guarantee-housing-finance.

[2] Ibid.

[3] See Susan Wachter and Benjamin Keys, "The Real Causes — and Casualties — of the Housing Crisis," Knowledge @ Wharton, September 13, 2018, http://knowledge.wharton.upenn.edu/article/housing-bubble-real-causes/ (accessed December 18, 2018).

[4] Peter Wallison, *Hidden In Plain Sight*, 2015, Encounter Books, New York: New York, P. 162.

[5] Wallison, P. 162. Also see Edward Pinto, "Government Housing Policies in the Lead-up to the Financial Crisis: A Forensic Study," American Enterprise Institute, 2011, P. 149, http://www.aei.org/wp-content/uploads/2010/10/Pinto-Government-Housing-Policies-in-the-Lead-up-to-the-Financial-Crisis-Word-2003-2.5.11.pdf (accessed December 18, 2018).

[6] Congressional Budget Office, "Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market December 2010," P. 10, https://www.cbo.gov/sites/default/files/111th-congress-2009-2010/reports/12-23-fanniefreddie.pdf (accessed December 18, 2018).

[7] According to the Congressional Budget Office, "the unpriced implicit guarantee, which reduced interest rates for mortgage borrowers, helped cause more of the economy's capital to be invested in housing than might otherwise have been the case." Congressional Budget Office, *Transitioning to Alternative Structures for Housing Finance: An Update*, August 2018, p. 7, https://www.cbo.gov/system/files?file=2018-08/54218-GSEupdate.pdf (accessed December 18, 2018).

been a long history, though, of successful political pressure that reduced capital at the GSEs due to ostensible concerns over affordable housing.[8] Although it would clearly be a mistake to resurrect these elements of the GSE system, the Act – as well as similar reforms recently proposed[9] – makes just this blunder.

**Federal Guarantees in the 2018 Bipartisan Housing Finance Reform Act**

The Bipartisan Housing Finance Reform Act of 2018 (the Act) implements an explicit federal guarantee for principal and interest payments on mortgage backed securities (MBS) through a new program at Ginnie Mae, currently the primary vehicle for financing all government-insured mortgages. Section 102 of the Act specifies certain criteria for loans to be eligible for pooling into these explicitly backed securities, and Section 103 provides that Ginnie Mae issue standards for issuers of such securities. As envisioned by the Act, mortgages cannot be pooled into federally backed MBS without some kind of privately financed credit enhancement, and the Federal Housing Finance Agency (FHFA) will oversee such enhancements. (This oversight role includes developing capital standards for the private firms that issue the credit enhancements.)

Overall, the Act envisions a system whereby various levels of private capital absorb losses on MBS first, prior to the taxpayers. In this new system, the private firms that issue credit enhancements would be allowed to charge a guarantee fee, much as the GSEs charged in the past. In this new system, however, (at least a portion of) the fees would be accumulated in the "Private Capital Reserves" fund to "backstop" the firms that issue the credit enhancements. Ultimately, taxpayers will be forced to cover any shortfall on losses that the fund is required to pay, much like taxpayers have to fund any shortfall for the FDIC deposit insurance fund or the reserve fund for the National Flood Insurance Program. In other words, these new firms would replace the role that the GSEs had: they would issue protection to MBS investors against losses and, in the event the firms fail, taxpayers would serve as insurers for losses on MBS not covered by private capital.

This new system, therefore, envisions an extra layer of "private capital" relative to the pre-crisis GSE system. However, an obvious similarity remains: the taxpayers' role, under both systems, is the equivalent of a catastrophic insurer of MBS. Section 106 of the Act states that the FHFA director can authorize various types of companies to operate as private credit enhancers, including "a corporation, mutual association, partnership, limited liability corporation, cooperative, mutual company, or any other organizational form that the Director considers appropriate," but it remains unclear which firms – outside of existing mortgage insurers – will fill this role and why they would do so, rather than invest in alternative financial ventures, unless they expect an above-normal return for providing credit enhancements.[10] Regardless, all mortgage holders under this new system ultimately have to pay into the guarantee fund, which simply means that the federal government would be forcing borrowers to pay for private investors to secure guaranteed returns.

**Federal Guarantees Are Unnecessary And Counterproductive**

The 2018 Bipartisan Housing Finance Reform Act, and other similar plans, seek to expand a system that failed to provide a particularly high home ownership rate, a stable housing market, or even a substantial direct cost savings to borrowers. Prior to the 2008 crisis, the GSEs enjoyed an

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[8] Norbert J. Michel and John Ligon, "Fannie and Freddie: What Record of Success?," Heritage Foundation *Backgrounder* No. 2854, November 7, 2013, pp. 4-6, https://www.heritage.org/housing/report/fannie-and-freddie-what-record-success.

