Financial Services Committee Republican Plan for Reforming Fannie Mae and Freddie Mac

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BACKGROUND

The economic crisis wrought by the housing bubble and the near-collapse of the financial system has devastated hard-working Americans. The unemployment rate is nearly 10 percent. Housing prices are down 30 percent from their peak while sales of both new and existing homes continue to decline. Trillions of taxpayer dollars have been committed to prop up this country's financial institutions. And all of this wreckage can be traced to the collapse of a mortgage finance system that was heavily manipulated by Congress.

The evidence is clear that the Government Sponsored Enterprises (GSEs) - specifically, Fannie Mae and Freddie Mac - were the proximate cause of the economic crisis. Ultimately supported by the taxpayers to the tune of hundreds of billions of dollars, Fannie and Freddie permitted their executives, investors, and creditors to make outsize profits when times were good, but stuck taxpayers with the tab when the housing bubble burst. Fannie and Freddie's access to cheap capital and the taxpayers' pocketbook helped run up housing prices to unsustainable levels, while crowding out lenders and investors who could not afford to compete against these government-sponsored juggernauts.

In the pursuit of short-term profits subsidized by the public purse, which Fannie and Freddie cloaked in an "affordable housing mandate" to shore up their political support, the GSEs were at the forefront of a relentless push to drive down lending standards, ensuring that millions of households that might have been better off renting and saving were placed in houses they ultimately could not afford. The GSE experiment of "public mission, private ownership" on which Fannie and Freddie were built must be judged for what it was: a failure that has left us with a weakened financial system, a surfeit of unsustainable mortgage debt, an oversupply of housing, and an open-ended commitment the Administration has undertaken to pay off those who fueled the housing boom, all at the expense of the American taxpayer.

Given the role that Fannie and Freddie played in the collapse of our nation's financial system, the American people have a right to expect that fixing these GSEs would be at the center of the Administration's so-called regulatory reform of the financial system. But instead of reforming the GSEs to create a sustainable mortgage finance system that does not careen from boom to bust or put the taxpayer at risk, the Administration has instead chosen to double down on this failed model, hoping to trigger a new housing bubble.

Rejecting the notion that government-sponsored enterprises are essential to a vibrant mortgage finance system, House Republicans support establishing a framework to reinvigorate housing finance that does not rely on government guarantees, that does not make private investors and creditors wealthy while saddling taxpayers with losses, and that does not set the stage for the next financial crisis. The legislative principles developed by House Republicans will restore market discipline and competition to the mortgage finance system, thereby ensuring that credit is extended to those who can pay it back, rather than enriching private investors and executives whose business model depends on cheap credit provided by the taxpayer.

OVERARCHING GOALS

To achieve a healthy, sustainable mortgage finance system, House Republicans support mortgage finance reform legislation that seeks to achieve the following goals:

• Reestablish a housing finance market that has long-term stability in which private capital is the primary source of mortgage financing - Because of their size and the open-ended support that the Administration has pledged to keep the GSEs alive no matter the cost, private capital has been shut out of the mortgage finance system, thereby contributing to the continued decline of housing prices overall. Rehabilitating our system of mortgage finance requires an end to the political manipulations and taxpayer guarantees that have distorted market incentives and contributed to these wide swings in housing activity.

• Restore stability and liquidity to the secondary market for residential mortgages, and prevent significant disruptions to the financial market - The Administration's commitment to keeping the two GSEs alive, no matter the cost, and to maintain the toxic combination of cheap capital and government guarantees, ensures that we will repeat the same mistakes that caused the housing market to collapse. The uncertainty about the future of the mortgage market that is created by the Administration's failure to put forth a credible plan to phase out Fannie and Freddie is freezing private capital in place and impeding a sustainable housing recovery.

• Encourage innovation and diversity in housing finance that provide choices for consumers - Thanks to government guarantees and cheap capital, the GSEs have monopolized mortgage finance and used their government privileges to crowd out competition, stifle innovation and restrict consumer choice. Consumers benefit from competition, and bringing competition to mortgage finance requires putting an end to the GSEs' monopoly.

• Protect taxpayers from further losses and future bailouts - When Fannie and Freddie were placed in conservatorship in September 2008, then Treasury Secretary Henry Paulson urged Congress to view this action as a "time out" while deciding their future role and structure. Instead, the Obama Administration has decided to make taxpayer bailouts the status quo for operating the GSEs. Putting in place an immediate plan to end the bailouts of Fannie and Freddie, which were designed to spare creditors from the consequences of their mistakes, will limit the losses that taxpayer will face as a result of the blank check given by the Administration on December 24, 2009. It will prevent future taxpayer bailouts by requiring creditors to be more vigilant in assessing the creditworthiness and business practices of the parties to whom they are extending credit.

