BACKGROUNDER

No. 3382 | FEBRUARY 4, 2019

Housing Finance Reform Possibilities Abound for 2019

Joel Griffith and Norbert J. Michel, PhD

Abstract

Mortgage securitizers Fannie Mae and Freddie Mac—America's largest government-sponsored enterprises (GSEs)—imploded in 2008, triggering a major recession and financial crisis in the United States. Instead of shutting down these failed companies, Congress chose to prop up the companies indefinitely. A decade later, both GSEs remain under government conservatorship with taxpayers standing behind all of their obligations, and the housing market even more distorted than it was leading into the crisis. Congress may now finally address the housing finance system, but many of the recent proposals would preserve—even expand—the worst parts of the failed GSE system. Many of these proposals call for an explicit federal guarantee of mortgage-backed securities, even though the implicit federal guarantees behind the GSEs' securities made housing less affordable and contributed to the significant lowering of credit standards in the years preceding the crisis. History shows that the housing market does not need this type of government guarantee, and Congress should work to make housing more affordable by shrinking the federal role in housing finance. This Heritage Foundation Backgrounder *compares recent proposals and explains the benefits and shortcomings of each.*

Key Points

- A decade after the housing market collapse and the federal takeover of Fannie Mae and Freddie Mac, government mandates, subsidies, and guarantees continue to distort the housing finance markets.
- Most proposals for housing finance reform contain structural flaws certain to make things worse. Taxpayers still bear the risk of massive bailouts of mortgage securitizers, as well as the fallout from another housing market collapse.
- Even if no taxpayer funds flow towards another bailout, merely the existence of the backstop will incentivize excessive capital to continue flowing to the residential housing market, driving up prices and misallocating resources at the expense of others.
- Congress can make housing more affordable by shrinking the federal role in housing finance. And, the Trump Administration can start to shrink the footprint of Fannie and Freddie without congressional action, thus helping to bring private capital back to market.

America's largest government-sponsored enterprises (GSEs)—mortgage securitizers Fannie Mae and Freddie Mac—began to implode in 2007, triggering a major recession and financial crisis in the United States. Instead of shutting these failed companies down, Congress chose to prop up the companies indefinitely.[1] More than 10 years later, the GSEs remain under government conservatorship with taxpayers standing behind all of their obligations, and the housing market even more distorted than it was leading into the crisis.[2] It now appears that

This paper, in its entirety, can be found at **http://report.heritage.org/bg3382**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Congress may finally address the housing finance system, but many of the recent proposals would preserve—and even expand—the worst parts of the GSE system that imploded in 2008.

Many of these proposals, for instance, call for an explicit federal guarantee of mortgage-backed securities (MBSs), even though the implicit federal guarantees behind the GSEs' securities made housing *less* affordable and contributed to the unsustainable increase in homeownership in the 2000s. History shows that the housing market does not need this type of government guarantee, and Congress should work to make housing more affordable by shrinking the federal role in housing finance. This *Backgrounder* compares recent proposals and explains the benefits and shortcomings of each.

The Housing Market Meltdown and the Aftermath

Robust homeownership was established in the U.S. long before the government became heavily involved in the housing market. From 1949 to 1968 (the year that Fannie Mae was allowed to purchase non-government-insured mortgages), government-backed mortgages never accounted for more than 6 percent of the market in any given year.[3] Yet the homeownership rate was 64 percent in 1968, virtually identical to what it is now. 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 and Freddie went from holding 5 percent of the nation's mortgages ($136 billion) to more than 20 percent ($1.6 trillion).[4] Between 1997 and 2007, the two GSEs purchased more than $700 billion in subprime private-label MBSs (PMBSs), and an additional $154 billion in Alternative A-paper (Alt-A) PMBSs, amounts that represented approximately 30 percent and 13 percent of the totals issued, respectively.[5] In the years leading into the crisis, the two GSEs dominated the mortgage market.

Investors who purchased Fannie and Freddie's bonds and MBSs ultimately provided funds for people to finance homes, and these bondholders and MBS investors enjoyed implicit government backing. 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 riskier 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.[6] Trillions of dollars of credit flowed to those with lower credit scores, minimal income docu-

1. For more on the details of how Congress expanded harmful government involvement in housing finance, see Norbert J. Michel and John Ligon, "Fannie and Freddie: What Record of Success?" Heritage Foundation Backgrounder No. 2854, November 7, 2013, https://www.heritage.org/housing/report/fannie-and-freddie-what-record-success. See also Norbert J. Michel and John Ligon, "The Federal Housing Administration: What Record of Success?" Heritage Foundation Backgrounder No. 3006, May 11, 2015, https://www.heritage.org/housing/report/the-federal-housing-administration-what-record-success.
2. Excessively easy monetary policy could have indirectly contributed to the crisis as well. See Norbert J. Michel, "Monetary Policy Reforms for Main Street," Heritage Foundation Backgrounder No. 3237, July 27, 2017, https://www.heritage.org/sites/default/files/2017-07/BG3237_0.pdf. Separately, a poorly designed regulatory framework for derivatives added to the harmful incentives that directed capital to the housing sector. See Norbert J. Michel, "Fixing the Regulatory Framework for Derivatives," Heritage Foundation Backgrounder No. 3156, September 14, 2016, https://www.heritage.org/government-regulation/report/fixing-the-regulatory-framework-derivatives.
3. 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.
4. Ibid.
5. 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). Also see 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).
6. The Congressional Budget Office (CBO) advises that "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 13, 2018).

mentation, less-stable employment history, and scant down payments[7]—often to finance second homes and investment properties.[8]

A decade has now passed since the housing market collapse and the government takeover of Fannie Mae and Freddie Mac, but government mandates, subsidies, guarantees, and other harmful incentives continue to distort the housing finance markets. These two GSEs presently hold more than $5 trillion in mortgage debt, an increase of nearly $420 billion since the end of 2012.[9] Mortgage insurance purchased through the Federal Housing Administration (FHA) continues to subsidize loans to subpar borrowers, and the FHA now guarantees $1.34 trillion of outstanding mortgage principal.[10] Taxpayers bear the ultimate risk of the underlying mortgages going into default, and all of these activities continue to distort the housing market.

