Edward J. DeMarco

President

Housing Policy Council

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Remember Where They Were so You'll Understand Where We Are:

The State of Housing Finance Reform

Thank you for the opportunity to be here today. The title of my remarks is a play on sportscaster Charlie Slowes' famous call to "remember where you are so you'll remember where you were." Charlie uses this saying to capture iconic moments for the World Champion Washington Nationals. I am referring to the state of housing finance reform.

To appreciate the current state of housing finance reform, I think it is important to understand where we have been. What are the origins of Fannie Mae and Freddie Mac? What role were they intended to play and how has that role evolved? Some of you who have been deeply immersed in these issues may find much of this very familiar. But I believe the lookback is warranted for a couple of reasons.

For starters, just like the Nationals, we have very few people in the same roles today as when the financial crisis struck with full force in 2008. Indeed, many important people working on housing finance issues today – members of Congress, congressional staff, regulators, Administration officials, press, and even folks in the industry -- were not involved in these issues eleven years ago.

The other reason for looking back is that the consensus for change that governed housing finance policy earlier in the conservatorships has been fraying as both memories fade and the state of our nation's politics worsen.

To provide a perspective on housing finance reform, I will pose and answer four questions:

1. Are Fannie Mae and Freddie Mac special or are they just subsidized?
2. What is the relationship between the 30-year fixed rate mortgage and a government guarantee?
3. What do we lose when the housing finance system lacks competition?
4. Since we continue to have serious challenges in meeting affordable housing needs, shouldn't we try to do something different?

Collectively, the answers to these questions provide insights for the pathway to housing finance reform. One common theme in the answers is Congress. Only Congress can fully address housing finance reform. Administrative actions can be helpful, but they cannot be the final answer. Another common theme is that the housing finance system will serve consumers better if it is more competitive and more transparent. Competition encourages innovation and lower prices. Enhanced competition then leaves government to do what it does best by setting standards and regulations and providing the ultimate financial backstop that maintains credit in all economic conditions.

Are Fannie Mae and Freddie Mac special or are they just subsidized?

This is a trick question – the answer is yes. Yes, they are special, and yes, they are subsidized. So then, what makes them special and how are they subsidized?

The Federal National Mortgage Association, what we know as Fannie Mae, began life as a government corporation. It was created by Congress in 1938 to support the federal government's promotion of home ownership through FHA mortgages. FHA itself was new on the scene, as was the government-backed amortizing mortgage FHA introduced. Fannie Mae facilitated the sale of the mortgages to suppliers of long-term capital, which tended to be in the money centers of the day. Remember, we are talking about the 1930s. At that time, it was difficult to connect those parts of the country with surplus capital to invest with parts of the country where capital was needed for economic growth. Fannie Mae was created to address this need.

Initially, Fannie Mae was supposed to buy *and sell* FHA mortgages, but guess what? It ended up buying *and holding* the mortgages. Does that sound familiar? In response, Congress, in 1954, directed Fannie Mae to begin liquidating its mortgage portfolio and acting as a conduit, that is selling mortgages it bought to other investors, then recycling the funds back into the primary market. At that time, Congress also revised Fannie Mae's charter to restrict it generally *to purchasing mortgages that met the purchase standards of private institutional mortgage investors."*[i]

That congressional mandate on purchase quality remains today as part of both Fannie and Freddie's charters.

In 1967, Fannie Mae was converted from a government-owned corporation to a privately-owned company. This was done to take it off budget and thereby increase funding for the Vietnam War.

Then from 1969-1970, in response to a credit crunch, Congress created the Federal Home Loan Mortgage Corporation -- Freddie Mac -- and authorized both Fannie and Freddie to purchase conventional mortgages.[ii]

Here is where our story gets interesting and the answers to my questions about the special role and subsidized nature of Fannie and Freddie begin to emerge.

