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Before the Subcommittee on Capital Markets and Government Sponsored Enterprises

"Legislative Hearing on Immediate Steps to Protect Taxpayers
from the Ongoing Bailout of Fannie Mae and Freddie Mac"

March 31, 2011

Christopher Papagianis is Managing Director and Policy Director at e21: Economic Policies for the 21st Century. e21 (also known as Economics21) is a nonprofit, nonpartisan organization dedicated to economic research and innovative public policy development. Mr. Papagianis was previously Special Assistant for Domestic Policy to President George W. Bush. In this role, he guided the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development. He briefed the President primarily on housing and finance issues. Prior to joining the administration, Mr. Papagianis worked in the U.S. Senate as one of the top policy advisers to Senator Jim Talent. Mr. Papagianis helped the Senator develop housing and public finance policy. Before serving in the U.S. government, Mr. Papagianis was awarded the prestigious Peabody Fellowship by Harvard University to pursue research related to public policy issues. Mr. Papagianis is a graduate of Harvard College.

Chairman Garrett, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to testify on the important topic: "Immediate Steps to Protect Taxpayers from the Ongoing Bailout of Fannie Mae and Freddie Mac." I am the Managing Director of the non-profit think tank e21: Economic Policies for the 21st Century (a.k.a Economics21). We aim to advance free enterprise, fiscal discipline, economic growth, and the rule of law. Drawing on the expertise of practitioners, policymakers, and academics, our mission is to help foster a spirited debate about the way forward for democratic capitalism. We are supportive of free markets while recognizing the need to devise and implement a reasonable structure of law and regulation that will help ensure our markets avoid catastrophic events in the future. We are therefore focused on developing policies that advance market performance and implementing rules to prevent market malfunction.

Previously, I was Special Assistant for Domestic Policy to President George W. Bush. In this role, I helped guide the collaborative process within the Executive Branch to develop and implement policies, legislation, and regulations across numerous agencies, including the Departments of Treasury and Housing and Urban Development.

Fannie Mae and Freddie Mac have been in conservatorship now for the past 30 months. Over this period, numerous proposals have been offered for how to reform, or re-envision, the government-sponsored enterprises (GSEs).[1] Given how dominant Fannie and Freddie are in terms of market share today, reform of these institutions will have a significant impact on the future of the $11 trillion market for residential mortgage finance.[2] In short, the stakes are quite high – and I agree with this committee's approach in assessing long-term solutions while at the same time considering reforms that can be advanced in the short-term to protect taxpayers.

Importantly, some of the proposals before this committee, if enacted, would accomplish two distinct things. They would protect taxpayers in the near-term and the implementation experience would provide invaluable lessons and data that could inform the broader debate about the future of housing finance in this country.

Before commenting on the individual proposals, I want to describe briefly what I think is the key analytical challenge before this committee – namely, that the most egregious excesses of the previous GSE model are not necessarily the primary sources of taxpayer losses (so far). The key take-away from this, I believe, is that there is still a lot of taxpayer risk in the GSE system. This means that near-term reform proposals can have important benefits even if they do not get at the root cause of most of the GSE losses over the past few years.

For example, the first instinct of many reformers would be to ensure that the GSEs (or their successors) are never again allowed to amass big mortgage portfolios. The second instinct

[1] A white paper released last month by the Treasury Department outlined three options.
[2] Federal Reserve data: http://www.federalreserve.gov/releases/z1/current/z1r-4.pdf

would probably be to strictly limit the mortgages that would qualify for purchase (or guarantee) by the GSEs.

Both of these reforms make sense – and should be pursued today. At the same time, addressing just these two issues now would not "fix" the problem with the GSEs or make the GSE model sustainable in the long-term. Of the GSEs' combined $226 billion in losses, over $166 billion (73%) are from the guarantee business.[3] The investment portfolio accounts for just $21 billion (9%) of the losses. Had the investment portfolios been eliminated, in say 2005 as proposed by some in Congress, the GSEs would have still suffered losses from guaranteed mortgages that would have wiped out their capital base several times over.

But, in seeing that over 70% of the losses came from mortgage guarantees, one might reasonably ask why wouldn't better limits on the types of mortgages that are accepted be the right way to go to protect future taxpayers? Again, I want to be clear that advancing this sort of limitation now would make for a sound near-term reform to protect taxpayers. But, just like with the mortgage portfolios, it's also important to acknowledge that restricting the types of mortgages that are accepted will not address the fundamental flaw (or question) in the GSE model: how exactly to accurately price the insurance – or what amounts to the cost of providing a government guarantee?