As a result of government entanglement, the private sector has all but disappeared from the securitization market. According to the Congressional Budget Office (CBO),

> In calendar year 2017, about 63 percent of new mortgage-backed securities (MBSs) were guaranteed by Fannie Mae or Freddie Mac. Most of the rest were guaranteed by Ginnie Mae, which guarantees MBSs backed by pools of mortgages insured by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), or the Department of Agriculture's Rural Housing Service. Just 3 percent of new MBSs in 2017 were "private-label" securities issued by private firms without a federal guarantee.[11]

The CBO anticipates that over the next decade, Fannie Mae and Freddie Mac will guarantee nearly $12 trillion in new mortgages.[12]

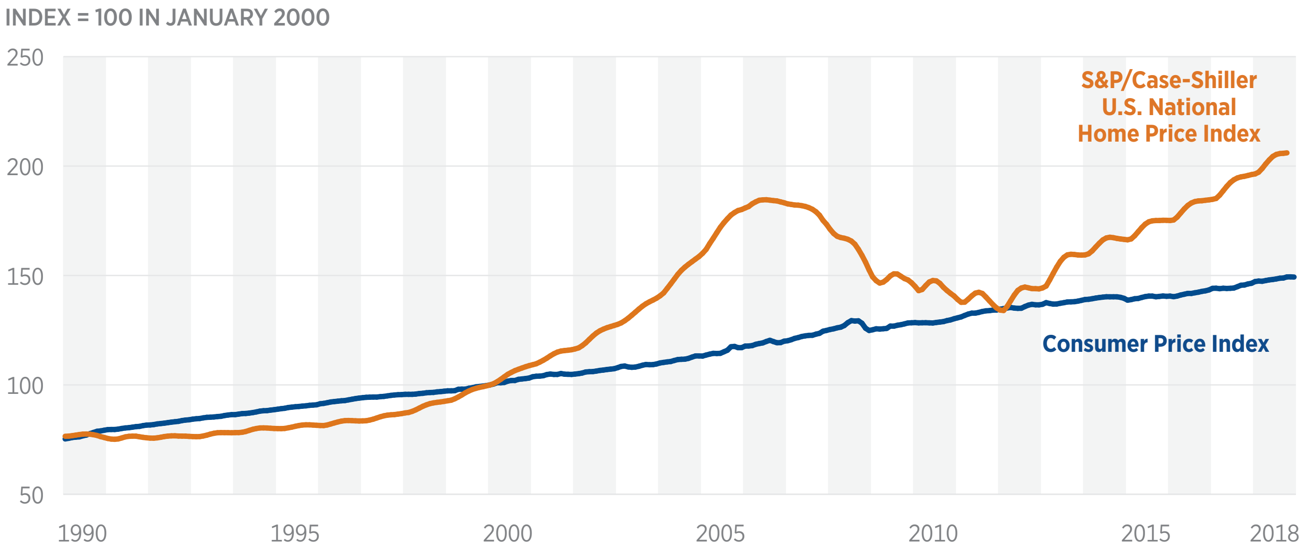
In 2017, barely 10 percent of all GSE volume involved primary homebuyer loans of $250,000 or less with a down payment of less than 15 percent. Removing the constraints on loan size, only 26 percent of GSE volume involved primary home purchases with a down payment of less than 15 percent. Refinances accounted for 40 percent of GSE volume and investor purchases accounted for another 7 percent of GSE volume.[13]

The continued government guarantees and subsidies in the wake of the housing market collapse contributed to a stunning rebound in home prices as capital flowed back into the housing market. As seen in Chart 1, after bottoming out 27 percent below the peak, home prices have spiked 54 percent since 2012, more than quadruple the rate of inflation.[14] Adjusted

7. "[B]y the middle of 2007, there were approximately 27 million subprime and Alt-A mortgages in the U.S. financial system—half of all mortgages outstanding—with an aggregate value of over $4.5 trillion." Peter J. Wallison, "Dissent from the Majority Report of the Financial Crises Inquiry Commission," American Enterprise Institute, January 14, 2011, p. 9, http://www.aei.org/wp-content/uploads/2011/01/Wallisondissent.pdf (accessed December 17, 2018).
8. "At the peak of the boom in 2006, over a third of all U.S. home purchase lending was made to people who already owned at least one house. In the four states with the most pronounced housing cycles, the investor share was nearly half—45 percent. Investor shares roughly doubled between 2000 and 2006. While some of these loans went to borrowers with "just" two homes, the increase in percentage terms is largest among those owning three or more properties. In 2006, Arizona, California, Florida, and Nevada investors owning three or more properties were responsible for nearly 20 percent of originations, almost triple their share in 2000." Andrew Haughwout et al., "'Flip this House': Investor Speculation and the Housing Bubble," Federal Reserve Bank of New York Liberty Street Economics, December 5, 2011, https://libertystreeteconomics.newyorkfed.org/2011/12/flip-this-house-investor-speculation-and-the-housing-bubble.html (accessed January 7, 2019).
9. Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, Series MDOTHFRAFHLMC and Series MDOTHFRAFNMA, https://fred.stlouisfed.org (accessed January 7, 2019).
10. U.S. Department of Housing and Urban Development, The Fiscal Year 2018 Agency Financial Report, p. 82, https://www.hud.gov/sites/dfiles/CFO/documents/afr2018.zip (accessed January 7, 2019).
11. Congressional Budget Office, Transitioning to Alternative Structures for Housing Finance: An Update, p. 5.
12. Ibid., p. 11.
13. Ed Pinto and Peter Wallison, eds., "The Taxpayer Protection Housing Finance Plan," American Enterprise Institute, January 2018, pp. 12 and 13, https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf (accessed December 13, 2018).
14. S&P Dow Jones Indices LLC, S&P/Case-Shiller U.S. National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/CSUSHPINSA (accessed December 13, 2018). The Case-Shiller Home Price Index is an index that tracks home prices given a constant level of quality. See S&P Dow Jones Indices, "Real Estate: S&P CoreLogic Case-Shiller Home Price Indices," https://us.spindices.com/index-family/real-estate/sp-corelogic-case-shiller (accessed January7, 2019).

