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# The Future of Fannie Mae and Freddie Mac: A Close Look at Legislative Options

## Inside the Corker-Warner and Hensarling plans for reforming the government-backed mortgage companies

By John Griffith and Andrew Jakabovics | August 2013

## At a Glance:

- In recent weeks, lawmakers have renewed efforts to reform the mortgage giants Fannie Mae and Freddie Mac and establish a new system of housing finance in the United States. Enterprise believes that any future system must be balanced, with appropriate support to both sustainable homeownership and affordable rental opportunities.
- Achieving that goal requires lawmakers to maintain aspects of the current system that work, including an explicit government backstop on qualifying mortgages and policies that promote access to affordable, sustainable mortgage credit.
- The bill recently introduced in the Senate by Sens. Bob Corker (R-Tenn.) and Mark Warner (D-Va.) is a promising step forward in the debate, and takes many of the necessary steps to maintain a liquid and resilient mortgage market. But more must be done to promote a stable and affordable rental market and ensure that mortgage credit is available to all creditworthy families.
- The Mortgage Finance Working Group, of which Enterprise is an active member, has offered a promising supplement to the Corker-Warner plan. Their proposal would spin off Fannie's and Freddie's existing rental housing operations into independent private entities, which would eventually have the option to purchase government insurance on the securities they issue. In exchange, the government would charge a fee, oversee all market activity and enforce strict affordability requirements on the rental homes financed through those securities.
- The bill recently introduced in the House by Rep. Jeb Hensarling (R-Texas) is more problematic. By drastically scaling back the government's role in the mortgage market—including eliminating the government guarantee—the plan could leave the U.S. housing market vulnerable to massive boom-and-bust cycles, increase the price and decrease the availability of rental housing, deepen the affordable housing crisis facing millions of working families and make homeownership out of reach for millions of lower-wealth but creditworthy families.

## Introduction

In September 2008, during the early days of the financial crisis, the federal government took control of mortgage giants Fannie Mae and Freddie Mac through a legal process called conservatorship. Since then, the companies have required $187.5 billion in taxpayer support to stay solvent, on which they've paid taxpayers an estimated $132 billion in dividends so far.

In return for this support, Fannie and Freddie have helped keep money flowing into the housing market by backing more than half of all single-family and multifamily mortgages since the housing crisis began. Between Fannie, Freddie and agencies like the Federal Housing Administration, the federal government backed roughly nine in 10 single-family mortgages made in the United States last year.

Just about everyone agrees that the current level of government support is unsustainable in the long run and that private capital must take on more risk in the mortgage market. There's much less agreement, however, over how we should reform the country's housing finance system to accomplish those goals.

Last year, Enterprise Community Partners laid out a set of priorities for any effort to reform Fannie Mae and Freddie Mac. They include:

- *Maintain a government backstop on multifamily mortgages.* Ensure adequate capital flow, liquidity and stability for the multifamily housing market, both subsidized and unsubsidized, at all points in the real estate and credit cycles.
- *Preserve the practices of the housing finance system that worked.* For years, Fannie and Freddie were critical in making low-cost capital available for affordable rental housing, both for new developments and preservation of existing homes. These business lines did not meaningfully contribute to either company's losses during the crisis.
- *Protect historically underserved markets and demographics.* This includes rural housing and small apartment buildings, as well as special needs populations like seniors, persons with disabilities and extremely low-income households.

Since Enterprise shared its priorities, dozens of plans to reform Fannie and Freddie have been released, but lawmakers have made little progress toward a more sustainable system. That has changed in recent weeks.

This brief lays out the main points of two prominent proposals under consideration today: the bipartisan bill released in June by Sens. Bob Corker (R-Tenn.) and Mark Warner (D-Va.) and the bill released in July by House Financial Services Chairman Jeb Hensarling (R-Texas). It also identifies our recommendations for next steps to advance the reform effort.

## Corker-Warner: A Promising Path to Reform

In June 2013, Sens. Corker, Warner and a bipartisan group of cosponsors introduced a bill that would dissolve Fannie Mae and Freddie Mac and establish a new system of housing finance in the United States. The bill adapts many recommendations from other bipartisan groups, including the Bipartisan Policy Center's Housing Commission, the joint recommendations of The Urban Institute, Moody's Analytics and the Milken Center, and the Mortgage Finance Working Group, of which Enterprise is an active member.

The bill recommends replacing Fannie and Freddie with private companies and a new government-owned corporation, called the Federal Mortgage Insurance Corporation or FMIC. The corporation's mission would be to regulate the entire secondary mortgage market, insure investors against catastrophic losses on qualifying mortgage-backed securities and ensure a liquid and resilient mortgage market. Here's how the proposed system would work.

