INDUSTRY PERSPECTIVES

After a Decade of Debates about the Right GSE Reform Model, We're Down to Two Choices

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A senior US Treasury official, in a conversation earlier this year, told me that the challenge of legislative reform of the two government-sponsored enterprises (GSEs) – Freddie Mac and Fannie Mae – was getting easier because the debate was getting centered on a much narrower range of alternatives, after years in which all sorts of paths were proposed.

As I referenced in *GSE Reform: None or Mostly Done?*, the housing finance policy community had thrown around all sorts of ideas about how to move forward after the two GSEs were placed in conservatorship in the 2008 Financial Crisis. Most of the ideas, though interesting to discuss, were not practically implementable. The transitions envisioned from the current GSEs to something new were, after review, thought by policy and industry specialists to risk major harm to homeowners and the economy. And almost all of these ideas about reform were described only on a fairly general basis, with little specificity as to exactly how they would work (including in particular how they would guard against unintended consequences and politicization, which became so impactful for the pre-conservatorship GSEs).

And all required legislation to accomplish.[1]

In the early years of conservatorship, while many of these ideas were being developed and discussed, all of them looked to ***replace*** the two GSEs; in fact, it seemed the very definition of "GSE reform" in those years was designing a new housing finance system that would effectively replace Freddie Mac and Fannie Mae.

One proposal became dominant in Washington policy circles during those early years: *wind down the GSEs, and replace them with well-more-than-two competing smaller guarantors*. It seemed to have the support of the lending industry, the Obama administration, and many Republicans. Support for this proposal culminated in the push to get behind and pass the

[1] This article is fully about reform via legislation. Through reform by administrative means, there is extremely limited ability to change the current model by which the two GSEs operate today.

bipartisan Corker-Warner GSE reform bill.[2] This bill included the then-broadly supported wind-down of the two existing companies and called for and accommodated the creation of a larger number of smaller guarantors – mini-GSEs in most ways – that would be financed by private capital and then compete for guarantee business from primary mortgage lenders.

In May 2014, however, the Corker-Warner bill died. The proximate cause of its death was severe disagreement over how to address GSE social obligations, such as the affordable lending goals. As is common in such a circumstance in Washington, the issue of GSE reform then went onto the policy back burner.

In the years post-2014, views began to change because facts changed. First, no plan to replace the two existing GSEs had emerged that most policy specialists thought likely to work properly without risking inordinate collateral damage to mortgage lending and homeownership. Second, the mortgage lending industry saw that the reforms to the GSEs in conservatorship were turning them into well-managed companies that served their customers better than ever (and treated taxpayers far better as well); the industry's perception then worked its way into the thinking of the policy community. And so, an amazing thing happened by 2019: *the range of GSE reform proposals was narrowed down to two leading alternatives, both of which are built on <u>keeping</u> the two GSEs!*

That's quite a turnaround, constituting a major political rehabilitation of Freddie Mac and Fannie Mae in those five years, from an almost universal belief they should be "wound down."

Interestingly, these two leading alternative models are being promoted – separately, of course – by the Senate Banking Committee's two leadership senators.

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[2] This proposal, by Senators Bob Corker (R-TN) and Mark Warner (D-VA), was later reformulated some by the chair and the ranking member of the Senate Banking Committee, and renamed after them as Johnson-Crapo. For simplicity, I will refer to it as Corker-Warner.

Senator Michael Crapo (R-ID), chairman of the Senate Banking Committee, is regarded politically as a traditional and non-extreme conservative Republican. He put out a short "Housing Reform Outline" this past February 1. His housing reform plan builds upon keeping the two GSEs, but then looks to have additional guarantors emerge to compete with them; that is, it hopes for a transition from a duopoly to a normal competitive market. This plan built upon the substantial policy pedigree that had produced the Corker-Warner bill.

Senator Sherrod Brown (D-OH) is the ranking member[3] of the Senate Banking Committee; he is regarded politically as a strongly liberal but traditional Democrat. He has put out no plan of his own but is becoming more and more specific about what he supports, citing plans from various industry associations by name, and most recently talking about what he perceives to be a consensus. And that consensus, according to Senator Brown in his introductory comments at the Senate Banking Committee's September 10, 2019 hearings on Treasury's newly-announced Housing Reform Plan, is also to build upon the two existing GSEs, keeping them in place but then treating them as utilities with traditional utility-style regulation by the Federal Housing Finance Agency (FHFA), their current safety-and-soundness regulator.

Both senators also look to lock in many of the reforms implemented during conservatorship, which I listed in *GSE Reform: None or Mostly Done?,* such as proper capitalization and the usage of credit risk transfer.

And, as mentioned in my previous writings, because I do not believe it is reasonable to expect competitors to arise to compete successfully against Freddie Mac and Fannie Mae, it seems that we are fundamentally left with the regulated utility model to move forward.

[3] The "ranking member" is the most senior member on the committee from the Senate's minority party, at that time the Democrats.

GSE Reform, 2009 to 2014

Almost immediately after the 2008 Financial Crisis, the housing finance policy community sprang into action with proposals addressing the "GSE problem." These ideas ranged widely, but all seemed to assume the two existing companies would just be "wound down." If there were GSE supporters who thought they should be fixed and reformulated, I did not hear of them – they just kept quiet.

