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We Can Reduce the GSEs' Risk Without Congress

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Winter Storm Jonas effectively brought all congressional activity to a halt this week. The House canceled all votes and the Senate is not expected to reconvene until Wednesday. This is a fitting development if you are a faithful watcher, as I am, of lawmakers' inability to do anything meaningful regarding Fannie Mae and Freddie Mac. Much like the effects of the blizzard, Congress has let other outside events overtake the prospects of housing finance reform.

Despite the urgency of needing to overhaul Fannie and Freddie, the chances of any legislative progress in 2016 are next to zero. In all likelihood, the government-sponsored enterprises will be handed to the next administration still in conservatorship with no exit plan. As no candidate, of any party, is devoting serious attention to the GSEs, it is also fair to assume that the next administration will not devote considerable energy in 2017 to resolving the situation.

This means the future of the GSEs — and any credible prospect of reducing their risk to the taxpayer — lie almost exclusively in the hands of their regulator: the Federal Housing Finance Agency. While the focus in the GSE debate has mostly been on Congress, the FHFA does have viable de-risking tools at its disposal. The agency should not delay in using them. The Obama administration has generally missed every opportunity to put Fannie and Freddie on better footing. But if the FHFA is truly committed to improving the situation — and protecting the taxpayer — the only solution is a combination of risk reduction and transfer.

But before focusing any further on the future, it is worth recalling what should have been. The law creating FHFA in 2008, just months before the federal takeover of Fannie and Freddie, instituted not just the new agency's conservator powers but also its ability to put the GSEs into receivership.

Having the government act as receiver for the two mortgage giants — instead of conservator — would have had many important benefits. It would have restructured the GSEs without any taxpayer support, while allowing them to continue to support the mortgage market. Just as importantly, receivership would have transformed Fannie and Freddie into "clean" companies, ready to be released back into the private market.

We are where we are today due to the failures of both FHFA and the Treasury Department to pursue this strategy. The most pressing problem resulting from the government's poor decisions

is the lack of significant capital. Compared to the current situation, the massive leverage of the GSEs going into the crisis almost looks responsible.

And if there is a repeat of 2008, the GSEs' current condition would make it likely that losses are transferred straight to the taxpayer. There will be another housing downturn, make no mistake. That is because we have not addressed the volatile effects of inelastic housing supply on pricing. When the next downturn comes, any government rescue may well look small in comparison.

So the FHFA needs to get serious about de-risking the GSEs. FHFA has made some modest progress in the area of risk transfer. Mortgage insurers have been subjected to greater scrutiny while also taking a larger piece of GSE credit risk. Regardless of their troubles during the crisis, mortgage insurers are less likely to be rescued by the taxpayer, offering some potential for market discipline. More can and should be done here. There is little reason MIs cannot take, say, a 50% first loss piece of credit risk — up from the current coverage cap of 35%. Substituting MI capital for a lack of GSE capital might not be the best approach, but it may well be the only approach readily available.

While greater MI coverage can transfer risk at the loan level, there also needs to be a greater transfer of risk to outside investors. One way to do that is by creating a mechanism whereby the market's belief that investors will be on the hook is more credible. Lately, the GSEs, with support from FHFA, have engaged in structured securitizations that can transfer risk to private market participants. But those deals run the risk of the market not believing that investors will actually suffer losses. Recall that both GSEs issued subordinated debt before the crisis, yet despite its subordinated nature such debt was protected.

For the recent risk-transfer securitizations to actually work, simply repeating "there's no guarantee" will be about as believable as it was before the crisis. To make such statements more credible, the FHFA could back the creations of GSE "living wills," or an independent bankruptcy-remote trust, to legally bind beforehand the order of priorities in the event of insolvency. Such structures existed in the crisis for private-label investors in mortgage-backed securities, allowing the MBS pool to continue on as a separate legal entity even when the issuer failed.

The FHFA is to be commended for modest attempts thus far to transfer risk out of the GSEs. But it has completely failed in protecting the system from the risk of faulty mortgages. Mortgages with a 3% down-payment, for instance, only make it more likely that borrowers will be underwater in any future downturn. There are also concerns about the concentration of Fannie and Freddie's geographic footprint. Their presence in the mortgage market in California, for example, is bigger than it was prior to 2008. As we approach the next housing peak, FHFA would be wise to improve the credit quality of GSEs mortgages while also taking steps to reduce geographic concentration.

I do not mean to shift focus away from the failure of Congress to pass GSE reform. Maybe the weather kept them away this week, but lawmakers cannot blame the historic snowfall for their failure to fix housing finance. Yet the FHFA still has the potential to succeed on many fronts where Capitol Hill has largely punted.

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