*Single-Family Securitization*

On the homeownership side, privately funded, government-approved entities would buy qualifying mortgages and package them into securities, much like what Fannie and Freddie do today. Other privately funded, government-approved entities would then insure timely payment of principal and interest on those securities—another role Fannie and Freddie play today.

If the security meets a few basic requirements, issuers would then have the option to purchase insurance against catastrophic risk from the FMIC. The government guarantee would only be eligible on securities made up of safe mortgages—defined by the recent "Qualified Mortgage" rule and a 5-percent down-payment requirement—and would only cover up to 90 percent of the security's value. The remaining 10 percent must be covered by private sources, such as private mortgage insurers or other first-loss investors. In times of economic crisis, federal regulators can alter that requirement to ensure that money keeps flowing into the mortgage market.

The FMIC would charge an appropriate fee to cover expected losses, plus a capital buffer of 2.5 percent. Fees would be kept in a Mortgage Insurance Fund to handle incoming claims, backed by the full faith and credit of the U.S. government.

The FMIC would also set rules for the entire secondary mortgage market and manage a single securitization platform for all FMIC-backed securities. In exchange, it charges a 5-10 basis point fee on all FMIC-backed securities to fund affordable housing initiatives through the Housing Trust Fund and Capital Magnet Fund. All other affordable housing goals or mandates would be eliminated.

*Multifamily Securitization*

The system for financing rental housing would work a little differently. Instead of winding down Fannie's and Freddie's multifamily business—both of which have remained steadily profitable since the crisis began—the bill simply transfers this business to FMIC.

The bill authorizes the FMIC to purchase, securitize and guarantee qualifying multifamily mortgages—for a fee, of course—backed by the U.S. government. So instead of slowly privatizing this business, the bill keeps it under full government control.

We're pleased that the Corker-Warner bill preserves an explicit government guarantee on qualifying multifamily securities. The guarantee brings important social and economic benefits to working families, both by supporting quality, affordable rental housing and ensuring that money keeps flowing into rentals during market downturns. And based on data recently released by the Federal Housing Finance Agency, we know that fully privatizing the multifamily market would meaningfully harm taxpayers.

That said, it's unclear whether the newly formed FMIC is the appropriate entity to handle the multifamily securitization business. The FMIC will be a regulatory and insurance entity, not a capital delivery or asset management firm. And private firms have decades of experience responsibly purchasing and securitizing multifamily mortgages.

## How to Strengthen the Corker-Warner Multifamily Proposal

The Mortgage Finance Working Group—a collection of finance experts, leading academics and affordable housing advocates, including Enterprise Community Partners—recently proposed an alternate approach to multifamily reform, meant to supplement Corker-Warner's basic market structure. Instead of transferring Fannie's and Freddie's multifamily operations to the FMIC, the Working Group recommends spinning them off into two private entities, entirely independent from Fannie and Freddie.

During a brief transition period, these entities would continue to purchase, securitize and insure qualifying multifamily mortgage-backed securities, with support from the U.S. Treasury as needed. When the FMIC is fully operational, the insurance function would be transferred to the federal government. From that point on, the new entities would have the option of purchasing FMIC insurance on the multifamily securities they issue, backed by the full faith and credit of the U.S. government.

Over time, the new entities would be required to raise private capital with the option of buying out the government's interest. Meanwhile, other government-approved, privately-funded companies would have the option of purchasing FMIC insurance on the multifamily securities they issue.

The Working Group also proposes strict affordability requirements for any issuer of FMIC-backed multifamily securities—requirements that are notably missing from the Corker-Warner bill. For each approved issuer, at least 60 percent of the rental units financed through these securities in a given year must be affordable to families making 80 percent of area median income or below. The issuer would also need to develop an annual plan for serving communities and market segments often neglected by private capital, including low-income communities, rural communities, subsidized affordable multifamily housing and small rental properties.

Similar to the single-family market, the FMIC would charge a 5-10 basis point fee on all multifamily securities it insures to fund the Housing Trust Fund and Capital Magnet Fund. It would also oversee the entire secondary multifamily mortgage market for safety and soundness.

## The PATH Act: A More Problematic Approach to Reform

In July 2013, just two weeks after the Corker-Warner bill was introduced in the Senate, House Financial Services Chairman Jeb Hensarling (R-Texas) released his own plan for reform called the PATH Act. On July 24, the PATH Act became the first housing finance reform bill to pass congressional committee since the financial crisis began in 2008.

Among other things, the PATH Act would wind down Fannie Mae and Freddie Mac over a five-year period and replace them with fully private firms that issue mortgage-backed securities. The federal government would monitor the secondary mortgage market but offer no guarantee on these securities.

