

The U.S. Can reform housing finance without any action from Congress

↳ By Alex J. Pollock

The U.S. came out of the 2007-12 housing bust with a housing finance system even more government-centric than it was before, because the Government completely took over Fannie Mae and Freddie Mac by way of a regulatory conservatorship. Most people assumed that Fannie and Freddie's financial collapse would inspire the U.S. Congress to reform them, which would mean fixing the excessive leverage of their own balance sheets and the excessive leverage the Government promoted through them in the whole housing finance sector. This, as it has turned out, was a bad assumption. Congress tried to create reform legislation, and the accompanying debates were long and energetic, but in the end nothing happened.

Meanwhile Fannie and Freddie remain dominant and huge operations. Their combined assets are a staggering \$5.5 trillion. These assets are supported by virtually no capital. Their latest quarterly financial statements show a capital ratio of a risible 0.2%, or a leverage of 500 to 1. Under current rules, the Government does not let Fannie and Freddie retain any earnings to speak of, so they are utterly dependent upon the continuing credit support from the U.S. Treasury. Without this support, they could not exist even for one minute. Their government conservatorships are in their eleventh year – an outcome nobody anticipated and nobody wants.

It now appears there is virtually zero probability of reform legislation in the current divided Congress.

However, significant reform can occur without needing Congress to act. A determined administration – the President, the Treasury Department, and the Federal Housing Finance Agency (which is the regulator and conservator) – can do a lot on its own, without any legislation. It looks like they intend to do so

President Trump recently told a conference of the National Association of Realtors:

- “My administration is committed to reforming our housing finance system... Fannie and

Freddie still dominate the market with no real competition from the private sector. And taxpayers are still on the hook... That's why I recently directed the Department of Treasury and HUD [the Department of Housing and Urban Development] to develop a framework for a modern housing finance system... one that welcomes private sector competition, protects taxpayers, and preserves home ownership.” (The transcript adds: “Applause”.)

The President was referring to his formal “Memorandum on Federal Housing Finance Reform” of March 27, 2019. This memorandum includes the following:

- “The Secretary of the Treasury is hereby directed to develop a plan for administrative and legislative reforms.”

As stated above, the legislative part of the reforms is very unlikely to happen, but the administrative ones can. The goals of the plan are to include:

- “Ending the conservatorships” of Fannie and Freddie”
- “Facilitating competition in the housing finance market”
- “Providing that the Federal Government is properly compensated for any explicit or implicit support is provides” to Fannie and Freddie” [italics added]
- “Establishing appropriate capital and liquidity requirements” for Fannie and Freddie. The capital requirements will need to be a lot higher than the current virtually zero. Personally, I am recommending a 4% tangible equity to assets requirement, reflecting that 4% is the global capital standard for prime mortgage credit risk. The Treasury will produce its own recommendation.
- “Increasing competition and participation of the private sector in the mortgage market”
- “Heightened prudential requirements and safety and soundness standards, including increased capital requirements” for Fannie and Freddie

And of special interest to my former colleagues in the Home Loan Bank of Chicago, the former home of the Secretariat of the IUHF: “Defining the mission of the Federal Home Loan Bank system and its role in supporting Federal housing finance.”

About all of these goals, the Memorandum directs that “the Secretary of the Treasury must specify whether the proposed reform... could be implemented without Congressional action. For each administrative reform, the Treasury Housing Reform Plan shall include a timeline for implementation.” That sounds serious.

And: “The Treasury Housing Reform Plan shall be submitted to the President for approval... as soon as practicable.”

If the Administration does implement administrative reforms, here are some suggestions for additional things it has the power to do:

- The FHFA should set for Fannie and Freddie, like for all other financial institutions, both a leverage capital requirement (for Fannie and Freddie, 4% of total assets) and a risk-based capital standard, requiring whichever is higher.
- Fannie and Freddie should pay a fee to the Treasury for its credit support based on what the Federal Deposit Insurance Corporation would charge an equally huge bank of equivalent riskiness for deposit insurance.
- The Financial Stability Oversight Council should designate Fannie and Freddie as the Systemically Important Financial Institutions [SIFIs] they are, since they have proven they can put the whole financial system at risk.
- The FHFA should ensure emphasis on sound credit risk management throughout the inevitable cycles.
- The Federal Home Loan Banks should especially expand the role of secondary mortgage finance in which the original lender retains credit exposure (“skin in the game”) for the life of the loan, which ensures an alignment of incentives superior to the Fannie and Freddie model.

- The Treasury should exercise the options it owns to acquire 79.9% of Fannie and Freddie's common stock at an exercise price of one-thousandth of a cent per share. This will represent a nice and well-deserved profit for the taxpayers who bailed Fannie and Freddie out.
- Will the Administration really act to implement reform through its purely administrative powers? I think there is a good probability that it will. Congress will, it appears, be left to continue debating without acting.