CHART 1

Home Prices Once Again Rising Faster than Inflation



NOTES: S&P/Case-Shiller U.S. National Home Price Index is not seasonally adjusted. The Consumer Price Index is for all urban consumers, all items, and is seasonally adjusted.

SOURCE: Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, https://fred.stlouisfed.org (accessed January 15, 2019). Datasets: CSUSHPINSA—S&P/Case-Shiller U.S. National Home Price Index, and CPIAUCSL—Consumer Price Index for All Urban Consumers: All Items.

BG3382 heritage.org

for inflation, residential property prices in the United States by the middle of 2018 had reached the levels of 2004—as the prior bubble neared its 2006 climax.[15] This pattern reflects that government policies are likely re-inflating a housing bubble.

Just as in the years prior to 2008, affordability concerns are growing. As seen in Chart 2, the home-price-to-income ratio peaked at more than 4.0 in 2006 before declining to under 3.0 in the wake of the meltdown.[16] It now stands at more than 3.5, significantly higher than the historic norm of around 2.8.[17] The decline in 30-year fixed interest rates from an average of 6.6 percent at the prior peak to a low of just 3.88 percent as the recovery began masked the impact of the rising home costs on affordability. Indeed, with mortgage rates now exceeding 4.6 percent, affordability concerns are beginning to surface again. Mortgage payments on median-priced homes as a percentage of income bottomed out at just 12.4 percent in late 2012 as interest rates dropped and home prices sank. This mortgage-payment-to-income ratio is now nearing 18 percent—the highest level since 2008.[18] A return to 6.6 percent

15. Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, Series QUSR628BIS, https://fred.stlouisfed.org (accessed January 7, 2019).

16. Zillow Research, "Data: Definitions–Other Metrics," https://www.zillow.com/research/data/ (accessed January 23, 2019). "To calculate mortgage affordability, we first calculate the mortgage payment for the median-valued home in a metropolitan area by using the metro-level Zillow Home Value Index for a given quarter and the 30-year fixed mortgage interest rate during that time period, provided by the Freddie Mac Primary Mortgage Market Survey (based on a 20 percent down payment). Then, we consider what portion of the monthly median household income (U.S. Census) goes toward this monthly mortgage payment. Median household income is available with a lag. For quarters where median income is not available from the U.S. Census Bureau, we calculate future quarters of median household income by estimating it using the Bureau of Labor Statistics' Employment Cost Index."

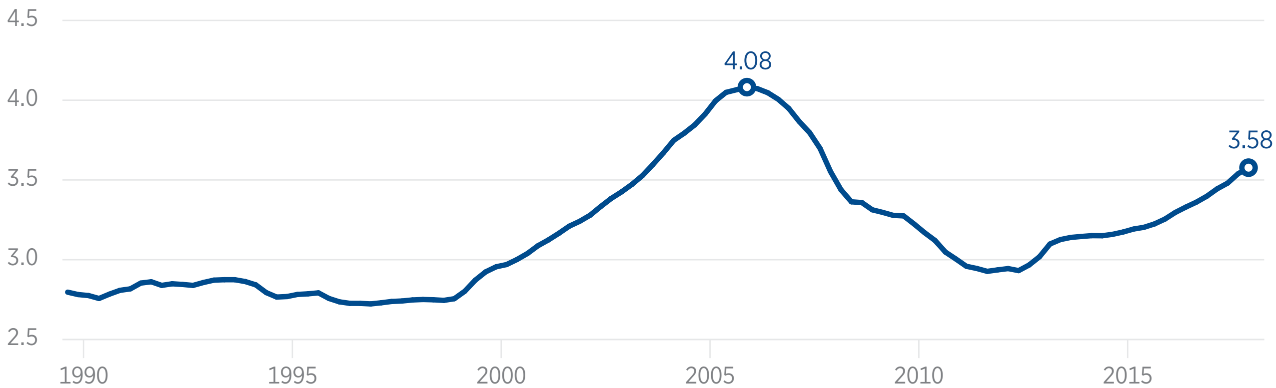
17. Zillow Research, "Data: Definitions–Other Metrics," second-to-last bullet point: "Mortgage Affordability, Rental Affordability, Price-to-Income Ratio, and Household Income are calculated as a part of Zillow's quarterly Affordability Indices." https://www.zillow.com/research/data/ (accessed December 13, 2018).