Put another way – for many, the challenge ahead appears to be designing a strategy to maintain a government guarantee for mortgage credit risk while attenuating some of the more egregious elements of the old GSE model. The problem with operating under this framework is that it was the mispricing that arose from the government guarantee that really turned out to be the big source of taxpayer losses. The argument for *only* limiting the types of mortgages that qualify presumes that the government or its agencies can accurately price the baseline credit risk and were just unable to price the incremental risk posed by lower FICO scores, higher loan-to-value ratios, or nontraditional payment features. In reality, pricing the baseline credit risk is every bit as difficult as pricing the relative increase in risk posed by nontraditional features.

It's for this reason that the most promising path for Congress appears to be putting the GSEs into receivership with the goal of liquidating their operations over a 5 to 7 year period. Any shortfalls would continue be covered by taxpayers so no creditor loses anything in a wind-down or is tempted to sell their securities. In the future, Congress would keep Federal Housing Administration (FHA) mortgages available for borrowers under certain income and mortgage loan thresholds and leave the rest of the market to the private sector.

The likely result would be higher mortgage costs generally, as the old (mispriced) government guarantees would be paid for by mortgage borrowers (upfront) instead of by taxpayers (over the

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[3] Federal Housing Finance Agency. Conservator's Report on the Enterprises' Financial Performance. Second Quarter 2010. http://www.fhfa.gov/webfiles/16591/ConservatorsRpt82610.pdf

long-term). But, as the Treasury department commented in their recent white paper: "mortgage rates are likely to rise somewhat under any responsible reform proposal."[4] If Congress wants to offset some of this cost increase, it has options[5] – it could explore ways to explicitly subsidize low-income borrowers through on-budget housing programs or through mechanisms like interest rate swaps.[6]

Mortgage Portfolios

Both GSEs issued debt with an implicit guarantee to build massive portfolios of the same mortgage-backed securities (MBS) they issued. Once a pool of mortgages was converted into GSE-guaranteed MBS notes, there was no need for them to then issue additional debt to repurchase the guaranteed MBS.

As argued by former Federal Reserve Chairman Greenspan and others, these portfolios served "no credible purpose"[7] aside from serving as a profit center for GSE shareholders and management. The profits came from the huge gap between the yields on mortgages and the interest rate Fannie and Freddie paid on their own borrowings, which was just slightly greater than Treasury rates thanks to government sponsorship (and the implicit guarantee of GSE debt).

The large investment portfolios made only modest contributions (at best) to reducing mortgage rates and improving liquidity. They did, however, create massive risks. For every $100 of mortgages added to the portfolio, the GSEs committed just $3 of equity capital, borrowing the remainder. Even this $3 per share was overstated because the GSEs could count deferred tax assets and "temporary" reductions in the market value of securities as capital. The risk was that a sudden increase in interest rates[8] could wipe out the GSEs' notional capital, or a sudden fall in interest rates could set off a wave of refinancing, causing the interest income on the new

[4] Reforming America's Housing Finance Market: A Report to Congress. February 2011. http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf

[5] Papagianis, Christopher. Testimony before the House Financial Services Committee. September 29, 2010. http://financialservices.house.gov/Media/file/hearings/111/Papagianisl092910.pdf

[6] Calomiris, Charles. Columbia University, Graduate School of Business. A Three Part Program for Housing Finance Reform. October 12, 2010. http://shadowfed.org/wp-content/uploads/2010/10/Calomiris-A-Three-Part-Program-for-Housing-Finance-Reform.pdf

Date, Raj. Cambridge Winter Center. A Framework for Evaluating Housing Finance Alternatives. August 18, 2010. http://cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/8/18_GSE_DECISION_TREE.html

[7] Greenspan, Alan. Federal Reserve Chairman. Remarks to the Conference on Housing, Mortgage Finance, and the Macroeconomy. May 19, 2005. http://www.federalreserve.gov/boarddocs/speeches/2005/20050519/

[8] Papagianis, Christopher. Economics21. The GSE Black Hole. November 19, 2009. http://www.economics21.org/commentary/gse-black-hole

mortgages to fall below the cost of existing borrowings. In short, the GSEs had far too little high-quality capital to serve as a buffer in front of taxpayers.