Private firms would have the option of issuing securities through a single platform with uniform rules and contracts, managed through a new nonprofit entity called the "National Mortgage Market Utility." The plan also lays out a framework through which private firms can issue "covered bonds," debt instruments backed by mortgages and other loans that are held on the issuer's balance sheet (not to be confused with a security, which is usually held by private investors, not the issuer).

The plan also repeals Fannie's and Freddie's affordable housing goals, eliminates the Housing Trust Fund and repeals Dodd-Frank's risk retention rule for private issuers of mortgage-backed securities. There is no explicit mention of Fannie's or Freddie's multifamily business in the current draft.

In addition to these changes, the PATH Act meaningfully scales back the size and scope of the Federal Housing Administration's mortgage insurance programs. It does so by limiting the agency's mission, increasing certain down-payment requirements, lowering the maximum insurance coverage, reducing maximum loan sizes and making several changes to the agency's capital and reporting requirements.

Each of these proposals requires rigorous analysis and serious debate, and Enterprise looks forward to contributing to that conversation in the coming months. But one thing is clear: the PATH Act would establish a profoundly different system of housing finance than the one we're used to—and not for the better.

If the PATH Act were to become law, only about 20 percent of the U.S. mortgage market would be guaranteed by the government at any given time, according to Moody's Analytics. This would lead to a more expensive and less liquid housing market, with profound consequences for both homeowners and renters.

Specifically, the Moody's analysis concluded that the PATH Act would cause interest rates to skyrocket (up roughly 20 percent from their current level), limit the availability of the 30-year fixed-rate mortgage (from 75 percent of the market down to 10-20 percent of the market) and make the housing finance system more vulnerable to investor runs and boom-and-bust cycles.

In addition, eliminating the government guarantee on multifamily mortgages would cause rents to rise by as much as 2 percent, as the total supply and value of rental homes would fall significantly, according to recent analysis from Freddie Mac. And by eliminating provisions that promote affordable housing, millions of working families will face an even deeper affordable housing crisis. Such adverse outcomes are not what our nation needs out of mortgage market reform.

## Specific Recommendations and Next Steps

We're thrilled that lawmakers are finally tackling housing finance reform. But we believe that the PATH Act moves the debate in the wrong direction, away from the growing bipartisan consensus on the appropriate level of government support necessary for a well-functioning housing market, as a comparative analysis from the Center for American Progress illustrates.

The bipartisan Corker-Warner bill, on the other hand, is a promising step forward in the debate over housing finance reform, and it takes many of the necessary steps that Enterprise believes are critical to ensure a stable, liquid and equitable housing market. Enterprise looks forward to working with members of Congress, the Obama administration and our partners across the country to hone the finer details of the proposal and ensure that any future system supports both sustainable homeownership and affordable rental opportunities.

Specifically, we recommend the following changes to strengthen the bill:

- Spin off Fannie's and Freddie's multifamily businesses to two independent private entities that continue to issue qualifying multifamily mortgage-backed securities, per the recommendations of the Mortgage Finance Working Group. These firms will then have the choice to purchase reinsurance against catastrophic losses from the FMIC. Over time, other government-approved private issuers also would have access to FMIC insurance.
- Establish clear affordability requirements for any issuer of FMIC-backed multifamily securities. Each issuer must ensure that at least 60 percent of the total rental housing units financed through FMIC-backed securities in a given year are affordable to households earning 80 percent of area median income or less. For purpose of this rule, "affordable" would mean tenants pays no more than 30 percent of their monthly income on rent.
- Set new rules that protect historically underserved markets and demographics in both the single-family and multifamily markets, including minority borrowers, rural housing and small multifamily developments. These protections can be achieved through annual reporting and planning as recommended by the Mortgage Finance Working Group, or through a revamped "duty to serve" regulation for Fannie and Freddie established by the 2008 Housing and Economic Recovery Act.
- Require servicers of FMIC-backed loans to pursue loss mitigation that aims to keep borrowers and renters in their home whenever economically justifiable, and allow for a minimal portfolio capacity to handle such modifications.
- Remove the requirement for so-called "fair value accrual accounting," which would overstate the true cost of the FMIC's guarantee and unnecessarily add to the consumer's mortgage interest rate. All budgetary accounting at the FMIC should follow the rules laid out in the Federal Credit Reform Act.

We're looking forward to a fruitful debate on the future of Fannie Mae and Freddie Mac in the coming months. The decisions made today will determine the availability, affordability and sustainability of mortgage credit for years to come—deciding whether millions of working families have a safe and stable place to call home. It's crucial that we get the details right.