18. Ibid.

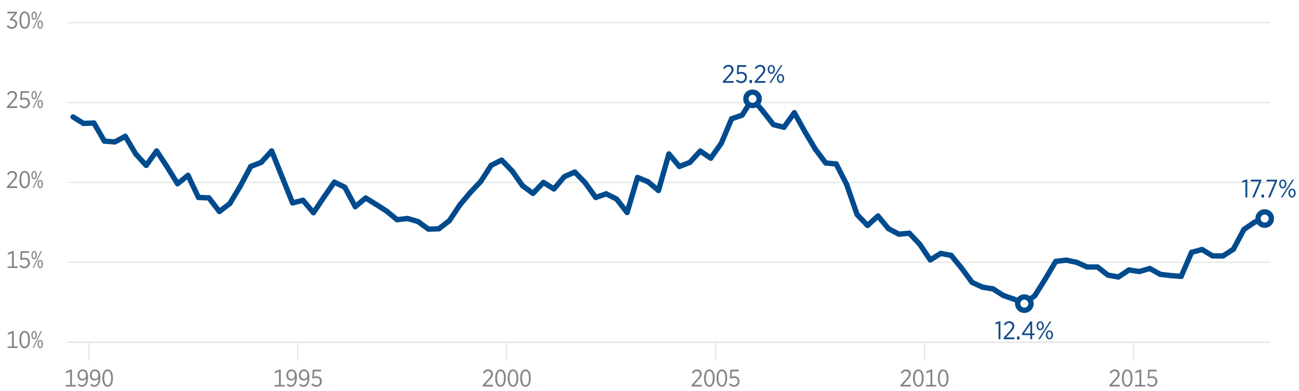
CHART 2

Historically Low Interest Rates Temporarily Mask the Full Cost of Rising Home Prices

RATIO OF HOME PRICE TO INCOME



MORTGAGE PAYMENT ON A MEDIAN VALUED HOME AS A PERCENTAGE OF MEDIAN INCOME



30–YEAR FIXED MORTGAGE RATE

SOURCES: Zillow Research, Affordability Indices, https://www.zillow.com/research/data/ (accessed December 13, 2018), and Federal Reserve Bank of St. Louis, Federal Reserve Economic Data, "30-Year Fixed Rate Mortgage Average in the United States," https://fred.stlouisfed.org/series/MORTGAGE30US (accessed January 15, 2019).

BG3382 heritage.org

30-year fixed mortgage rates (still below the historical average) would increase a mortgage payment by 25 percent even with no increase in home prices.

Continued misplaced blame on a lack of regulation, rampant greed, and corruption blunts the urgency for substantive housing finance reforms. Yet the need to protect taxpayers, improve affordability in housing markets, and end the misallocation of capital to the housing sector remains. As it stands now, approximately 90 percent of GSE volume is devoted to refinances, investor purchases, lower loan-to-value (LTV) loans, and pricier homes purchased by higher income earners.[19] In other words, the current system—itself an extension of the failed GSE framework—does little to broadly support homeownership. Congress can rectify this situation by eliminating the failed GSE model—but Congress has seriously considered very few proposals that take such an approach.

Proposals for Revamping Housing Finance Span the Ideological Spectrum

Congress, policy experts, think tanks, and trade associations have offered proposals over the past decade to reform the housing finance system. Some proposals call for shrinking the role of the federal government, while others would enlarge and solidify the government's role by providing an explicit federal guarantee of MBSs, continuing a plethora of "affordable housing" mandates, and channeling billions of dollars to housing projects favored by politicians. The House and Senate have each debated starkly different legislative overhauls to the housing finance system, but neither chamber of Congress has passed any legislation. In the absence of concrete legislative action, a number of scholars have proposed that the Federal Housing Finance Agency (FHFA) exercise its administrative authority to institute needed reforms. This section provides an overview of the leading proposals.

The Protecting American Taxpayers and Homeowners (PATH) Act. The House's 2018 PATH Act would diminish the outsized role of the federal government in housing finance, including repealing the charters (under Section 102 of the act) of both Fannie Mae and Freddie Mac after a five-year wind-down. A federal government guarantee would remain in place for any still existing debt obligations or MBSs.[20] Section 104 permits conforming loan limits to decline if the housing price index declines. Section 104 also prohibits new high-cost loan areas and modifies the high-cost loan-limitations formula in a manner that will create relatively lower high-cost loan limits. Section 103 limits mortgage assets of each enterprise upon its exit from conservatorship to a maximum of $250 billion each.

Section 202 ensures that the FHA may continue to insure residential home mortgages for a limited swath of customers and purposes: first-time homebuyers, low-income or moderate-income mortgagers, local counter-cyclical market adjustments, and disaster areas. FHA requirements are further tightened under section 222 by generally disqualifying borrowers from FHA eligibility for seven years following a residential foreclosure.

Affordable Housing Provisions. Section 103 of the PATH Act repeals the power of the FHFA Director under the 1992 GSE Act to set affordable housing goals.[21] The PATH Act would also repeal the obligation for GSEs to be leaders in developing loan products and flexible underwriting guidelines for use by very-low-income, low-income, and moderate-income families in the manufacturing housing, affordable housing preservation, and rural markets.[22]

Separately, the PATH Act repeals affordable housing allocations requiring Freddie Mac and Fannie Mae to annually set aside 4.2 basis points (bps) of every dollar of unpaid principal of new business purchases for the Housing Trust Fund and the Capital Magnet Fund.[23] This required set-aside adds more than $120 to a $300,000 mortgage. Politicians channel these billions of dollars to housing developments, programs, real estate projects, and services demanded by special interests. The public would be far more

19. Peter J. Wallison and Edward J. Pinto, eds., "The Taxpayer Protection Housing Finance Plan: Gradually Winding Down Fannie Mae and Freddie Mac and Improving the FHA," American Enterprise Institute, January 2018, pp. 12 and 13, https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf (accessed December 13, 2018).

20. Protecting American Taxpayers and Homeowners Act of 2018, H.R. 6746, 115th Congress, 2nd Sess.

21. 12 U.S. Code § 4561.

22. 12 U.S. Code § 4565.

23. For more on these funds, see Norbert J. Michel and John Ligon, "GSE Reform: Trust Funds or Slush Funds?" Heritage Foundation *Issue Brief* No. 4080, November 7, 2013, https://www.heritage.org/housing/report/gse-reform-trust-funds-or-slush-funds.

likely to scrutinize these projects if funding required annual congressional appropriation rather than indirectly levying a fee on homebuyers. As such, elimination of these allocations would bring heightened transparency to affordable housing subsidies.