[9] Norbert Michel and John Ligon, "Fannie and Freddie 2.0: The Senate Does Not Get the Government Out of the Market," Heritage Foundation *Issue Brief* No. 4201, April 18, 2014, https://www.heritage.org/housing/report/fannie-and-freddie-20-the-senate-does-not-get-the-government-out-the-market.

[10] Section 107 of the Act prohibits the issuers of MBS from serving as approved private credit enhancers.

estimated annual subsidy ranging from a low of about $7 billion in 1995 to a high of approximately $20 billion in 2003.[11] Research shows that the bulk of this subsidy, however, stayed with the GSEs and that borrowers may have benefited by paying, at most, 0.50 percent less in interest rates than if there had been no GSE subsidy.[12] Given the relatively small impact on interest rates, along with the minor long-term impact on homeownership rates, it is difficult to argue that the GSE subsidies were necessary for the housing market to function properly.[13]

Overall, federal programs to boost homeownership by way of increasing low-equity long-term debt have expanded nearly continuously since the 1930s.[14] Even though the U.S. homeownership rate has remained nearly constant over the past 50 years, the level of residential mortgage debt has increased nearly sixfold – from approximately $1.8 trillion in 1968 (the year Fannie became a GSE) to roughly $10 trillion in 2013 (based on Federal Reserve data). Furthermore, from 1990 to 2016, as federal involvement in housing finance expanded, home prices have outpaced income – median home prices increased from 2.73 to 3.36 times median household incomes during this period.[15] Yet, the level of equity that households have accumulated in their homes has trended downward since the 1980s, and is approximately 20 percentage points lower than it was in the 1970s.[16] That is, while policymakers tout the benefits of countless government programs as boosting homeownership, most government policies actually increase *mortgage* ownership while requiring those mortgages to be even larger.

Interestingly, the U.S. is the only major country in the world with a federal government mortgage insurer, government guarantees of mortgage securities, *and* GSEs in housing finance.[17] Yet, volatility of home prices and home construction from 1998 to 2009 in the U.S. was among the

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[11] John L. Ligon and William W. Beach, "A 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, 2012, pp. 5–6, http://www.heritage.org/research/reports/2013/01/a-housing-market-free-of-fannie-mae-freddie-mac.

[12] Ibid.

[13] This conclusion is supported by The Heritage Foundation's macroeconomic simulation of removing these government guarantees from the housing market. See Ligon and Beach, "A Housing Market Without Fannie Mae and Freddie Mac."

[14] John L. Ligon and Norbert J. Michel, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation Backgrounder No. 2877, February 7, 2014, http://www.heritage.org/research/reports/2014/02/gse-reform-the-economic-effects-of-eliminating-a-government-guarantee-in-housing-finance.

[15] John L. Ligon, "Fannie Mae Should Rethink Its Plans to Expand Role in Housing Finance Sector," The Daily Signal, June 29, 2017, https://www.dailysignal.com/2017/06/29/fannie-mae-rethink-plans-expand-role-housing-finance-sector/. Also see Edward J. Pinto, "Fifty Years Of Housing Policy Failure: How Housing Policies Make Homes Unaffordable," American Enterprise Institute, October 26, 2015, http://www.aei.org/publication/fifty-years-of-housing-policy-failure/ (accessed December 19, 2018). Additionally, data shows that in 1989, nearly 90 percent of U.S. housing markets were affordable (defined as having a median home price to median income ratio of 3.0 or less) with only 4 percent severely unaffordable (a ratio of greater than 5.0). By 2005, after more than a decade of affordable housing policies, less than a third of markets were affordable, and 30 percent of markets were severely unaffordable. See "The Taxpayer Protection Housing Finance Plan," American Enterprise Institute, Eds. Peter Wallison and Edward Pinto, January 2018, P. 42.

[16] John L. Ligon and Norbert J. Michel, "Why Is Federal Housing Policy Fixated on 30-Year Fixed-Rate Mortgages?," Heritage Foundation Backgrounder No. 2917, June 18, 2014, http://thf_media.s3.amazonaws.com/2014/pdf/BG2917.pdf.

[17] Michael Lea, "International Comparison of Mortgage Product Offerings," Research Institute for Housing America Special Report, September 2010, https://www.mba.org/news-research-and-resources/research-and-economics/research-institute-for-housing-america/published-reports/2011-2009/international-comparison-of-mortgage-product-offerings (accessed December 19, 2018).

highest in the industrialized world.[18] Finally, not only has the U.S. homeownership rate remained relatively stable for most of the post-WWII period, but it does not rank particularly high among developed nations. For instance, as of 2012 the U.S. rate was at the median— 8 out of 16 developed countries—and was equal to the average value for European countries.[19] Thus, even with its higher than typical subsidies and government backing, the U.S. has not appreciably increased its homeownership rate relative to countries with less government involvement.