Fannie Mae and Freddie Mac entered the small world of entities known as government-sponsored enterprises, or GSEs. In basic terms, this means they carried the following distinctions, which made them special:

- As private companies, they were chartered by Congress. Typically, private companies are chartered by the individual states, not Congress. However, Congress has the authority to charter private companies and has done so on a few occasions. The Farm Credit System and the Federal Home Loan Bank System are other examples of congressionally chartered GSEs.
- As congressionally chartered entities, Fannie Mae and Freddie Mac were given a public mission. That is, Congress dictated in their charters what lines of business they could be in and limited their activities to those lines. Congress even gave them their corporate names.
- And finally, Congress has not given out more of these charters. Without a new act of Congress, no private company with similar capabilities can say, hey, I want that charter and I want to compete with Fannie and Freddie on the same terms.

To understand their federal charters is to understand the economic subsidy that flows from those charters. Before conservatorship these subsidies were often captured by management and shareholders. The GSEs' federal charters and other federal laws include an exemption from state and local income taxation and an exemption from registering their debt and the mortgage securities they issue with the Securities and Exchange Commission. Their debt and mortgage-backed securities, or MBS, are privileged in other ways, including:

- Banks can hold GSE debt and MBS without limit – they cannot do that for any other private debt or MBS;
- GSE securities may serve as collateral for public deposits and for loans from the Federal Reserve and Federal Home Loan Banks;
- They are lawful investments for federal fiduciary and public funds; and
- The Federal Reserve acts as their fiscal agent, issuing and transferring GSE securities through the Fed's book entry system.

This is a case where the whole is greater than the sum of its parts. As Treasury Under Secretary Gary Gensler noted near the end of the Clinton Administration,

> Taken together, these statutory benefits provide the GSEs with three advantages in financial markets: Lower funding costs; the ability to operate with less capital; and lower direct costs.[iii]

Before the conservatorships, this sum of the parts yielded the market's perception of the GSEs' implied guarantee from the federal government, a guarantee that became explicit with the conservatorships and the Treasury preferred stock agreement. The specialness of their charters allows Fannie Mae and Freddie Mac to borrow at lower interest rates than other private financial institutions. Moreover, their capacity to borrow is enhanced in illiquid markets due to this implicit /explicit government support. This same government backing, combined with weak regulatory capital rules, allowed the GSEs to operate with substantially less capital than any other private firm could. The various exemptions also reduced their operating costs, and the exclusivity of their charters is a barrier to entry to other firms.

In sum, Fannie and Freddie aren't special because of their own competitive prowess or mortgage finance ingenuity, they are special because Congress gave them advantages not enjoyed by other firms. They have not been subject to the checks and balances inherent in the risk-taking structures of private capital markets. They have not been subject to all the regulatory guardrails embedded in our securities laws that govern fully private market participants and market transactions. And they have not been subject to capital and liquidity standards and other prudential rules comparable to other private companies that perform similar functions.

In 2008, Congress granted the FHFA considerable authority over Fannie and Freddie. However, Congress did not grant the FHFA Director the authority to amend their charters in any way, nor issue new ones. Congress reserved that power for itself. No recap and release strategy or even receivership option, absent Congress, will change that fact.

In short, only Congress can change the charters and thus fix the problems the charters themselves produce.

Before turning to my next question, let me anticipate that some might say that banks enjoy charter privileges too. Indeed, they do – deposit insurance and access to the Federal Reserve window, for example. But there is no limit on bank charters and even large banks can and do fail. And banks operate under far greater prudential oversight. GSEs really are special.

What is the relationship between the 30-year fixed rate mortgage and a government guarantee?

From the financial crisis until recently, a core element of the debate over housing finance reform has been whether a government guarantee is necessary to maintain the depth and liquidity of the market for 30-year fixed-rate mortgages. With former Chairman Hensarling's bipartisan reform proposal last year, and the Treasury's recent recommendations on housing finance reform, we should consider that debate settled.