The Housing Finance Reform and Taxpayer Protection Act of 2014 (Johnson–Crapo). Co-sponsored by Senator Tim Johnson (D–SD) and Senator Mike Crapo (R–ID), this act would dissolve Fannie Mae and Freddie Mac and revoke their charters.[24] Title II of the act establishes a new federal agency, the Federal Mortgage Insurance Corporation (FMIC), to serve as a new federal regulator of the mortgage industry.[25] An explicit federal guarantee on MBSs issued by potentially hundreds of guarantors (securitizers) would replace the implicit guarantee presently available to MBSs issued by the two leading GSEs.[26] In other words, Johnson–Crapo envisions a market of many smaller GSEs whose securities are explicitly backed by the federal government.

Credit-Risk-Sharing Mechanisms. On the individual loan level, Johnson–Crapo requires private mortgage insurance ranging from 12 percent to 35 percent on the unpaid principal balance, depending on the LTV of the mortgage (Section 2). For single-family securities, Section 302 further requires the FMIC to develop, adopt, and publish credit-risk mechanisms sufficient to cover losses equal to at least 10 percent of the principal or the face value. Section 703 requires that multifamily guarantors maintain at least 10 percent capital. Credit-risk-sharing arrangements can be used to meet this multifamily guarantor capital requirement.

Once these requisite layers of protection are in place, insurance on MBSs may be purchased by guarantors from a Mortgage Insurance Fund (MIF) operated by the FMIC (Section 303). Ultimately, the plan envisions reserves equal to 2.5 percent of the outstanding principal balance of the covered MBSs. If payouts exceed MIF reserves, the federal government guarantees that the obligations of the MIF will be honored. In many ways, this approach mimics the prior system under which private insurers of the underlying mortgages of GSE products were supposed to be in a first-loss position for all loans without a 20 percent down payment. The implicit federal guarantee was only anticipated in the event of a catastrophe. This system also bears similarity to the Federal Deposit Insurance Corporation model, where member institutions pay a fee into the fund, but the federal government is on the hook for all catastrophes regardless of fund resources. In fact, Section 311(h) of Johnson–Crapo grants the FMIC resolution authority for failing guarantors identical to relevant provisions of the Federal Deposit Insurance Act.

Discretion of Regulators to Waive Risk-Sharing Requirements. In order to avoid a freeze in housing market credit availability, Section 305 grants the FMIC broad powers to waive credit-risk-sharing requirements during periods of "unusual and exigent market conditions." In addition, during periods of sustained home price declines, the FMIC would be authorized to transfer a mortgage guarantee on a refinanced mortgage regardless of the current value of the home. In other words, the underlying collateral could potentially be worth less than the value of the new federally guaranteed loan.

Affordable Housing Provisions. Johnson–Crapo imposes an annual affordable-housing fee of 10 bps on outstanding principal balances of mortgages underlying the federally guaranteed MBSs. This fee would flow to the Housing Trust Fund, the Capital Magnet Fund, and the Market Access Fund. These programs provide loans, grants, and housing projects that too often are riddled with political favoritism. Of course, real estate developers and owners are the immediate beneficiaries of this largesse. Levying a hidden tax on home buyers to alleviate high rent prices is an improper tool for a problem primarily caused by local zoning regulations, rent controls, and tangled eviction laws.[27]

24. Housing Finance Reform and Taxpayer Protection Act of 2014, S. 1217, 113th Congress, 2nd Sess.

25. See Norbert J. Michel and John Ligon, "U.S. Financial Markets Do Not Need a New Regulator: Senate Misses the Mark," Heritage Foundation Issue Brief No. 4191, April 3, 2014, https://www.heritage.org/government-regulation/report/us-financial-markets-do-not-need-new-regulator-senate-misses-the-mark.

26. For more on the Johnson–Crapo plan, see Norbert J. 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.

27. Emily Hamilton, "The Case for Preemption in Land-Use Regulation," Mercatus Center, July 20, 2017, https://www.mercatus.org/publications/case-preemption-land-use-regulation (accessed December 13, 2018).

Although the securitizer may pay the fee, homeowners indirectly bear the costs in the form of higher interest rates. On a $300,000 mortgage, 10 bps amounts to an additional $300 annually ($300,000 * 0.10 percent). Over the lifetime of a 30-year loan, 10 bps of additional annual interest totals more than $6,600.

Section 210 instructs the FMIC to identify areas of the primary mortgage market suffering from less than "equitable access" to the housing finance system. The onus is on guarantors to show each year how they are supplying the credit needs of these underserved market segments. In addition, Section 704 requires that at least 60 percent of rental units contained in loans collateralizing MBSs issued by multifamily guarantors were affordable to low-income families.

The Milken Institute Plan. This proposal would also end the government conservatorship of Fannie Mae and Freddie Mac, transforming these newly privatized securitizers into entities mutually owned by seller-servicers (the lenders).[28] The duopoly under the current charter would end as other mutually owned entities could choose to compete in the securitization business. After securing requisite credit enhancements, all platforms would be enabled to issue MBSs backed with an explicit government guarantee purchased from Ginnie Mae. The plan grants wide authority to the FHFA to regulate the housing finance system, set private credit enhancement standards, license private-sector credit enhancement entities (often the securitizers), and standardize the "housing finance ecosystem."[29]

Credit-Risk-Sharing Mechanisms. The Milken plan attempts to diminish the risk of government bailouts by requiring three layers of privately funded protection for MBSs: credit-risk-transfer mechanisms (CRTs), an equity capital buffer of securitizers, and a privately funded MIF. If these three layers of protection fail, a federal government guarantee purchased by the securitizer through Ginnie Mae provides the final backstop for MBS investors.