The future of housing finance in this country should not involve the GSEs (or their successors) building up big portfolios. Removing portfolios from the current equation would leave the GSEs buying and guaranteeing mortgages, converting the mortgage payments to guaranteed cash flows from MBS notes, and standardizing MBS notes to enhance investor acceptance and market liquidity.

In this world, the investors in GSEs (or the government) would capture the guarantee fees on the mortgages and pass through the rest of the mortgage payments to investors in the MBS. Under Section 1109 of the Housing and Economic Recovery Act of 2008 (HERA), the GSEs are set to reduce their mortgage portfolios by 10% a year until they reach $250 billion. At that point, no further reduction in the maximum limit is currently required.

The combined value of the portfolios today is ~$1.5 trillion. Through the 1990s, the portfolios as a share of the total number of U.S. mortgages outstanding stayed below a 6% market share. By 2000, they reached a market share of approximately 19%, but then fell back down to a 12% share by 2009.[9] These numbers are useful because they reveal just how dominant market investors and commercial banks are in terms of *holding* U.S. mortgage assets (88%). Therefore, it should not be difficult for market investors and banks to take-up the market share of the GSEs if they are directed to accelerate sales from their portfolios.

It's important to remember that basically all mortgage investments originate in the capital markets. They can be funded through deposits, GSE retained portfolios, private MBS investments, or covered bonds. In general, when one access point is limited, growth in another channel can usually provide the offset. Professor Dwight Jaffee of the University of California at Berkley has made this point before. He has also noted that as the "GSE retained mortgage portfolios run off, so will the debt that funded these portfolios…[and] the investors in this debt are thus one example of a set of investors who could replace the GSEs as mortgage holders."

Limiting New Activities and Mortgage-types

New limits should be implemented on the mortgages that would qualify for purchase (or guarantee) by the GSEs. This seems to be precisely what the Obama Administration has in mind, as the maximum mortgage that would qualify for purchase would be $625,000, down from the largely non-binding current cap of $729,000.[10] Since the government provides a subsidy when it

[9] Jaffee, Dwight. University of California, Berkley. Reforming the U.S. Mortgage Market Through Private Market Incentives. January 31, 2011. faculty.haas.berkeley.edu/jaffee/Papers/JaffeeMortgageReform.pdf
[10] In the Treasury Department's white paper, the Administration expressed that it would like to see Congress let the law (HERA) that temporarily increased the loan limits to expire, as it's scheduled to do on October 1, 2011.

allows a mortgage to have a guarantee, the question is whether this subsidy with its attendant cost should be provided to people buying homes with $700,000+ mortgages?

In addition, the GSEs should be blocked from engaging in any new activity or business that would further risk taxpayer dollars. This should include restrictions on the types of assets they can buy or guarantee, as well as strict limits on plans that would commit taxpayer dollars to try and prevent, or delay, foreclosures. On this later point, FHFA should have to present any new plans to Congress so that it can make its own determination, especially in instances where actions may help some homeowners at the expense of others. It would also be useful if the FHFA would present Congress and its scorekeepers with more data to estimate the effectiveness of mortgage modification programs. Currently, many modification programs are scored as reducing ultimate taxpayer losses from delinquent mortgages in spite of evidence that re-default rates are 58% after twelve months in the case of loans modified in the third quarter of 2009.[11]

The affordable housing goals for Fannie and Freddie should also be eliminated. There are other avenues through which support for affordable housing activities can be carried out, including through the Department of Housing and Urban Development and the Federal Housing Administration. One of the lessons from the crisis is that public subsidies for affordable housing or higher risk lending should be subject to the regular checks-and-balances of Congressional oversight and appropriations.

Guarantee Fee Pricing (G-Fee)

The reforms highlighted above would have made for a solid GSE reform agenda back in 2005. The data and lessons from 2006 until conservatorship demonstrate that more needs to be done now to protect taxpayers (both in the near term and long term) – and that takes us to the fundamental issue of how to price the insurance or what's known as the mortgage guarantee.

The conforming mortgage limit was $417,000 when the GSEs rapidly expanded acquisitions of subprime and Alt-A mortgages in 2005-2007. The average mortgage purchased by the GSEs is still about $217,000.[12] While it makes sense to limit government involvement to more modest mortgages moving forward, the loan limit issue is less about protecting taxpayers and more about ensuring that ongoing subsidies are properly targeted (and aren't captured by affluent borrowers).