**An Administrative Wind Down Would Make Congressional Action Easier**

The last 10 years have proven that it will be enormously difficult for Congress to get the federal government out of the housing finance market. And if any of the recent proposals are the best that Congress can do, then Congress should simply wait for the Trump administration to shrink the government's footprint in housing finance. By taking some very simple steps, the administration can gradually ensure that larger portions of the housing market will be taken over by the private sector.[20] For instance, the administration can:

1. Begin a gradual reduction in the conforming loan limits of the GSEs, starting with the elimination of the high-cost area limits.
2. Begin to focus the GSEs primarily on financing home purchases by eliminating their support for the financing of cash-out refinance mortgages, the purchase of second homes, and "investor" loans for rental properties.
3. Begin to reduce the standard conforming loan limits.

During the first nine months of 2018, the GSEs securitized more than $578 billion of purchase *and* refinance single-family mortgages. A recent analysis published by *Inside MBS & ABS* estimated that almost 40 percent of that footprint, approximately $225 billion, could be pared by eliminating support for investor loans ($38 billion), second mortgages ($24 billion), cash out refinances ($107 billion), high-cost loans ($40 billion), and the GSE patch (QM/DTI test) loans ($15 billion).[21] The Trump administration can undertake each of these reforms without new legislative authority, and taking such actions would be more beneficial to more Americans than any of the current proposals currently being considered in Congress.

**Conclusion**

Given the spectacular 2008 failure of the government's housing finance policies, it is truly unfathomable that Congress would contemplate perpetuating anything like that pre-crisis system. Yet Congress appears on the brink of doing just that – most of the proposals under consideration create a system that replaces implicit government guarantees (that everyone, rightly, fully expected to be honored), with explicit guarantees. Advocates of these proposals unabashedly want borrowers to pay fees that secure investors' returns, and Congress appears ready to succumb to this pressure.

[18] Dwight M. Jaffee, "Reforming the U.S. Mortgage Market Through Private Market Incentives," in Satya Thallam, ed., House of Cards: Reforming America's Housing Finance System, George Mason University, Mercatus Center, March 2012, pp. 23–25, http://mercatus.org/sites/default/files/House_of_Cards_March_2012.pdf (accessed December 19, 2018).

[19] Jaffee, "Reforming the U.S. Mortgage Market Through Private Market Incentives," P. 23.

[20] "An Administrative Approach To Reducing GSEs' And FHA's Footprint," American Enterprise Institute, Fisher et al., August 17, 2018, http://www.aei.org/publication/an-administrative-approach-to-reducing-gses-and-fhas-footprint/ (accessed December 19, 2018).

[21] "How to Shrink the GSE Footprint Without Having to Ask Congress to Do Anything," *Inside MBS & ABS*, Volume 2018, Number 46, December 7, 2018.

Typical Americans will lose big if Congress moves in this direction because government guarantees for financial securities ensure that investors pay little attention to the true underlying risk in those securities. There is no better example of the consequences of such policies than the 2008 crisis.

These guarantees produced excessive leverage, investors who didn't know or care what was in their portfolio, overbuilding in the housing sector, and home prices that rose to unsustainable levels. As expected, all of the special interests that benefitted from that system – the well-connected lobbyists for mortgage bankers, commercial bankers, relators, and investors – have been fighting desperately to maintain their profits. Members of Congress should stand firm against this rent-seeking, and the utter destruction that the 2008 crisis caused across America should make doing so very easy.

Relying on investor guarantees, standardization, government mandates, risk allocation by dictate, and strict regulation doubles down on the failed government policies that created the 2008 crash. Unencumbered, markets function so that risk is allocated to those best able to handle it, and so that firms avoid restricting access to credit to credit-worthy borrowers. Policymakers that push against these forces because their constituents do not want to hold risk and because they want to expand credit beyond existing levels, are directly responsible for (at the very least) the housing finance market turmoil realized during 2008 and the costs of the associated bailouts.

History has proven that financial markets will provide funds for housing without the federal government socializing investors' losses. If policymakers want to make housing more affordable, they should push for an open, vibrant, competitive market, without heavy regulation and government guarantees. Such a market would make consumers better off, even though it may fail to bolster the standing of all the well-connected special interest lobbyists. An explicit federal guarantee of mortgage backed securities will continue to make housing less affordable and markets unstable, as did the so-called implicit guarantees of the pre-2008 system.

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