The plan envisions a system where CRTs sold to investors by the securitizers cover 400 bps (4 percent) of losses on the underlying securities.[30] To transfer the first 400 bps of losses on a $1 billion portfolio, a securitizer could sell (that is, borrow money) a $40 million CRT bond ($1 billion * 0.04). If the bond yields 5 percent interest, the securitizer would pay $2 million ($40 million * 0.05) annually for this $40 million in protection against default. If $10 million of the insured mortgages in the portfolio default, the principal balance on the $40 million CRT bond would decline to just $30 million ($40 million - $10 million of defaults). This $10 million decline in bond principal represents additional capital now available for MBS investors in the event of a default.

As envisioned by the Milken plan, the equity capital buffer provided by the mutual owners of the securitizers covers the next 200 bps of losses on the underlying assets. The MIF covers a third layer of losses up to an additional 200 bps beyond the combined 600 bps covered by CRTs and the capital buffer. Fees levied on the securitizers fund the MIF, but these fees are ultimately passed along to home buyers in the form of higher mortgage costs. If MIF balances prove inadequate to cover this third layer of loss, government funds may temporarily replenish the MIF. In such a case, further industry assessments would be levied on the securitizers in order to repay the government.[31]

Affordable Housing Provisions. The Milken plan imposes a 10 bps annual user fee on outstanding principal balances of mortgages underlying MBSs guaranteed by Ginnie Mae.[32] This assessment would be divided between funding the MIF and affordable

28. Michael Bright and Ed DeMarco, "Toward a New Secondary Mortgage Market," Milken Institute Center for Financial Markets, September 2016, p. 2, https://assets1b.milkeninstitute.org/assets/Publication/Viewpoint/PDF/Toward-a-New-Secondary-Mortgage-Market.pdf (accessed December 13, 2018).

29. Ibid., p. 5.

30. As explained by the Federal Reserve Bank of New York, "GSE credit risk exposure can be segmented into expected, unexpected, and catastrophic losses." The more extensive the loss, the less likely the loss is to occur. Typically, a CRT "focuses on transferring the unexpected losses borne by the mezzanine bonds." For instance, the first 0.5 percent of losses is an "expected" loss not usually covered by a CRT. The next 3.5 percent of losses would qualify as an "unexpected loss" with any additional losses—and retained by the GSE—considered "catastrophic." See David Finkelstein, Andreas Strzodka, and James Vickery, "Credit Risk Transfer and De Facto GSE Reform," Federal Reserve Staff Report No. 838, February 2018, p. 15, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr838.pdf (accessed December 13, 2018).

31. Bright and DeMarco, "Toward a New Secondary Mortgage Market," p. 2.

32. Michael Bright and Ed DeMarco, "Affordable Rent and Access to Home Ownership," Milken Institute Center for Financial Markets, May 2017, p. 15, https://assets1c.milkeninstitute.org/assets/Publication/Viewpoint/PDF/Affordable-Rent-and-Access-to-Homeownership2.pdf (accessed December 13, 2018).

housing programs. As MIF reserve levels increase, a greater proportion of the user fee would flow to affordable housing programs. Once MIF reserves exceed 2 percent of the guaranteed mortgage balances, the entirety of the fee funds programs such as down payment assistance, mortgage payment assistance of low-income borrowers in default, or to provide loans to "more-marginal" borrowers.[33] The authors of the Milken plan justify this cost as a way for borrowers to "pay it forward" for the privilege of enjoying a secondary market made possible by the government guarantee.[34]

Despite the acknowledged concerns with "explicit affordable-housing goals" and subsidization of low credit borrowers, the authors promote an amorphous "duty to serve applied to the system as a whole." The plan promises this approach does not "necessarily mean blunt numerical targets but rather a standing obligation to have, and carry out, a prudent business plan that demonstrates commitment [to this duty]."[35] Although the plan decries the crony capitalism inherent within the existing GSE charters, the proposal merely extends the cronyism to numerous other securitizers in a more transparent manner.

The Mortgage Bankers Association (MBA) Plan. The MBA also proposes to end the government conservatorship of Fannie Mae and Freddie Mac.[36] Their successors would be re-chartered as guarantors equipped to issue MBSs with an explicit federal guarantee. Other securitizers would also be permitted to obtain charters to compete with them in the issuance of government-guaranteed MBSs. Similar to the Milken Institute's plan, the government backstop of MBSs only kicks in if private credit enhancements prove insufficient.

Mortgage Securitization as a Utility. The MBA considers the residential mortgage securitization business to be akin to a privately owned utility that "derives much of its existence and powers from the state."[37] Those entities chartered in order to issue federal guarantees on these mortgages would be subject to regulation by the FHFA (or a successor agency).[38] Issuers of government-guaranteed MBSs would be required to abide by the dictates of the regulator regarding target rates of return for equity investors and product pricing. In order to foster competition, regulators would be authorized to hold different guarantors to separate pricing standards.[39] Firms wishing to participate in this government-guaranteed MBS market must subject themselves to this arbitrary handicapping by the regulator.

Credit-Risk-Sharing Mechanisms. Mortgages originated by private lenders would obtain primary-market credit enhancement from private insurers.[40] At the FHFA Director's discretion, this enhancement could be in a number of forms including mortgage insurance, lender recourse, or loss sharing. With this protection in place, these individual loans would then be sold to FHFA-approved guarantors. The guarantor would be required (at the FHFA's discretion) to distribute risk related to the portfolio as a whole to institutional credit investors. This risk sharing would likely be in the form of CRTs (described earlier). A MIF (similar to the Milken Institute's proposal) funded by insurance premiums levied on guarantors provides one final layer of protection under the "government wrap" on the MBSs.

