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## How Tax Reform Could Accelerate GSE Reform And Not Necessarily In A Good Way

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The tax reform currently being debated by Congress could prove to be a long-run boon for the U.S. economy by encouraging investment and removing some of the distortions that are in the current tax code.

However, another thing that it may inadvertently accomplish--and that few people have yet to comprehend--is that it may hasten the need for Congress to fix the mortgage market as well. Most mortgages do not remain with the issuer; Fannie Mae and Freddie Mac, two government-sponsored enterprises, buy the mortgage--or the right to receive monthly payments from the mortgagee, with the house as the collateral. They then put various mortgages together and sell the various bundles to investors. By ensuring the mortgages meet certain standards and providing a guarantee that the mortgages won't go bad they add value.

Of course, when the housing market collapsed the GSEs found themselves holding hundreds of billions of dollars of mortgages (and various other crummy assets to boot) of dubious value. In the midst of the financial crisis, Congress passed the Housing and Economic Recovery Act (HERA), which allowed the Treasury to declare Fannie and Freddie insolvent and place them into conservatorship. Treasury then infused the two enterprises with \$188 billion dollars, and simultaneously assumed 79.9% ownership of each entity, and the extant shareholders retained 20% of the company, at least at the time. It also claimed an annual dividend equal to ten percent of its investment.

After the housing market rebounded the Fannie Mae and Freddie Mac rebounded as well, and by 2012 they began earning enormous profits: In that year alone their combined profits exceeded \$130 billion.

Those profits led to the Obama administration deciding to use that money to reduce the reported government deficit, and it issued an amendment to Treasury senior preferred stock purchase agreement, specifying that the entire net worth of Fannie and Freddie be swept into the Treasury's coffers. The shareholders of the other 20% of the GSEs were effectively wiped out.

Close to nine years later, after the passage of HERA, and putting the GSEs into conservatorship and implementing the sweep, the government has not only recovered its entire investment in the GSEs but has also earned a handsome profit.

However, it is not yet certain that the maneuver is legal, and the courts are currently adjudicating that issue. What's more, the sweep leaves the two GSEs bereft of capital, dependent upon the Treasury for a line of credit, functionally keeping taxpayers on the hook for any shifts in the market. Herein lies the problem that tax reform will only heighten.

The problem is this: Fannie and Freddie had sizeable losses before 2012 that exceeded \$150 billion. It can carry forward those losses to reduce future tax obligations, should they be allowed to keep their profits. Under the current corporate tax rate of 35%, those reduced tax obligations amount to \$53 billion.

However, should the corporate tax rate fall to 20% the value of these deferred tax assets would fall to \$30 billion. That is a \$23 billion reduction in the value of these assets.

This is more than merely an accounting result: unless the combined profits of Fannie and Freddie exceed the reduction in the value of the deferred tax assets in the quarter that tax reform passes--which it almost certainly won't--that means that the GSEs will need money from the Treasury to keep operating.

The problem with that is that the optics are terrible: The issue is that when voters see that they are costing the government money again, Congress may feel a sudden urgency to "fix it" immediately. Congress doesn't always perform well when it's under the gun.

Congress should resolve the limbo of Fannie Mae and Freddie Mac pronto; their lack of capital and uncertain situation helped create a moribund housing market that has slowed down the U.S. economy for nearly a decade. Housing starts from 2009-2016 were well below the pre-Great Recession period: We have to go back fifty years, when there were half as many households in the U.S. as today, to find a period when housing starts outside of a recession were as low as they have been in the last seven years.

Treasury can resolve the current housing market morass by allowing the regulator and conservator of the GSEs to retain capital, and if tax reform makes that need clearer to people then all the better. The constrained, ambiguous status of Fannie Mae and Freddie Mac has exacerbated a growing housing shortage and dampened economic growth for nearly a decade. It's long past time for the American taxpayer to be freed from this economic quagmire.

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