Perhaps the best way to understand the pricing problem is to review the credit risk of some of the highest quality mortgages guaranteed by the GSEs (where quality is based on FICO,

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[11] Fannie Mae 2010 Credit Supplement. January 24, 2011. See slide 16: http://www.fanniemae.com/media/pdf/newsreleases/q42010_credit_summary.pdf

[12] Fannie Mae Earnings Report. 3rd Quarter 2010. See page 84: http://www.fanniemae.com/ir/pdf/earnings/2010/q32010.pdf

downpayment, and other measures of a borrower's ability to pay). To unpack the data, a good place to start is Fannie Mae's monthly funding summary from December 2010.[13] It shows that 4.5% of all loans were 90 days past due. Based on the 2010-Q3 credit supplement,[14] 28.2% of all loans had some non-traditional feature and these loans had an 11% delinquency rate. This means that the 71.8% of traditional prime, 30-year fixed rate mortgages must have a serious delinquency rate of 1.95%.[15]

While this seems low, consider that the GSEs charge only 20 basis points per year to guarantee these mortgages. But a foreclosure typically results in a 30% loss, including the decline in property value, which means that credit losses on the highest quality mortgages will be about 58 basis points, or three times as much as the fee charged to guarantee them. (It is important to remember that today's delinquency rate is down by one-fifth from the peak of 5.6% recorded in 2010, so losses during the worst months of the crisis would have exceeded GSE income by an even larger magnitude.) Finally, this calculation is very conservative, as losses on prime interest-only loans and prime loans with an LTV greater than 90 with mortgage insurance and on all subprime and Alt-A loans are excluded.

How much would the government entity have to charge to cover these costs? Perhaps about 75 basis points to 1 percentage point – once overhead costs and risk premiums are included, or more than three-times the rates it normally charges. But, this is only an estimate. The scope of the problem is not just figuring out how much to charge in addition to this 0.75% to 1% to cover nontraditional features. Rather, the purpose of this analysis is to reveal just how difficult (if not impossible) it is for a government enterprise to price just the base-line credit risk.

An important intermediate step would be to require an increase in the guarantee fees as if Fannie and Freddie were held to the same capital standards as private banks or financial institutions. This principle was articulated by the Administration in their white paper.[16] Advancing legislation that codifies some of the consensus ideas like this one will send important signals to the market. For example, it will reduce any uncertainty around intent and administrative implementation. Under previous rules, the GSEs were only required to hold 45

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[13] Fannie Mae Monthly Summary. December 2010.
http://www.fanniemae.com/ir/pdf/monthly/2010/123110.pdf

[14] Fannie Mae 3rd Quarter Credit Supplement. November 5, 2010.
http://www.fanniemae.com/ir/pdf/sec/2010/q3credit_summary.pdf

[15] $.045 = (.282*.11+.718*X)$

[16] "We support ending the unfair capital advantages that Fannie Mae and Freddie Mac previously enjoyed and recommend FHFA require that they price their guarantees as if they were held to the same capital standards as private banks or financial institutions. This will mean that the price of the guarantee offered by Fannie Mae and Freddie Mac explicitly reflects its risk, and will help the private market compete on a level playing field, reducing Fannie Mae and Freddie Mac's market share over time. Although the pace of these price changes will depend significantly on market conditions, such changes should be phased in over the next several years." Reforming America's Housing Finance Market: A Report to Congress. February 2011.

basis points in capital against their guarantees. If Fannie and Freddie were instead required to hold their guaranteed MBS at fair value and hold 5% minimum capital against their entire book of business, the GSEs' financial resources would probably be equal to their guarantees. As with many of the near-term ideas covered in this testimony, it makes sense for Congress to advance legislation on this issue as it tries to restore some of the checks-and-balances with the Administration and regulators.

GSE Debt Issuance

The charters for Fannie and Freddie require that the Treasury secretary approve all their plans to issue new debt. For decades this practice was carried out in a manner that was consistent with the letter of the law: the GSEs submitted reports on each new debt issuance plan for prior approval by the department. But, this process was deemed too burdensome during the Clinton Administration and the process was shelved despite the fact that it weakened Treasury's oversight.