Expansion of Credit. The MBA specifically wants to explore ways of "[u]pdating documentation and derivation of income requirements to better capture self-employed or nontraditional household income that may help to identify creditworthy borrowers."[41]

Affordable Housing Provisions. The MBA plan imposes an affordable housing fee on mortgages newly acquired by guarantors.[42] Unlike other pro-

33. Ibid., p. 16.
34. Ibid., p. 15.
35. Ibid., pp. 12–14.
36. Mortgage Bankers Association, "GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market," April 2017, p. 17, https://www.mba.org/issues/gse-reform?_zs=iS2FG1&_zl=KdDk3 (accessed December 13, 2018).
37. A similar feature is even included in the PATH Act.
38. Mortgage Bankers Association, "GSE Reform: Creating a Sustainable, More Vibrant Secondary Mortgage Market."
39. Ibid., p. 17.
40. Ibid., p. iii.
41. Ibid., p. 40.
42. Ibid, p. vi.

posals, this would not be a recurring assessment on all mortgages underlying federally guaranteed MBSs. This assessment works similarly to the fee required under current law for GSE purchases in order to fund the National Housing Trust Fund and the Capital Magnet Fund.[43]

Rather than rely solely on the quantifiable housing goals set by the FHFA under the existing system (such as the percentage of mortgages made to borrowers below a certain income threshold), the MBA plan would also include "qualitative efforts" to reach those in need (such as a marketing campaign to a particular neighborhood).[44] The FHFA would have the power to set these goals annually and to hold securitizers responsible for meeting these goals. The plan explicitly endorses the concept of subsidizing the credit risk of "underserved" market segments in order to meet these goals.[45]

The Bipartisan Housing Finance Reform Act (Bipartisan Act) of 2018. The Bipartisan Act would repeal the charters of Fannie Mae and Freddie Mac after five years.[46] Section 415 reorganizes each of these GSEs into one of these two forms: a private credit enhancer (PCE) of individual mortgages or an issuer (a securitizer) of federally guaranteed MBSs backed by individual mortgages with private credit enhancement. Section 107 generally precludes PCEs from issuing MBS products unless securitizing mortgages through an approved mortgage purchase program from smaller lenders under Section 116. The act envisions other entities competing with these re-organized GSEs in the credit-enhancement and mortgage-securitization business. An explicit guarantee from Ginnie Mae on conforming MBSs replaces the implicit guarantee available previously to only the GSEs.

Credit-Risk-Sharing Mechanisms. Section 104 of the Bipartisan Act instructs the FHFA Director to develop, adopt, and publish approval standards and procedures for PCEs to provide loan-level insurance for mortgages comprising a pool of government-guaranteed MBSs. To minimize the risk of PCE insolvency, Section 110 requires PCEs to utilize CRTs, and imposes leverage restrictions on the capital-to-insured-mortgages ratio. PCE-leverage restrictions on capital and equity to insured mortgages may be met through capital obtained through the sale of CRTs.

As an additional safeguard, Section 111 envisions a Private Capital Reserves Fund financed with fees levied on private insurers. Reinsurance of the fund is also required to further share risk. In the event that a private insurer becomes insolvent, reserve proceeds will cover losses on mortgages insured with PCEs. Under Section 111, the FHFA Director sets the fees paid to the reserve by PCEs based on a percentage of the original principal obligation of the insured mortgages. Minimum Private Capital Reserves are set at just 2 percent of aggregate unpaid principal balances of the unpaid balances of insured eligible conventional mortgages. Fee variances based on the credit risk of individual loans are not permitted. In other words, lower-risk borrowers subsidize higher-risk borrowers.

If these mechanisms fail, a Ginnie Mae guarantee ensures that MBS investors suffer no losses. Ginnie Mae determines approval standards and procedures for those issuing MBSs with its guarantees and determines the fees to be charged to the issuers.

Extensive FHFA Discretion. Section 108 requires the FHFA to maintain oversight over all approved PCEs to ensure operation in a "safe and sound manner, including maintenance of adequate capital and internal controls." Section 109 gives the Director power to establish "prudential standards" to "minimize the risk presented to the Private Capital Reserves," and to determine capital requirements and leverage restrictions of private credit enhancers. Section 111 gives the Director power to temporarily suspend this minimum Private Capital Reserves requirement. Furthermore, Section 110 permits the FHFA Director to "waive or lower" the CRT amount—or the CRT requirement altogether—if she determines it to be "necessary due to adverse market conditions for approved private credit enhancers" and the enhancer has "a sufficient amount of equity capital exceeding the minimum amount required for approved credit enhancers." Notably, Section 111 also allows the FHFA Director to lower the amount of reinsurance required during "any period" when the Director deems it "necessary

43. Ibid., p. 44.
44. Ibid., p. 42.
45. Ibid., p. 43.
46. The Bipartisan Housing Finance Reform Act of 2018, 115th Cong., 2nd Sess.

based on market conditions." In fact, the amount may also be lowered during the GSE privatization transition period for as long as the Director chooses.

Affordable Housing Provisions. The Bipartisan Act imposes an "affordability fee" on outstanding principal balances of mortgages underlying MBSs guaranteed by the federal government. This fee funds affordable housing activities and housing finance "access." The act specifically promotes vouchers that can be used to meet homeownership expenses or as down payment grants for home purchases.

Vague language instructs Ginnie Mae and FHFA to "ensure that market participants are appropriately providing access to mortgage credit and secondary mortgage market financing for all creditworthy borrowers." Furthermore, the act promises the promotion of "affordable mortgage credit and affordable housing." These aims will likely lead to a continuation of affordable housing loan targets.

Summary of the Competing Proposals

With the exception of the PATH Act, these proposals share extensive commonalities:

- Releasing the two largest GSEs (Fannie Mae and Freddie Mac) from conservatorship and ending their duopolistic charter. Other entities will be permitted to compete with these former GSEs in the government-insured securitization business.

- Replacing the implicit guarantee with some form of an explicit federal guarantee on the MBSs—and opening up this guarantee to securitizers in addition to the existing GSE giants.