But if they were to be wound down, what would replace them? The Tea Party-aligned Republicans consistently answered this question with "nothing – let the private markets just operate as they will," but that answer did not garner enough support. Another alternative did garner a lot of support: a competitive secondary market, populated by a reasonable number of guarantors of modest size rather than the mega-sized duopoly of Freddie Mac and Fannie Mae; each such smaller guarantor would have access to just enough government support to keep the existing 30-year fixed rate mortgage in place.

As best as I can tell, the policy dominance of this model at that time can be traced back to three sources:

> *First*, *the GSEs' own lobbying efforts created the false perception that they were normal competitive companies.* While the two GSEs entered the 1990s as much smaller companies, both became large and highly profitable during that decade (including by exploiting the ability to build large investment portfolios subsidized by implied-guarantee funding).[4] They also engaged in extensive lobbying and public relations campaigns to defend that market position and the resulting profits. I personally recall that one aspect of their lobbying was the claim that because they were normal financial institutions, on par with the largest banks, their executives deserved the same high

[4] Prior to the late 1980s, the largest source of residential mortgage financing in the US was the "thrifts" – savings & loans and mutual savings banks. But their business model collapsed as interest rates rose starting in the late 1970s, culminating in the 1989 "thrift crisis" (also known as the S&L crisis). After that, the GSEs – bolstered by the invention of the pass-through residential mortgage-backed security – grew rapidly to become the largest source of mortgage financing.

compensation levels found in such banks![5] It was all clearly self-interested, but the lobbying and PR was extensive, of long duration, and generally effective. And so in the minds of government officials and much of the industry itself, the image of the GSEs as normal competitive companies came to predominate, even though the reality – they executed a specific, government-given mission specified in their charters, with all sorts of limitations on what they could do; they were heavily subsidized by the government;[6] and they split a government-created secondary market between them – was that they were not normal companies at all.

Second, *an influential paper by the Mortgage Bankers Association proposed replacing the duopoly with a number of smaller companies.* In September 2009, the MBA, the largest and most influential housing finance industry association in Washington, outlined its view of how the secondary mortgage market should be structured going forward given its collapse and the conservatorships of Freddie Mac and Fannie Mae.[7] The role played by the two GSEs was to be replaced by an unspecified number of a new type of firm: the “mortgage credit-guarantor entity.” It described a business model to have private capital stand in front of a government guarantee to investors in qualifying mortgage-backed securities (MBS). So, this was an attempt to replace the GSEs with competing, shareholder-owned guarantors – but ones that were to be monolines and quite specifically structured and regulated for their special role in secondary mortgage finance.[8] In terms of the vision described, it was designed to take a strong step towards “normal competition” among many firms and away from the duopoly of the two GSEs. But this larger number of companies, far from being regular for-profit commercial

[5] And their top executives did indeed get paid on par with their counterparts at the largest banks.
[6] Their two biggest subsidies were (1) the ability to grow investment portfolios of discretionary mortgage assets funded by implied-guarantee (i.e., extremely cheap) funding, and (2) being allowed to have capital ratios well below normal market standards. The subsidized investment portfolios eventually became the largest source of profits for each company.
[7] Mortgage Bankers Association, “Recommendations for the Future Government Role in the Core Secondary Mortgage Market,” September 2009.
[8] The object of early proposals was to get private capital in front of the taxpayer when facing mortgage credit risk. The development of credit risk transfer, which also does just that, was not contemplated at that time.

companies, were still designed to have very proscribed powers, specific limitations and the appropriate regulations to support a narrowly-defined policy role.

Third, a Treasury report likewise proposed replacing the duopoly with a number of smaller companies. In February 2011, the US Treasury and the Department of Housing and Urban Development (HUD) jointly issued what is now known generally as the "Treasury White Paper" on housing finance.[9] The GSEs and housing finance had not been addressed in the rather immense bill, known as Dodd-Frank, designed to tackle issues from the 2008 Financial Crisis, and now the Obama administration was getting around to the topic. After many pages of history and reviewing well-known observations, the document listed three alternative directions of how to proceed: *all* were based upon "a privatized system of housing finance." The third option, which had the most government involvement and thus was the only one to address the function historically performed by the two GSEs, made reference to "a group of private mortgage guarantor companies that… would provide guarantees for securities backed by mortgages" and which would, in turn, be able to access reinsurance from the government in some fashion. So, the idea of many competing guarantors - but with some support from the government to continue the traditional 30-year fixed rate mortgage – was at the core of this third option, just as in the MBA's paper of two years earlier.

Also, the Treasury White Paper spoke several times of "winding down" Freddie Mac and Fannie Mae – and I can attest that when I arrived in 2012 it was still the formal policy of President Obama.[10] And this was from a Democratic administration, even though

[9] US Department of the Treasury and US Department of Housing and Urban Development, "Reforming American's Housing Finance Market: A Report to Congress," February 2011, https://www.treasury.gov/initiatives/documents/reforming%20america's%20housing%20finance%20market.pdf.