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## Appendix: Side-by-Side Comparison of the Corker-Warner and Hensarling Plans

| | Corker-Warner | PATH Act |
|---|---|---|
| Official title | Housing Finance Reform and Taxpayer Protection Act of 2013 | The Protecting American Taxpayers and Homeowners Act |
| Summary | Wind down Fannie and Freddie over a 5-year period. Privately funded, government-approved entities guarantee timely payment of principal and interest on qualifying mortgage-backed securities. Creates a new government corporation (FMIC) to regulate the MBS market and provide catastrophic guarantee on MBS that meet product standards, including a 5% down payment, 80% LTV if no mortgage insurance. Private capital must have 10% first loss position. FMIC charges a fee for government insurance held in a Mortgage Insurance Fund, backed by the full faith and credit of the U.S. government. | Winds down Fannie and Freddie over a 5-year period and replaces them with fully private firms that issue and guarantee mortgage-backed securities. The federal government monitors the secondary mortgage market but offers no guarantee on these securities. Securities are issued through a single platform with uniform rules and contracts, managed through a new nonprofit entity called the "National Mortgage Market Utility." Establishes a framework for private entities to issue covered bonds. Reforms occur alongside an overhaul of the Federal Housing Administration's insurance programs and changes to Dodd-Frank mortgage regulations. |
| Who issues qualifying mortgage-backed securities? | Government-approved private entities for single family MBS, FMIC for multifamily MBS. No issuer can have more that 15% of the FMIC-guaranteed market (with exceptions). | Private firms. |
| Who insures qualifying mortgage-backed securities? | Government-approved private entities for single-family, FMIC for multifamily. Private capital must maintain a 10% first loss position. | Private firms. |
| Nature of the government guarantee | Private entities can purchase an explicit government guarantee against catastrophic risk on qualifying MBS. Only applies to securities made of loans that meet the "Qualified Mortgage" rule and have a down payment of at least 5 percent. Regulators can alter the restrictions on the guarantee in times of crisis. | No government guarantee on single-family or multifamily mortgages, beyond FHA and other existing agencies. |
| Portfolio investments by covered entity | Issuers can hold loans or the first loss position on their balance sheets for up to 6 months to facilitate securitization. | Not applicable. No government guarantee. |
| Affordable housing provisions | Sets aside 5-10 basis points on all FMIC-backed MBS to fund the Housing Trust Fund and Capital Magnet Fund. Alters the HTF to fund research and testing of products that promote access and affordability. | Repeals the affordable housing goals and the mandate to fund the Housing Trust Fund. Scales back FHA's insurance business by narrowing its mission, increasing minimum down payments, lowering loan limits and reducing maximum insurance coverage. |

## Appendix: Side-by-Side Comparison of the Corker-Warner and Hensarling Plans (cont.)

| | Corker-Warner | PATH Act |
|---|---|---|
| Multifamily provisions | Transfers existing multifamily business to the FMIC. Authorizes the FMIC to guarantee any multifamily mortgage it purchases for a fee, backed by the full faith and credit of the U.S. government. | No specific recommendations, but no government guarantee on any multifamily mortgages beyond FHA. |
| Oversight | FMIC approves all loan originators, servicers, issuers and guarantors of MBS eligible for the government wrap. FMIC also maintains a single securitization platform for FMIC-backed MBS, including common pooling and servicing agreements and data standards. The Mortgage Insurance Fund must build up to a minimum capital reserve of 2.5%. | FHFA regulates the entire secondary mortgage market, including the new National Mortgage Market Utility. The utility sets "best practices" standards for private securitization and maintains a common securitization platform to be used by private firms on a voluntary basis. Both QM and non QM loans are eligible for the platform. |
| Transition | Wind down Fannie and Freddie over a 5-year period, starting with an immediate decrease in conforming loan limits. Transfer all single-family assets to the Treasury to be sold off in a way that maximizes return to taxpayers, minimizes market disruptions and returns money to equity investors when possible. Within 8 years, study the impact of full market privatization. | Set a 5-year limit to end the conservatorship and subject the GSEs to receivership and liquidation. Lock in current dividend payments to pay back taxpayers. Wind down the GSE's retained portfolio by 15% a year, down to a floor of $250,000. Lower the conforming loan limits by $20,000 per year down to $525,000. Increase private risk in new GSE business by 10 percent each year. |
| Legal Changes to the Housing Trust Fund | 80% of the 5-10 bp fee must go to the HTF. Allows the HTF to fund grants, loans, credit enhancement and pilot programs to support sustainable homeownership and affordable rental programs for households below 120% AMI. Mandates a certain percent allocation for each activity and guaranteed support to rural communities. | Eliminates the Housing Trust Fund. |