• Require that taxpayers be made whole on outstanding loans, guarantees and capital infusions made by the government - The most expensive part of the government-engineered rescue of the financial system has been the rescue of the GSEs. On Christmas Eve last year, the Administration announced that it was removing the $400 billion cap from what the administration believes will be necessary to keep Fannie Mae and Freddie Mac solvent. The Administration's commitment to keep the GSEs alive is now without limit. Rather than extending the blank check that the Administration has given the GSEs, House Republicans will end the flow of taxpayer funds to the GSEs and ensure that taxpayers are made whole.

KEY LEGISLATIVE PRINCIPLES

To achieve the above-mentioned goals, House Republicans are committed to pursuing the following principles as part of GSE reform legislation:

1. Wind down the operations of Fannie Mae and Freddie Mac within four years, ending once and for all the disastrous government experiment in privatized profits and socialized losses – This includes sun-setting the current GSE conservatorship and winding down the federal subsidies granted through their charters.

2. Phase out, over two years, the elevated conforming loan limits in high-cost areas established in the Continuing Resolution enacted on October 30, 2009, thereby cutting off taxpayer subsidies of millionaires’ mortgages – The additional subsidies created by raising the loan limit in high-cost areas to $729,750 disproportionately benefit mortgage holders with high incomes. They artificially drove up the cost of housing and contributed to the housing bubble as demand increased and borrowers were encouraged to take on mortgages they could not afford. The higher limits have also allowed the government to extend its monopoly in the mortgage finance market as Fannie Mae, Freddie Mac and FHA currently guarantee more than 95% of all mortgages. As a result, private capital has been shut out of the mortgage finance system, and taxpayers are put at risk of having to foot the bill for significantly greater losses than currently projected.

3. Reduce the mortgage portfolio holdings of Fannie and Freddie by 25% a year over four years - The principal mission of Fannie and Freddie is to buy conforming mortgages and resell them to investors, thus freeing up funds for banks and other lenders to make new mortgages. However, the GSEs expanded their mortgage investment strategy to take advantage of low interest rates on agency bonds. They used cheap debt to lever up and profit on the yield spread they earned on their mortgage portfolio over their cost of funds. But this strategy also exposed Fannie and Freddie to both the interest rate risk and credit risk of the mortgages in the portfolios. This approach enriched shareholders and management, but did little to benefit homebuyers or the overall liquidity of the national secondary mortgage market. The structure of the GSEs led to this classic moral hazard situation. During the real estate boom, shareholders were doubly enriched while debt holders didn't feel compelled to monitor the GSEs' leverage and risk-taking because of the implicit government guarantee. Taxpayers continue to be exposed to greater losses as long as Fannie and Freddie continue to maintain significant portfolio holdings.

4. Reduce leverage by phasing in, over four years, capital requirements that are consistent with global standards for large, complex financial institutions - Fannie and Freddie remain critically undercapitalized. In 2007, the subprime-backed securities they held, alone, accounted for 71% of Fannie Mae's core capital and 116% of Freddie's core capital. Their minimum capital levels of 2.5% for on-balance sheet asset and 0.45% for off-balance sheet guarantees were far below the 10% that other large, complex financial institutions are required to hold. Currently, there are no capital requirements for Fannie and Freddie. They were suspended by FHFA for the duration of the conservatorship. The GSEs are only required to maintain a positive net worth. Excessive leverage led to the downfall of Fannie and Freddie, and the suspension of even minimum capital requirements puts taxpayers at significant risk of incurring even greater losses while the GSEs are in conservatorship.

5. Establish a regulatory framework for a U.S. covered bond market - Covered bonds are an innovative source of private mortgage market financing which have worked well in many European countries. They are also a private market solution to the need for market participants to have "skin in the game." A covered bond is a form of debt issued by a financial institution where a specific set of high quality assets (typically loans) are set aside into a pool for the benefit of the bondholders. The issuers of covered bonds are responsible to their bond holders for the risk posed by the underlying loan pool. For example, if the underlying loans default, bond holders can make claims against the issuer. And if the

issuer becomes insolvent, bondholders retain full claim on the loan pool. Additionally, issuers of covered bonds are required to account for the risk posed by their bonds on their balance sheets.