[10] In early meetings after I became CEO of Freddie Mac in May 2012, Treasury gave me a moderately long list of things they wanted the company to do (all on an advisory basis; only the FHFA, as our conservator, could actually give us orders). The only thing "wind down" about that list was that the discretionary investment portfolio was to

Democrats had historically been notable supporters of the two GSEs; the wind-down policy had taken hold during the administration's early years when the GSEs were still politically very toxic, and had continued even as their political rehabilitation was under way.

This policy model – having an unspecified number of well-more-than-two guarantors compete in the secondary mortgage market – thus became the strongly dominant vision for GSE reform right out of the starting gate. There was no thought at all of the existing duopoly's surviving – it just seemed too outlandish![11]

The plan to wind down the two GSEs and replace them with a greater number of smaller guarantors was embodied in the Corker-Warner bill, as described above. Washington's modus operandi was on full display in the bill's development. As it increasingly looked like the best bet for moving forward, and especially since it was bipartisan, all sorts of policy and industry groups focused heavily on it (the option of administrative reform, not requiring legislation, was not widely known at that time). These groups engaged in what looked to me like a bit of a feeding frenzy to get to the senators or the congressional staff working on the bill: they wanted to play a role, to be influential (and to be seen to be influential), and to shape the outcome according to their ideological or economic interests.[12]

In that frenzy, I also observed closely the "just get it passed" mentality, which might be summarized thus: "don't worry about the details or what might not work so well; it's more

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shrink. Otherwise, it was all about doing more, not less. So, right off the bat, I saw the difference between a formal high-level policy – where optics and politics were dominant – and the practical reality of "getting things done."

[11] 2011 saw the bottom of housing prices, and consequently was the last year with the GSEs routinely generating losses. They began to earn profits steadily starting in 2012. This turnaround definitely impacted how the two companies were viewed in policy, industry and political circles.

[12] Full disclosure: I was "discovered" by Senators Warner and Corker during the process of their designing up their bill in early 2014, and they called on me to be a technical expert to help the bill's development. As the GSEs in conservatorship are not allowed to lobby elected officials, in all such meetings with the senators and their staff I was accompanied by an FHFA representative to be able to ensure that I was not lobbying, just giving the technical advice being requested.

important to keep the momentum going and get the bill passed – we can worry about corrections or changes to improve it later."[13]

The bill narrowly passed by the Senate Banking Committee. Senators Corker and Warner had won support from the more moderate members of both parties. But that was it. The more conservative Republicans wanted to wind down the GSEs and let the private market operate. The more liberal Democrats objected to a specific feature of the bill concerning the affordable housing obligations which had been placed upon the two GSEs in prior legislation. That feature eliminated those obligations (e.g., the official "affordable goals") due to their perceived lack of transparency and effectiveness, and replaced them with a new fee to be paid instead to the government, which would then spend the money, on budget, for housing support.[14] Since the bill passed the committee vote with only a small margin and would require 60 votes to pass the full Senate, Majority Leader Harry Reid (D-NV) deemed it not worth bringing to the floor for a vote. And that means it "failed."

After the failure of the bill, on which so much energy and focus had been expended, the let-down in the housing finance policy community was palpable. The result was two-fold. The topic of GSE reform went from front burner to back, with efforts now directed (once again) towards idea development rather than specific legislation. At the same time, many members of the community shifted their focus away from GSE reform altogether and towards narrower, specific issues that stood a better chance of being passed in Congress.

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[13] In fact, some details of the bill were highly problematic; I wrote about them in a confidential memo to the Federal Housing Finance Agency (FHFA), the regulator of the GSEs, in the spring of 2014 as the bill was being finalized. I wrote in particular that the transition was going to be quite disruptive, with all sorts of collateral damage to homeowners and the lending industry. My memo later leaked out after having been provided by FHFA to congressional staff.

[14] According to Gene Sperling, talking as a member of a panel I was on at the Milken Institute's annual policy gathering in 2014, the Obama administration pushed the more liberal senators hard to support the bill; Sperling had been chair of the National Economic Council during the time of that push. He said those Senators rejected his argument that the fee would be very large relative to any realistic estimate of what value had been delivered by the historic regime of affordable goals. It is reported that, among their other reasons for rejecting the push by their own party's president, those senators did not think that large fee, after all the steps it would have to pass through as an "on budget" expenditure, would ever really materially benefit homeowners.

After the bill died, I also recall the quiet comments from inside policy circles about problems extending beyond its politically problematic handling of affordable lending obligations: the bill was too “complicated”; there was a high risk that the private sector wouldn’t show up with the very large amounts of capital required to finance the envisioned mini-GSEs; the transition to the new system could be rocky, causing collateral damage to homeowners, to the housing construction and lending industries, to the economy as a whole, and thus also to the electoral prospects of the bill’s supporters.

The State of Play in GSE Reform: 2016, and the Narrowing Funnel

In mid-2016, to fulfill a request by the FHFA, Freddie Mac’s Board of Directors and management produced a comprehensive review of the ideas for GSE reform prominent at the time, with the pros and cons of each. They identified five prevalent GSE reform models:

> *Lender cooperative(s).* In this model, mortgage lenders would cooperatively own one or more[15] new GSEs that would succeed Freddie Mae and Fannie Mae. The notion was that primary market lenders, then, would control their own secondary market access, eliminating the friction between the two.
>
> *Government corporation*. A single, government-owned company would do the work now done by Freddie Mac and Fannie Mae (largely by taking them over and combining them). The example of the federal government’s success in creating the Tennessee Valley Authority in the Great Depression was cited by this idea’s promoters.
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> *Pure free market.* This was (and still is), not surprisingly, a favorite of the very conservative think tanks and some Tea Party elected officials, and consists of fully winding down the two GSEs, but in an orderly fashion to accommodate private capital markets – via securitizations and bank lending – to fully take up the slack over time.