- Credit-loss mechanisms to reduce the risk of a government bailout of MBS investors. These mechanisms include mortgage insurance on individual loans prior to being sold to securitizers, credit-risk transfers, capital buffers for both the securitizers and the insurers, and some version of an industry-wide mortgage insurance fund. Once these layers of privately funded protection are exhausted, the government guarantee provides payments to MBS investors.

- A variety of fees based on the insured mortgage values for use in affordable housing slush funds. A continuation and possible expansion of affordable housing goals—both qualitative and quantitative—remains part of the scheme. Down payment assistance and targeted developments are examples of programs funded with these fees. Furthermore, those with better credit histories will be forced to subsidize those with higher risk through hidden fees. The MBA plan would impose a one-time affordable housing fee on new mortgage purchases rather than a recurring annual fee on underlying unpaid mortgage balances.

- High-level bureaucrats enjoy an immense amount of concentrated power to determine approvals of private credit enhancers, to enhance capital requirements, to dictate the credit risk required to be retained by counterparties, and to waive credit-risk-sharing requirements. In addition, bureaucrats retain discretion over affordable housing mandates. The lack of accountability and transparency is the antithesis of free markets or the democratic republican ideal.

These proposals would cement government control over nearly one-fifth of the economy. Inducing a continued misallocation of capital to the housing sector through subsidies and government guarantees of MBSs may enrich lenders, securitizers, and MBS investors. However, these policies will perpetuate inflated prices, deprive other sectors of needed financial resources, and place the burden of catastrophic risk on the federal taxpayer. In addition, the affordable housing fees force all borrowers to enrich a handful of developers and real estate investors and subsidize higher-risk borrowers. It is difficult to argue that these policies improve the status quo for anyone other than the special interests who will gain additional federal protections.

Reform from Within: The Administrative Solution

It has proven incredibly difficult for Congress to shrink the federal government's role in the housing finance system. All of these plans have faced major

47. Peter J. Wallison and Edward J. Pinto, eds., "The Taxpayer Protection Housing Finance Plan: Gradually Winding Down Fannie Mae and Freddie Mac and Improving the FHA," American Enterprise Institute, January 2018, p. 21, https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf (accessed December 13, 2018).

obstacles in Congress; none have mustered majority support from either chamber. As a result of the inaction, private firms find it impossible to compete with the federal government in the securitization business.

However, a solution is within reach. Because the FHFA possesses the authority to enact several key policy changes on its own, the Trump Administration can start to shrink the footprint of the GSEs without congressional action, thus helping to bring private capital back to the market. This process of restoring the role of the private sector may be phased in to minimize market disruption.

In just seven years, GSE liabilities could be reduced by 39 percent by implementing some basic changes.[47] Based on The Taxpayer Protection Housing Finance Plan, a proposal authored by American Enterprise scholar Ed Pinto and other contributors, these policy changes include the following:

- Eliminate the geographic price differentials for conforming loan limits.
- Narrow the GSEs' focus to the financing of primary homes. This change involves eliminating support for second homes, vacation homes, investment properties, and cash-out refinancing.
- Begin a broader reduction in conforming loan limits over five to 10 years.

Enacting these reforms will enhance housing affordability (particularly for first-time home buyers), diminish systemic and taxpayer risk, and result in less personal debt and more personal savings.

Policy Recommendations

In order to alleviate risk and begin curtailing economic distortions, Congress should do the following:

- **Sever the special status given to these GSEs.** This approach will communicate to the market that this implicit guarantee is terminated and allow MBS prices to more fully reflect the risk involved. Continuation of these guarantees leads to excessive risky debt. Private investors, not federal taxpayers, should bear the financial risks.
- **Direct the FHFA to raise Fannie and Freddie's mortgage guarantee fees (g-fees) immediately,** while the GSEs remain in conservatorship. This fee (56 bps per $100,000 in 2017) is paid by the lender seeking the federal guarantee, although it is effectively passed along to the borrower in the form of a higher interest rate. Raising the g-fee would make the rates available on non-government-guaranteed mortgage loans more competitive, scaling back the role of the GSEs. Some potential borrowers may choose to forgo homeownership for the time being, alleviating some of the artificially induced housing demand.

Even without congressional action, the FHFA should eliminate the geographic price differentials for conforming loan limits, narrow the GSEs' focus to the financing of primary homes, and gradually reduce conforming loan limits.

Conclusion

The GSEs have long enjoyed a funding advantage due to special government favors (no federal or state income taxes, no Securities and Exchange Commission filing requirements, and a line of credit at the Treasury). Broadly, investors understood that the federal government would ultimately guarantee their investments in GSE securities in the event that borrowers failed to repay. This government backing heavily contributed to the vast expansion of housing finance credit, spurring an unsustainable increase in home ownership rates and a doubling in overall home prices from 1998 to 2006. Rather than pare back the federal role in housing finance, congressional inaction has expanded the government's role, leading to higher home prices and increased taxpayer risk.

Few of the plans gaining popularity on Capitol Hill mitigate these problems. Most of the plans make the current situation *worse* by expanding guarantees, subsidies, and mandates. Furthermore, these plans force mortgage holders to pay fees under the guise of expanding affordable housing, even though it is far from clear that this scheme will produce any material public benefit. Previous government attempts to improve affordability have contributed to higher home prices, and robust homeownership has already been established in the U.S. without such fees. If Congress wants to provide further housing subsidies, it should do so in a transparent manner.

Optimally, Congress will work to make housing more affordable by shrinking the federal role in housing finance. If Congress does not do it, the Trump Administration should do it. The solution lies in gradually removing federal guarantees, eliminating federal mandates, and improving regulatory incentives. These policies will allow private market participants to appropriately price and insure financial risks. The economy will further benefit from reduced government interference in the housing market as the artificially large flow of capital to the housing market is allocated to other sectors.

*—**Joel Griffith** is Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom, at The Heritage Foundation. **Norbert J. Michel, PhD,** is Director of the Center for Data Analysis of the Institute for Economic Freedom.*