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Trump and Calabria Begin to Reform Fannie and Freddie

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Just when it seemed that reforming the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac was becoming a "third rail" that politicians did not want to touch, Trump administration officials — from the president on down — are now making bold statements about curbing the powers of GSEs in the housing market and reducing their risk to taxpayers.

In his May 16 address at the National Association of Realtors convention, President Donald Trump **lamented** that "Fannie and Freddie still dominate the market with no real competition from the private sector and the taxpayers are still on the hook if another crisis should happen."

The president is correct on his points about both lack of competition and taxpayer risk. As I noted in a 2017 Competitive Enterprise Institute **study**, the GSE role in the housing market is even greater than before the crisis, with Fannie and Freddie and other government entities backing nearly 90 percent of U.S. mortgages.

I also noted that stress tests conducted by the government show that Fannie and Freddie may need up to $100 billion in new bailout money if there are changes in interest rates or economic volatility.

In his speech to the Realtors, Trump proclaimed that the status quo with the GSEs is no longer acceptable. He announced that his administration was pursuing a housing finance reform plan "that welcomes the private sector, competition, protects taxpayers and preserves homeownership for future generations to come." He also pledged to "get rid of ridiculous regulations so you can build and build quickly and build beautifully."

Similar sentiments about GSE reform have been expressed by Mark Calabria, whom Trump nominated and the Senate recently confirmed to become the director of the Federal Housing Finance Agency, which oversees Fannie and Freddie. "I don't make a habit of predicting the future," Calabria **said** in a May 20 address to the Mortgage Bankers Association National Secondary Market Conference and Expo. "But if there's one thing I know for sure it's that Fannie and Freddie will look much different at the end of my five-year term than they do today . . . the status quo is no longer an option."

My organization, the Competitive Enterprise Institute, will carefully evaluate GSE reform plans as more details are unveiled, but we have high hopes for Calabria's tenure at FHFA. When Trump named him as a pick, I **praised** the nomination and CEI joined other conservative and free-market groups in a **letter** to the Senate calling for Calabria's swift confirmation. I and other CEI scholars have worked with Calabria since he was a housing and finance policy analyst at the

Cato Institute. There, Calabria proffered many constructive ideas on how to reduce the government's role in housing, protect property rights, and lift regulatory barriers to a free and prosperous housing market.

At FHFA, the actions he can take are constrained by the laws of Congress, but Calabria told the conference that he will utilize his power to the extent allowed to effect reform. "There are a number of things I can't do, where we need congressional authority," he **said**. "But there are a number of things I can do."

Calabria will, however, face difficulty in making a free-market transition at every step of the way, even from seemingly technical policy minutiae that affects the way the Fannie and Freddie are governed. One threat to reform, for instance, comes from a recent mandate by Congress that could impair the utilization of home buyers' credit scores for the loans the GSEs purchases, leaving taxpayers at greater risk.

When Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act last year — a mostly good piece of legislation that contained needed relief for community banks and credit unions from Dodd-Frank burdens such as the **Volcker Rule** — it included a provision directing the FHFA to review the way the GSEs make use of credit scores. With the justification of promoting competition, politicians and interested parties are pushing the FHFA to force Fannie and Freddie to allow alternative methodologies of credit scoring on the loans it purchases from banks and credit unions.

CEI is all for lifting regulatory barriers to competition in credit scoring, as we are in every other type of business. That's why we have pushed for policies like a deregulatory "**sandbox**" at the Consumer Financial Protection Bureau that would ease barriers for products that improve consumers' access to credit, including new types of credit scoring services. Interestingly however, in this case, there really aren't small upstart firms banging at Fannie and Freddie's doors with proposals to score the loans they buy. Rather, the main challenger to the FICO score is VantageScore, which is produced by a joint venture of the Big 3 credit bureaus Equifax, Experian, and TransUnion.

But regardless of who the competitors are, focusing on "competition" for services provided to the GSEs — before reforming and bringing competition to the mortgage market these state-backed entities dominate — is putting the proverbial cart before the horse. With Fannie and Freddie, which are implicitly backed by taxpayers and which since 2008 have been majority-owned by a government "conservatorship," the issue isn't really competition but stewardship of taxpayer dollars.

Like it or not (and **CEI** **scholars** **have** **said** **repeatedly** that we don't like such arrangements), Fannie and Freddie have been implicitly backed by the federal government since their origins decades ago, and since they were put into "conservatorship" in 2008, the federal government has owned 79.9 percent of each of them. As long as they have implicit or explicit taxpayer guarantees — and we are pushing for the day that they are completely privatized and don't have any government guarantee—their first responsibility should always be to the American taxpayer. As such, they need to choose the firms that help them process loans using a similar level of due diligence the Pentagon utilizes when choosing tanks.

The FHFA that Calabria heads must look at what processes have or haven't worked. And the facts show that when utilized properly, the FICO credit score has been able to sort through good and bad risks reasonably well. Developed by the Fair Isaac Corporation in 1989, the FICO score is used to judge risk for borrowers in a wide variety of credit applications from credit cards to car loans. Fannie and Freddie began utilizing it for home buyers in 1995 to help determine which mortgages to purchase from banks and credit unions.

While no credit scoring methodology can be perfect, FICO held up well even during the financial crisis, especially when compared to the mechanisms from other institutions such as the credit rating agencies.

The main problem seemed to be that Fannie and Freddie, as well as the Wall Street banks, pushed FICO scores to the side when they would have deterred the processing of risky loans. As noted in Michael Lewis' best-selling "**The Big Short**" and its movie adaptation, the short-sellers who would get rich betting against the housing boom, were able to spot something wrong with the housing market after seeing low FICO scores in AAA-rated mortgage bonds. "I've seen some (AAA-rated bonds) that I know for a fact are filled with 95 percent subprime shit with FICOs below 550," **said** a "short" trader in the movie.

And Fannie and Freddie in particular got into trouble when they began to give less credence to a borrower's FICO score. American Enterprise Institute housing policy scholars Peter Wallison and Edward Pinto **found** that in the years leading up to mortgage meltdown of 2008, Fannie and Freddie not only bought millions of mortgages held by borrowers with FICO scores below 660 — a threshold under which a bank regulator guidance document deemed borrowers to have a "relatively high default probability" — they deceived the market by labeling many of these loans as "prime" instead of "subprime."

The GSEs ignoring these FICO scores proved to be at their peril — and that of taxpayers and the economy as a whole — as the scores turned out to be pretty good at predicting which borrowers would default. As Wallison, who was also a member of the Financial Crisis Inquiry Commission, **wrote** in his opinion in the commission report, "As of December 31, 2008, borrowers with a FICO score of less than 660 had a serious delinquency rate about four times that for borrowers with a FICO score equal to or greater than 660."

Then there is the compliance costs of adapting to a new scoring system, both for Fannie and Freddie, and for the banks and credit unions that make the mortgages the GSEs purchase. The Credit Union National Association, which represents the nation's credit unions, stated in a **comment letter** to the FHFA that while "increased market competition in the credit-score industry" was beneficial, "the frequent modification of the GSEs credit-scoring models … could discourage competition in the lending market by increasing costs for smaller lenders less capable of quickly and cost-effectively absorbing those changes."

A transition to a competitive mortgage market led by the private sector will bring along with it many beneficial innovations for borrowers and lenders, including in credit scoring. But until this transition moves further along, policymakers must be wary of any proposed action that could jeopardize the larger goal of GSE reform.