[15] It was unclear if there would be a single such cooperative or more.

Mini-GSEs in competition. Despite the Corker-Warner bill's failure, its underlying model was still prominent: the two existing GSEs should be wound down and replaced with a new group of smaller but similar guarantors enjoying the support of the government so as to protect the 30-year fixed rate mortgage. The quiet criticism of the Corker-Warner bill had indeed been quiet, so there was still a lot of hope the model could somehow be made to work.

Regulated utilities. The two GSEs would be retained as is, but would be subject to a newly created utility regulation regime, where pricing and products would require regulatory approval, much as an electric utility's rates and "terms of service" are approved by a state public service commission. This idea was not, as far as I can recall, mentioned at all – and certainly not prominently – until well after 2014; even in mid-2016, when Freddie Mac's Board did this work, it was just beginning to be talked about.

These five prominent models for GSE reform either had gone or would go through a policy "funnel" to see which could get strong enough support to make its way into legislation. By early 2019, only two basic proposals remained, both of which build upon the existing two GSEs. This winnowing of policy ideas is a messy, even chaotic process. But in the case of GSE reform, I was able to observe three key elements of the process:

Informal peer review among housing finance policy experts. As the sponsors of the five models – and variations on them – wrote and spoke to other members of the housing finance policy community, did they gain adherents and convince others to proselytize on the idea's behalf, or were they largely ignored? To gain adherents, an idea must do some combination of the following: (1) appear to actually solve the problem, (2) appeal to a person's political ideology, and/or (3) appeal to a person's economic and political interests (or sympathy with the interests of others). In short, there is often a selling process for an idea – the world may beat a path to the proverbial better mousetrap, but not to a better policy solution. Repetition in article after article and at conference after

conference is absolutely in the playbook of the sponsors of ideas as they seek to advance them. "What works best" is not guaranteed to win this race – ideological and economic interests are ever-present.

Industry and technocratic feedback. Many members of the housing finance policy community deal at a relatively abstract level. They often do not have the detailed expertise to know what reasonable-sounding idea would actually work well or be the source of immensely bad "unintended consequences." So, they need feedback from the subset of the policy community and others who have expertise at the boots-on-the-ground level – that is, from technocrats and industry members.[16]

Catching the eye of the right person in power. The objective of all the winnowing steps above is to catch the eye – and support – of a policymaker who has the power to turn an idea into actual legislation or regulation or government action, i.e. lobbying. Such a policymaker might be an administration official or one of the relevant members of Congress, such as a committee or sub-committee chair or ranking member. Getting the attention of such a person is obviously a process hard to predict or control.

The five ideas listed above went through this winnowing process – which amounts to a giant scramble for "mindshare." Below, I describe the obstacles encountered by each during this process, which has done a reasonably good job of eliminating the weaker ideas and, as of today, has left just two contenders.[17]

Lender cooperative(s). While appealing because it was a "cooperative," which seems to be an idea both Democrats and Republicans were willing to support, this idea was also – in comparison to Corker-Warner – a low-risk proposal, as the big change would mainly

[16] While industry members have specific and valued expertise, they also are likely biased by their bottom-line economic interests. Thus, their recommendations and views must always be considered with caution.
[17] These two contenders represent very much just today's lay of the land. There are always individuals pushing new or even old ideas, looking to somehow find a sympathetic ear among policymakers.

be in who owns the GSEs, rather than in how they operate. But the proposal had not adequately considered the issue of capital. That is, to run their operations, the one or more cooperatives were going to require capital of at least $100 billion in aggregate, a huge amount of money. Since the cooperatives would not be public companies with their own access to the stock market, that capital would have to come from the member/owners.[18] Non-bank lenders, who originate mortgages to sell quickly to the GSEs or others, have no such financial capacity to then contribute capital to support the credit of those mortgages for a decade or more, so they were against the idea. Small bank lenders could in theory provide that capital but not all that easily (and bank capital requirements on the equity investment would be quite high), so they were against it. Interestingly, even the large banks (an industry official told me) did not want to provide the capital. And the idea thus fell from favor shortly after.[19]

Government corporation. This idea, still alive today, had three big flaws. First, there was the issue of the $100 billion or more worth of capital needed. To avoid the taxpayer having to put that large amount in, the most publicized version of this proposal[20] made it a free lunch via a "creative" approach that did not find adequate support.[21] Second, Republicans and, I would guess, many others did not want a vehicle that was likely to be even more politicized than the historic GSE system, and the precedents of other

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[18] As a rough estimate, a primary mortgage lender would have to put up as capital about 2 percent of the outstanding principal balance of all the mortgages that lender had originated and which were still outstanding.

[19] But in an example of how special interests work in Washington, when this capital problem became apparent, I recall a few industry people did try to come up with a solution in which the government would take the GSEs' earnings over many years to build up the $100 billion-plus and then donate it to the cooperative. Needless to say, this "gift" of ballpark over $100 billion from the taxpayer to the bank and non-bank lenders was not a well-received idea.