In simple terms, a government guarantee allows the securitization process to separate credit risk investors from so-called rate investors. Rate investors are those willing to undertake the interest rate risk, including prepayment risk, of a long-term, fixed rate mortgage. These investors, many of them foreign institutions precluded from undertaking credit risk, are the keys to the depth and liquidity of our 30-year fixed rate mortgage market. Banks cannot sustain substantial investment with that duration since the maturities do not align well with their shorter-term deposit liabilities. Such a mismatch was the root of the savings and loan crisis of the 1980s.

The consensus in favor a government guarantee is based upon substantial private capital bearing mortgage credit risk in front of the guarantee, and that the guarantee should attach to a mortgage security, not to the company issuing the security. Moreover, the guarantee should only cover catastrophic credit losses, the level of loss associated with a Great Depression or Great Recession scenario, not a more ordinary economic downturn. It is very difficult under both tax and accounting rules for the private sector to manage that tail risk. The government is far better positioned to distribute such losses across generations rather than concentrate them on the unfortunate cohorts that bear the brunt of such a crisis.[iv]

Today, a government guarantee for the 30-year fixed-rate mortgage exists based upon Treasury's support to the GSEs while in conservatorship. That guarantee, however, has a dollar limit, and any event that produces significant future losses to Fannie or Freddie could be a source of concern for markets. To remove this uncertainty and ensure a stable, lasting system favorable to long-term, fixed-rate mortgages requires Congress enacting an explicit guarantee. Yet any such guarantee should be implemented in a way that maintains market discipline in the pricing and accumulation of mortgage credit risk. That requires a competitive market in which individual credit risk takers can, and are allowed, to fail.

What do we lose when the housing finance system lacks competition?

What do we lose when we lack competition in the secondary mortgage market? I believe we lose a lot – and our failure to appreciate what is lost keeps our housing finance system from realizing its potential to fully meet the needs of potential home buyers.

Any list of the consequences of inhibiting a competitive housing finance system should start with these:

1. Systemic Risk: The absence of market competition concentrates risk among the few market participants, in this case, Fannie and Freddie. Systemic risk is exacerbated because this limited competition reduces attention to risk management.
2. Monopoly pricing: The absence of market competition means we get monopoly or oligopoly pricing, not a competitive market price. That means consumers may pay more than they need to and that at least some lenders may realize lower returns than if they had competitive bids for their loans.
3. Limited innovation: Absent the need to maintain an edge to stay ahead of the competition, the secondary market lacks incentive to continuously improve and the results include lack of innovation to serve emerging borrower needs and slow adoption of new technology to lower origination and servicing costs. Note that lower costs and more innovation will lead to more qualified borrowers.
4. Misallocation of capital: By regulating Fannie and Freddie to materially lower capital standards relative to the rest of the market, we misallocate capital both within the housing finance system and between housing finance and competing capital uses, including those that could lead to greater economic growth or more housing construction.

5. Decreased access for small lenders: It is common sense that if a market has only one or two buyers, rather than dozens of buyers, it will be harder for small producers to access those buyers. In the mortgage world, the largest loan originators are going to be able to sell their loans into the secondary market because the secondary market thrives on scale. With only two buyers, not even mandates on guarantee-fee equivalency can mask the inherent challenge smaller production shops have selling their mortgages. Yet, if the market were more competitive, with numerous outlets to sell mortgages, there would be greater demand for the loan production of smaller lenders.
6. Decreased demand for affordable products: Congress imposed housing goals on Fannie and Freddie to ensure that they paid enough attention to loans in those markets. This is the same phenomenon that affects smaller lenders. Increased competition in the secondary market would mean increased competition for affordable loans as well. Think about this: Would we have greater access to credit and lower credit prices if we had just two banks operating nationwide and no community or regional banks to compete with them?
7. Policy distortions: It would be hard to overstate the political influence over housing policy wielded by Fannie Mae and Freddie Mac before conservatorship and the challenge that created to achieving sound public policy and regulation. These GSEs distorted our politics as well as our markets and we must factor that into our calculus of their systemic risk.