6. Create a regulatory safe-harbor for mortgages that meet underwriting standards that are consistent with the Federal Reserve Board's final HOEPA rule - To encourage the return of private capital to the mortgage finance market, investors need transparency and confidence that the loans they purchase meet appropriate underwriting standards, including the ability to repay and the integrity of the documentation. The Federal Reserve's Home Ownership and Equity Protection Act rules that were revised in July 2008 provide a framework for increasing investor confidence by enhancing the integrity, consistency, and proper functioning of the mortgage market. However, title VII of H.R. 4173, the Wall Street Reform and Consumer Protection Act, which passed the House on December 12, 2009, establishes only a limited safe harbor from legal liability and provides for expanded assignee liability for mortgages that meet stringent underwriting standards, thereby making it difficult to assess the legal risk of investment in mortgages. These and other financial limitations in H.R. 4173 will discourage private investment from returning to the mortgage market.

7. Eliminate the maturity mismatch that allows Fannie and Freddie to fund long-term assets with very short-term borrowing, exposing taxpayers to enormous interest rate risk - The GSEs finance their portfolios of long-term (typically 30-year) mortgages with short-term borrowing (typically three months to five years). Thanks to the government's implicit (and now explicit) guarantee of Fannie and Freddie's debt, they are able to raise capital cheaply while crowding out lenders and investors who cannot afford to compete against them. However, if interest rates were to increase, as many economists and market analysts predict, Fannie and Freddie will incur even more substantial losses, with the taxpayers picking up the tab. This is what happened to the savings and loan industry in the 1980s. When interest rates started rising in the mid- to late-1970s, the value of 30-year fixed rate mortgage portfolios dropped as much as 25 percent and causing much of the industry to become insolvent.

8. Create an Inspector General for the Federal Housing Finance Agency and require the IG to submit regular reports to Congress so long as the Federal government's ownership and control of Fannie Mae and Freddie Mac continues - The Housing and Economic Recovery Act of 2008 dissolved the Federal Housing Finance Board and established in its place the Federal Housing Finance Administration. Although most former FHFB employees were automatically given similar positions at the same grade and pay level at the new agency, the Independent Inspector General was the exception. As a result, FHFA does not have an independent auditing authority to oversee and report to Congress on the operations and actions of Fannie Mae and Freddie Mac. While the two GSEs are being wound down, every effort should be made to limit further taxpayer exposure to potential losses through rigorous oversight and regular reporting to Congress.

9. Ensure fully transparent and honest accounting of all government spending and liabilities by moving the operations of Fannie Mae and Freddie Mac onto the federal budget, and subject the debt issued by the two GSEs to the national debt limit - The Congressional Budget Office (CBO) noted in January that the federal government controls both GSEs and is operating them to fulfill the public purpose of supporting the housing and mortgage markets. Therefore, failure to include their financial transactions alongside all other federal activities in the budget not only undermines budget accountability, but it also makes efforts to encourage the deployment of private capital to the housing finance market more difficult because of uncertainty about their mission and objectives. The blank check the Obama Administration gave to Fannie and Freddie has proven to be costly to U.S. taxpayers, but the exact amount of that liability is being hidden. Including them in the budget process is the only way to ensure accountability by the Administration and effective oversight by Congress.

10. Immediately suspend the compensation packages approved for the senior executives of Fannie Mae and Freddie Mac, and establish a compensation system in accordance with the rates of pay for Executive and Senior level employees of the United States Government - As a result of the government's actions, U.S. taxpayers now own at least 80 percent of the two GSEs and it is unlikely that they will be returned to private shareholders. The Congressional Budget Office has concluded that Fannie Mae and Freddie Mac have effectively become government entities whose operations should be included in the federal budget. Despite being government agencies, on December 24, 2009, the FHFA approved 2010

compensation packages for their chief executive officers of $6 million each, including incentive pay of $2 million each, which is 15 times more than the President and 30 times more than a Cabinet Secretary. FHFA also approved multi-million dollar compensation packages for a number of the GSEs' top executives, payable in cash rather than in the type of stock options that have characterized compensation arrangements at other large financial institutions that have received extraordinary government assistance. Given the recent attention to incentive compensation structures of financial firms and how they may have contributed to excessive risk-taking, there is no better example of misaligned incentives than those that were, and continue to be, in place at Fannie Mae and Freddie Mac.

NOTE: Click here to view the Republican goals and principles for GSE Reform.

Additional Resources:

House Republicans Release Principles For Reform Of Fannie Mae And Freddie Mac

Bachus Responds to Frank, Dodd Comments on Financial Reform Legislation

Bachus: Administration Paying Lip Service to Fannie, Freddie Reform While Committee Republicans Have Offered Concrete Legislative Proposals

3-11-10, Bachus Urges Senate To Address Fannie, Freddie Failures In Financial Regulatory Reform Legislation