[20] Jim Parrott, Lew Ranieri, Gene Sperling, Mark Zandi, and Barry Zigas, "A More Promising Road to GSE Reform," The Urban Institute, March 2016, https://www.urban.org/sites/default/files/publication/79771/2000746-A-More-Promising-Road-to-GSE-Reform.pdf.

[21] I personally view the proposed "creative" capital structure as being technically very troublesome, resulting in a well-disguised version of classic undercapitalization. It has no common equity (so that the taxpayer does not need to put money into the corporation to capitalize it, which makes it more politically attractive) but instead relies upon credit risk transfer and preferred shares for all its capital. Credit risk transfer, according to all measures used today by the GSEs and the FHFA, cannot provide anywhere near a full substitute for common equity, and such heavy usage of preferred shares runs directly counter to bank regulatory practice, which limits the usage of preferred shares to roughly one-sixth of equity capital.

government-run financial corporations made that a serious worry[22] as it just facilitated congressional interference in pricing and other economic decision-making. And third, the lending industry did not generally like the idea of being subject to a monopoly, and a government-run one to boot, as that looked like a recipe for poor service and lagging technology going forward. As a result, this idea's support remained limited – mainly to its proposers; even its target audience of elected officials of more extreme liberal views did not, that I can recall, speak up in support of it in any material way. So, this proposal never really got major traction.[23]

Pure free market. There has been a small group of very conservative individuals who long have criticized the GSEs (with much justification prior to conservatorship). These individuals prefer small government, and the GSEs definitely come from a tradition of big government. Since conservatorship began, they have steadily called for the wind-down of the two companies, or anything materially heading in that direction, arguing that the private capital markets will just take up the slack and everything will be fine. They received support during the years in question from Jeb Hensarling (R-TX), then the chair of the House Financial Services Committee (HFSC), considered a Tea Party Republican. In July 2013, Hensarling even proposed a specific bill (the Protecting American Taxpayers and Homeowners Act, or PATH Act) calling for the virtual elimination of Freddie Mac and Fannie Mae. But even the Republican leadership of the House found it too extreme because it was likely too disruptive to homeownership, and so even though the House was under the control of a Republican majority, the bill was never introduced for a full vote. The idea of a "pure free market" to replace the GSEs seems to always be around, but has been and is unlikely to get mainstream support because too few policymakers are willing to take the risk of homeownership disruption on the blind faith that private capital markets will be able to replace the GSEs without

[22] For example, the Pension Benefit Guaranty Corporation currently is reported to have a deficit of $54 billion.
[23] Given the current drift of politics in the race for the Democratic nomination for president, one can see a lot of sympathy for a government corporation, as so many of the leading candidates seem to be pursuing brands of being against large for-profit corporations. So, some version of a government corporation concept could potentially get new life breathed into it.

painful change (e.g., much higher rates, the loss of the 30-year fixed rate, etc.) to the electorate.

Mini-GSEs in competition. As I described above, substantive criticisms of this model emerged after the Corker-Warner bill's failure. There were significant technical issues with the complexity of the approach; it was too dependent upon new guarantors actually showing up (and it wasn't clear what would happen if they did not); the transition was quite risky to the national economy. This model has garnered much support, but still has not dealt with those criticisms.

Regulated utilities. I do not recall this model being discussed at all prior to 2014, as the thrust to "wind down" the GSEs had been so strong. The first time I recall its being prominently and publicly aired as a path forward, and not just quietly discussed among policymakers, was when the FHFA director at the time, Mel Watt, sent a letter to Senators Crapo and Brown, at the request of the latter, in January 2018.[24] The letter suggested a low-risk GSE reform, with the two companies continuing in existence (although more were allowed to enter and compete, if there was ever interest in doing so) but becoming regulated like electric utilities – that is, their prices and major ways of doing business would be subject to regulatory approval. Unlike many of the other proposals, because it just layered utility-style regulation onto what existed already, this model didn't have any noticeable Achilles heels: transition was non-disruptive, there was no depending upon new guarantors showing up without any assurance they actually would, and so on. The idea began to gain significant momentum, especially in the mortgage industry which, since any disruption would be at its expense, was motivated to support low-risk solutions. This momentum reached a decisive point in February 2019 when the National Association of Realtors (NAR), with the support of many other housing and housing finance industry associations, put out its "A Vision for

[24] Federal Housing Finance Agency, "Perspectives on Housing Finance Reform," January 16, 2018, https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FHFA-Perspectives-on-Housing-Finance-Reform.pdf.

Enduring Housing Finance Reform," which very strongly called for a regulated utilities approach.[25] As the NAR is listed as the second-highest-spending lobbying group in Washington, this was very powerful backing.[26]

So, the result of this funnel, the winnowing down of the policy ideas through early 2019, was that the "cooperative" idea had faded away because of the issue of capital, and the "government corporation" and "pure free market" concepts were just too narrow and too partisan in their appeal to garner broad support.

That left standing two approaches: the "mini-GSEs in competition" and the "regulated utility" models. But, of course, the "mini-GSEs in competition" model still had to grapple with the problems described above.