Certain administrative reforms can address some of these problems. For example, the Housing Policy Council is actively supporting efforts to expand competition in the secondary market by:

1. Eliminating the GSE patch from the CFPB's ATR/QM rule;
2. Amending the SEC's Regulation AB II to encourage publicly registered private label mortgage securitization – there have been no such transactions since the SEC finalized this rule in 2014 – and requiring that the GSEs meet the same standards; and
3. Ensuring market participants have the data they need to make sound credit judgements by making the GSEs' data on loan performance and appraisals more broadly available to market participants.

These measures can improve the competitive landscape yet many of the impediments to competition are rooted in law. So, once again, the conclusion is this: Congress needs to act. Only Congress can fix the laws that impede competition.

Taking this one step further, Congress needs to authorize a system in which both the government and private market participants are called upon to do what they each do best. The government needs to set guardrails, ensure market transparency, address market failure, and focus subsidies where Congress determines they are needed. Private market participants should compete to serve customers, and price and manage risks, thereby allocating capital more efficiently, expanding consumer choice, and incentivizing innovation.

Since we continue to have serious challenges in meeting affordable housing needs, shouldn't we try to do something different?

My answer to this question is a resounding yes. Certain minority home ownership rates are alarmingly low. Younger families and low- and moderate-income households continue to face hurdles in achieving homeownership. Since the current system has produced unsatisfactory results, we should be challenging ourselves to come up with something better and not relying on programs that do not produce desired outcomes.

Also, the homeownership challenges of today are not the same as those a generation or two ago. Markets have changed. Technologies have changed. Consumer demands have changed. Sources and characteristics of employment, income, and indebtedness have changed. So why use the solutions from the past? Unfortunately, the housing finance reform debate has seen little constructive work in this area. Far too many stakeholders are resisting change rather than exploring ideas or programs that produce better outcomes for low- and moderate-income households. It is time for that to change.

We need to work harder to solve the problems of housing supply, the number one barrier we face today. We also need to focus on financial literacy, down payment and closing costs assistance, and ensuring households have the reserves needed to weather bumps in the road, especially given the material increase in income fragmentation and volatility today relative to the past. We need to focus on building consumers' home equity and not just their debt load. And we need to consider the recommendations in HUD's housing finance reform report on how to make FHA work better and be a more reliable component of our affordable housing efforts.

We have a great opportunity in housing finance reform to not just raise a considerable revenue stream to help solve these problems, but we have the chance to improve our approach to the problems. We should focus on measuring outcomes and we should judge our efforts on whether they produce more sustainable mortgage loans to households facing the biggest difficulty obtaining home ownership.

How do we do that? We need Congress to encourage innovation, to direct that new approaches be tried and measured and, if they fall short, try something different. This effort should engage regulators, lenders, and advocates together, for I believe we share the desired goal, but we lack the coordination and infrastructure to get the job done.

Conclusion

I posed four questions about our housing finance system and in the end, the answer to each was the same. We need Congress to act, to legislate changes that fix what's wrong with our current system since much of what is wrong is embedded in law. We need to embrace what government can do, but we also need to embrace the power of competitive markets to improve welfare and opportunity.

Thank you.

[i] The United State Department of the Treasury (July 11, 1996). *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*. P. 18. (emphasis added)
[ii] Ibid. p. 19.
[iii] H.R. 3703—THE HOUSING FINANCE REGULATORY IMPROVEMENT ACT—PART 1: Hearings Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, House, 106th Congress (March 22, 2000) (Testimony of Treasury Under Secretary Gary Gensler).
[iv] For a more in-depth discussion of this issue, see Principles of Housing Finance Reform: Hearings Before the Committee on Banking, Housing, and Urban Affairs, Senate, 115th Congress (June 29, 2017) Testimony of Edward J. DeMarco, President, Housing Policy Council). See pages 4-7.