As Emil Henry, former Assistant Secretary of the Treasury, has commented:

> By the mid-2000s, the GSEs' process of debt approval had devolved to a simple notification of the Treasury, without any formal process of approval. The pace of debt issuance was so rapid that such notifications came to the Treasury weekly, typically on one piece of paper that simply listed proposed issuances without supporting data (such as income statements or balance sheets) upon which to make informed judgments.[17]

Congress should make clear that it wants a more robust process to review GSE debt issuance. The authority to do so already exists; and it should be used by the Treasury. The GSEs (working with FHFA) should provide Treasury with a full justification for debt issuances, including all relevant financial data. Re-instating this process would also open up another path for winding down the GSEs, should either the Administration or Congress decide it wants to move forward. By resuming its authority to sign-off on debt issuance, the Treasury department could one day decide to start limiting GSE debt issuances. New restrictions could be calibrated with private market activity to ensure that mortgage market liquidity is maintained.

Risk Retention Policy

Under Dodd-Frank, federal regulators must define what a "qualified residential mortgage" is and then require lenders to retain 5% of the credit risk on any mortgages that don't meet the QRM directive.

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[17] Henry, Emil. How to Shut Down Fannie and Freddie. The Wall Street Journal. November 11, 2010. http://online.wsj.com/article/SB10001424052748704635704575604570042260954.html

The federal regulators released their proposal this week. While the rule isn't final and public comments still need to filed and reviewed, this draft did propose exempting the GSEs (or deeming their mortgages as "qualified"). This is a very important decision and one that Congress should consider carefully.

First, let's put aside whether a new risk retention provision was necessary or wise.[18] Exempting the GSEs from the QRM rule could serve to maintain (if not expand) their dominance relative to the private market. It will be difficult for a private market to develop if government-sponsored mortgage products are exempt from a provision that directly impacts mortgage costs and prices. The development of a private market for non-QRM mortgages will also be hindered because the origination channel will orient itself towards mortgages that qualify for GSE purchase as had been the case in the past.

The draft rule also proposes that qualified mortgages have a 20% downpayment. Coupled with an exemption for the GSEs, this means that private lenders could end up originating low downpayment loans only to try and sell them to the GSEs.[19] In plain economic terms, this is adverse selection – and it is taxpayers who will once again be exposed through GSE purchases and guarantees to riskier loans that have lower downpayments. If low downpayment loans are too risky to allow private lenders to originate and distribute (without any risk retention), it is appropriate for Congress to question whether they are not also too risky for government-backed entities.

During the debate around the Dodd-Frank law, and specifically the QRM section, Members considered the question of how to treat all the government agencies that either guarantee or insure mortgages. The final language of Dodd-Frank, as it was enacted, specifically did not exempt the GSEs (as it did FHA and the other explicitly guaranteed government mortgage operations). If the regulators believe a GSE exemption is now good policy, Congress should consider weighing in through new legislation. Exempting the GSEs would mean that more than 90% of today's housing market is carved out.

The current situation (post-crisis) presents an opportunity to provide a coherent strategy for moving to a new housing finance system. Instead of embracing this moment, the QRM proposal – as it currently stands – could provide an entirely new competitive advantage for the GSEs and make the risks of dislocation to moving to an entirely new system even greater.

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[18] Many would argue that there had been too much risk retention (in mortgage-related assets) at the big banks before the crisis – and that this concentrated (and leveraged) exposure was why many banks needed to be bailed out.

[19] The GSEs can purchase loans with less than a 20% downpayment, as long as some form of credit enhancement is included.

FHFA Inspector General and GSE Employee Compensation

The last two proposals before the committee concern the authority or powers of the FHFA Inspector General and the compensation levels of GSE employees.

The FHFA Inspector General should have the tools to serve as a check on the FHFA – and to ensure that it is protecting taxpayers consistent with its role as conservator. New legislation in this area would be consistent with some of the other aforementioned proposals. For example, requiring that the IG report to Congress on a quarterly basis would provide a useful avenue for a Congressional check on GSE activities. In conservatorship, the GSEs act like an arm of the government and they it makes sense that they should be overseen as such.

With regards to the compensation question, I would point to the fact that there is a consensus now that the GSE-model is broken and not to be reconstituted. Whereas the employees at Fannie and Freddie used to work on behalf of shareholders, it is clear that they are now working on behalf of taxpayers. As such, it is reasonable for Fannie and Freddie employees to be transitioned to a pay-scale that is consistent with other government agencies, like the Federal Housing Administration and the Government National Mortgage Association (Ginnie Mae).

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Important decisions still need to be made about the long-term role of the GSEs and the government in the U.S. housing finance system. It might take some time to come to an agreement on a wind-down strategy or a lasting structure for housing finance. Ahead of these decisions, however, it is still important to make progress in reducing the risk presented by the GSEs and protecting taxpayers – while at the same time ensuring that families have adequate access to mortgages.