That was the "state of play" at the beginning of 2019, with the policy funnel having done its work in the years since the failure of Corker-Warner in 2014.

Senator Crapo's "Housing Reform Outline"

In addressing the core weaknesses of the "mini-GSEs in competition" model, members of the housing finance policy community often had multiple objectives. Naturally, they wanted to try to solve the problem and make "competition" work.[27] But the reality is that those who work for think tanks are almost always bound to develop and support an approach that ideologically matches the brand of that think tank (and its funders). Those who work for industry associations are similarly bound to develop and support an approach that fits the economic

[25] National Association of Realtors, Richard Cooperstein, Ken Fears, and Susan Wachter, "A Vision for Enduring Housing Finance Reform," February 7, 2019, https://www.nar.realtor/fannie-mae-freddie-mac-gses/working-paper-nar-s-vision-for-housing-finance-reform.

[26] Per the Center for Responsive Politics. Also, the NAR had members in every House district and every state, and so is relevant to every single member of Congress.

[27] The primary mortgage market, with over a thousand lenders who deal with the two GSEs, is highly competitive. The issue at hand is making, or not, the secondary market a normal competitive one. The secondary market organized around securitization (as opposed to bigger banks buying mortgages from smaller firms) was never competitive in this normal manner, as it had effectively been created by the US government.

self-interest of the particular industry. So, the whole process is very convoluted and not necessarily very effective.

Senator Crapo, as chairman of the Senate Banking Committee, who stated multiple times in public that he wanted to pass legislation for GSE reform, faced a decision. Unlike the policy professionals, he was an actual policymaker with power. As such he had a choice: he could stick to the ideology of his party, which called for the full wind-down of the two GSEs as part of any solution, erasing the entities and names Freddie Mac and Fannie Mae forever; this option would likely never become legislation, although him proposing it might score political points. Or, he could go with pragmatism to get something actually passed that actually worked.

And he went pragmatic – although not quite totally!

On February 1, 2019, Senator Crapo introduced his two-plus-page, single-spaced "Housing Reform Outline."[28] The core of this plan is the same "mini-GSEs in competition" model that was at the heart of Corker-Warner. But Senator Crapo and the staff of the Senate Banking Committee had clearly understood the weaknesses of that business model, especially the "build it and hope they will come" risk in eliminating the existing GSEs without any assurance that multiple new guarantors would actually show up in the required number and size – and so *he jettisoned the "wind down the GSEs" policy that had been at the core of all previous similar proposals*.

This shift is of major importance. The Republicans had previously been adamant that the two existing GSEs be wound down, but it was just proving too hard to design a reform plan that both fulfilled that requirement and seemed likely to work going forward without undue risk to homeownership. Senator Crapo's outline therefore just allows Freddie Mac and Fannie Mae to

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[28] Senator Mike Crapo, "Housing Reform Outline," https://www.banking.senate.gov/imo/media/doc/Housing Reform Outline.pdf.

be the first two of the multiple guarantors that would compete for business among mortgage lenders.

Instead of wind-down, *the Crapo outline thus keeps the two GSEs and builds upon them*.

The remaining Achilles heel of the Crapo outline, where the Senator did not go fully pragmatic, is his call for a forced shrinkage of the market share of the two existing GSEs. The outline gives a to-be-specified timeframe for a to-be-specified maximum market share for each, with the goal of somehow "forcing" new guarantors to show up.[29] But it does not say anything about how to deliver such a forced shrinkage and new entrants successfully competing for business.

If the arrival of these new entrants was uncertain for Corker-Warner, it is even more uncertain in the Crapo outline, because in the former such new guarantors would just be competing with other new entrants; in the latter, though, they would be competing with the large and well-entrenched Freddie Mac and Fannie Mae. As I have argued elsewhere, the barriers to new entrants being successful in such competition are fundamentally insurmountable.[30]

A senior Treasury official, commenting to me upon the Crapo outline, said that it was not possible in reality to force such a shrinkage in market share because one could not force new entrants to show up. All that could actually be done was to make it as easy as possible for such new entrants to show up, but a reform plan could not be dependent upon it.

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[29] Both the timeframe and the market share are indicated by "XX" – i.e., to be determined later – in the Crapo outline.

[30] Don Layton, "How Deep Is the 'Economic Moat' Around the Two GSEs?" Joint Center for Housing Studies of Harvard University, September 2019, https://www.jchs.harvard.edu/sites/default/files/harvard_jchs_how_deep_is_the_GSEs_economic_moat_layton_2019.pdf.

So, the Crapo outline has that flaw – it requires the two existing GSEs to have smaller market share, but has no means by which to force such a change. The market will therefore likely, in my view, remain a duopoly – a market situation that requires utility-style regulation to prevent implicit collusion in setting prices (i.e., guarantee fees) too high.[31]

The GSE Regulated Utility Model[32]

As I wrote above, the reputation of the GSEs began to improve in the mortgage industry, if not with all sectors of Washington, through the years of conservatorship after the foreclosure crisis had peaked and began its decline in 2012 and 2013. Not only were the bad years more distant in the rearview mirror, but the reforms made during conservatorship began to take hold and become appreciated. The companies, freed from their historic heavy focus on lobbying to keep their hidden subsidies, began instead to focus primarily on truly competing for business, introducing new technology that reduced the costs and paperwork burden on lenders, and managing risk better (especially by developing and implementing credit risk transfer, so they were not just piling up massive concentrated mortgage credit risk anymore). The shrinkage of their excessively-sized investment portfolios was implemented smoothly. And the FHFA put out a credible capital requirement proposal (still outstanding and unfinalized) that addressed the companies' historic undercapitalization, with all the risk and taxpayer exposure that had engendered. All around, they were becoming more like well-run commercial enterprises than they probably had ever been, and the mortgage industry saw that – and liked it.

[31] I am focused on the core structure of the Crapo outline. It also has a long list of specific features, many of which are reasonable. But some are highly controversial and politically sensitive features that are inconsistent with the core pragmatism of the bill or which will be deal-breakers to Democrats (such as substituting a fee for affordable lending requirements, a policy which the Democrats now are fully against).

[32] A regulated utility approach consists of the following: the utility runs as a shareholder-owned company earning a return on its capital, but there is a government agency – usually called something like a "public service commission" at the state level – that regulates its "pricing and terms of service" in the public interest. To ensure that the regulation is balanced, the enabling legislation requires that the utility be permitted to earn a "fair return" on its capital. There is a formal process for applying for pricing changes, the regulator gets involved in monitoring quality of service, and so on. This approach has existed for about a century or more in all 50 states, and also in many localities, and despite some ups and downs, historically it is considered to do a decent job of having a public service be delivered by a private company. It is best known for being used by electric utilities and also many water systems (thought of as natural monopolies); an interesting non-monopoly area where it is also used is in street-hail taxis: you don't have to haggle over what you will pay because there is already a rate on the taxi meter that has been established so as to deliver a "fair return" to the taxi's owner.

After all the years in which the GSEs had been politically toxic, the mortgage industry, and especially smaller lenders, began drifting toward a policy focus which had at its core a concept of "let's just fix what's wrong with the two GSEs, and then move on." There are more than a thousand smaller lenders that deal with the two GSEs, and there are several industry associations representing them in Washington. A senator at a meeting I attended back in 2014 said that "everyone – both the R's [Republicans] and the D's [Democrats] – loves small lenders." So, they are a reasonably influential force in DC. And all those proposals for major business model change in the housing finance system via legislation had been making them very nervous. As I wrote in *GSE Reform: None or Mostly Done?,* big changes make "big waves which swamp small boats," and smaller lenders were very worried they were the small boats that would get swamped. Big change was potentially an existential threat to them.

The industry's support for preserving the existing GSEs became publicly visible when, in June 2017, the "Main Street GSE Reform Coalition" – comprised of two small lender associations, various community housing groups and a home-builders industry association – called for the recapitalization of the GSEs so they could eventually exit conservatorship, meaning the "wind-down" policy had been abandoned.[33] But this coalition did not follow to the logical conclusion that a regime of utility regulation – to prevent price collusion, among other undesirable results – would therefore be required.

This next logical step was taken half a year later in then-FHFA Director Mell Watt's January 2018 letter to Senators Crapo and Brown, which called explicitly for regulation of G-fee pricing by the FHFA so that the guarantors would earn a "fair return" – the standard phrase used in public utility regulation at the state level.

Support for the regulated utility approach became fully mainstream a year later, when the NAR issued its "New Vision" in February 2019. This vision was centered on turning the GSEs

[33] See the summary of their "principles", which includes that specific recommendation for recapitalization – https://www.communitylender.org/main-street-gse-reform-coalition-common-gse-reform-principles

into “government-chartered” and “shareholder-owned regulated utilit[ies].” It built upon the basic pre-conservatorship system of the two companies. However, it called for strong regulation of the GSEs by a specifically empowered FHFA, and for the continuation of fixes implemented during conservatorship (e.g., adequate capital requirements) that had successfully addressed the defects and unintended consequences of the historic GSE system. More than just calling for a regulated utility approach, though, the document attempts to strongly counter the notion that the GSE secondary market is somehow a normal market in which competition in the ordinary manner makes sense. It eloquently explains that the two GSEs are not just profit-maximizers working in a competitive marketplace: they are two firms operating a duopoly in a stockholder-centric, for-profit environment, but they are also carrying out a “public mission” to provide liquidity to the primary market, with advantages and limitations via their charters. Their special status, the paper argues, requires a careful balancing act that only utility-style regulation can deliver.[34]

Coming from one of the most influential political constituencies in DC, the NAR’s support for the regulated utility approach, rather than for a wholesale revamping of the housing finance system, carried immense political weight.[35] And NAR got many housing- and housing finance-related groups to say favorable things about their plan, so it became even more influential than it originally appeared.

The regulated utility approach seemed very practical and common-sense in its way. Its proponents pointed out the very low risk of transition and its relatively easy implementation; it could keep the market working without depending on the hoped-for entry of new competitors funded by the private sector. Furthermore, because old problems had been successfully addressed, the risk of their re-appearance was now felt to be much diminished, especially

[34] While this paper addresses issues for legislative reform, the concept of administrative reform – not publicly discussed until 2017 and 2018 – is automatically aligned with the public utility approach. That is because, with just two guarantors by the historic legislation, the potential for implicit price collusion is just too high.
[35] Interestingly, the NAR document did not explicitly come out against potentially chartering a third (or more) GSE; it was just silent on the matter. However, because it focused solely on the two existing companies, a duopoly seemed to be clearly implicit in its proposal.

compared to the risks involved in some dramatic new approach, which could (and likely would?) start all over again the cycle of unintended consequences and politicization.

Finally, the regulated utilities approach could be pursued by *both* legislative and administrative means, perhaps with an administrative reform being a down-payment on future legislation that could fill out the approach in certain key ways (e.g., by giving the FHFA the authority, via legislation, to act as a utility-style "price and terms of service" regulator in addition to its existing safety-and-soundness remit).[36]

The culmination of this evolution – the total abandonment of the "wind-down" policy and the adoption of the regulated utility approach, preserving the two existing GSEs – occurred when Senator Brown, in the September 10 hearings on the Treasury's just-released housing reform plan, called the regulated utility approach part of what he understood to be a consensus solution – and indicated his own support for the approach.

Later in the hearings, even though Treasury had not included a single word about the regulated utility approach in its reform document, Secretary Mnuchin indicated he was willing to work with the Senator on exploring it.

Conclusion and a Compromise

The secondary market for mortgages, in the eyes of those supporting an "add competitors" policy, is one where government – between the two GSEs and the FHA (and VA) – has crowded out the private sector. But I believe this view has the history backwards: the secondary mortgage market was overwhelmingly created by the government and consequently the market developed to take advantage of that government role and support. In fact, the entire trading of MBS (especially the famous "TBA" – to be announced – market) and the pricing of it that underlies relatively inexpensive mortgage rates (including the 30-year fixed rate and free

[36] Until that happens, the FHFA can act as such a utility-style regulator under an amended PSPA, whereby the two GSEs agree to subject themselves to that regulation in exchange for support of their obligations by Treasury.

prepayment) depends upon that government support so that MBS can be pure interest rate risk securities, while the credit risk is managed separately (originally by being kept on GSE balance sheets, and now mostly via CRT).[37] The secondary mortgage market was never dominated by the private sector; why should anyone expect it to be in the future?

The long and winding policy process thus seems largely to be coming down in the right place. The regulated utility model is the only one that seems likely to work properly. It reflects the government's historical role in the secondary market, and it pragmatically solves the problems of that market in a relatively low-risk fashion.

Although the January 2018 letter from FHFA Director Watt to Senators Crapo and Brown called for the regulated utility approach, it never said that there would be just Freddie Mac and Fannie Mae. The FHFA document left open the possibility that others would emerge to compete. It did not *require* them to do so, but it provided avenues (some call them "on-ramps") for them to do so. Unlike Senator Crapo's outline, then, which mandated that others emerge to compete (I am still flummoxed as to how Congress thinks it can mandate something like this), Director Watt's recommendation was that it be *allowed* to happen – but if it did not, things would work fine anyway.

Later on, in early 2019, a senior Treasury official said the same thing to me – let's allow others to emerge, but move forward regardless as they might not.

And that is the compromise that seems ready to be had where both parties can claim a victory.[38] Combine the regulated utility approach liked by Senator Brown and the industry with

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[37] One industry representative was quoted to me as saying "I am not interested in what someone thinks the mortgage system should look like if we were starting all over again." Those who envision a private-sector secondary market are doing just that. Maybe the TBA market, which is dependent upon government support of the GSEs, should never have been developed – but it is now core to the markets, and losing it is considered by almost all groups involved in housing finance to be a bad idea.

[38] There are, of course, additional issues about which there can be significant disagreement in Congress. Two major ones are (1) the social obligations on the GSEs, where the Democrats like what exists today while the Republicans wish to replace it with an additional simple fee to the government, and (2) the Crapo proposal to use Ginnie Mae

the multi-competitor approach proposed by Senator Crapo, *but just do not mandate that the competition must emerge* (as it is seems very unlikely to do so). This combined approach can be the guiding light for GSE reform via administrative means (with obvious limitations on what can be changed) and also later via legislative means (where many more things can be changed). In fact, if the conventional wisdom in DC is accurate in its belief that legislative reform is not in the cards for at least several years, *the regulated utility approach is the only one really consistent with reform by administrative means anyway!*

I also believe a change of language may help everyone understand exactly what is going on. In the Crapo outline model, the competing firms are, as much as possible, normal for-profit companies. But in the regulated utility model that Senator Brown supports, the NAR document makes it clear they are not such normal for-profit companies. Instead, they are a particular case of what is sometimes called a "public benefit corporation," which is defined as "a type of corporation that allows for public benefit to be a charter purpose in addition to the traditional corporate goal of maximizing profit for shareholders."[39] Given the history of the GSEs, it is pretty clear that, from the first day when Fannie Mae was privatized fifty years ago, they were always meant to be public benefit corporations.

So, let's call this the "public benefit regulated utility" approach, and let's have "on-ramps" to allow other competitors to emerge (while fully recognizing that this likely will not happen).

This pragmatic, politically viable approach is ready to go, if Washington will just grab it and run with it.

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to issue the GSEs' mortgage securities, which is considered eccentric and impractical by the industry but which is liked by certain housing finance policy individuals known for conservative ideology.

[39] Public benefit corporations are sometimes called public policy corporations.