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New Actions on the Housing and Financial Crises—Do No Harm?

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On July 27, 2008, the U.S. Senate passed and sent on to the president the "Housing and Economic Recovery Act of 2008," reportedly the most important hosing bill since the Great Depression. The bill was originally aimed at addressing the foreclosure crisis which began in late 2006 and became especially apparent in the financial crisis that emerged in August 2007. Its passage was accelerated by the near or real failures of Fannie Mae and Freddie Mac, the nation's two largest government sponsored enterprises (GSEs), who play a central role in the functioning of the nation's housing, mortgage and financial markets. It is unlikely that the new steps will have much effect on the foreclosure crisis or short-term economic performance, but they create serious uncertainty over the future of the GSEs, federal finance and the status and role of the U.S. financial markets. It is likely, however, that the new arrangements for Fannie Mae and Freddie Mac will not remain static for more than a few months and that newly authorized steps for the new regulator of the GSEs are likely to ramp up the discussion and need for regulation soon.

The New Housing Bill

The new bill was originally aimed at providing relief to the mortgage foreclosure crisis. At the end of the first quarter of 2008, 2.5 percent of all mortgages were in the foreclosure process, up from about 1 percent in mid 2006. This was largely due to the growing foreclosures among subprime loans, which climbed to a 10.7 percent rate from about a 3.5 percent rate in 2005. Owners of about 1.5 million homes entered foreclosure over the past year and this is expected to climb to about 2.5 million over the next year (see Tatom 2008 for a fuller description of the foreclosure problem and its effects).

The new bill expands upon efforts to use Federal Housing Administration lending to refinance problem loans about to enter foreclosure. In the new bill, mortgage holders spending more than 31 percent of their income on housing (principal, interest, property taxes and insurance) can refinance with FHA. They must first obtain their lender's willingness to take a 10 percent "haircut" on the remaining balance of the loan. Mortgage holders must also be capable of paying the new loan and they must agree to pay the federal government half of any capital gain they might receive on a sale of the home within the first five years that it is outstanding. Congress appropriated $300 billion for these new loans, expecting to help up to 400,000 people, but this total could rise to up to 2 million mortgages holders if more are qualified than expected. This provision ends September 30, 2011.

Ironically, the program does not begin until October 2008, and, based on recent trends, as many as 400,000 mortgages are likely to enter foreclosure by then. This reflects the most obvious shortcoming of the bill: it is too late and too little to make a serious dent in the foreclosure problem. Perhaps 40 percent of the homeowners faced with the foreclosure problem will have already lost their homes before the program begins, and fewer than 20 percent of the remainder will be able to obtain some relief from this program. Moreover, even for the few borrowers who are assisted, the foreclosure rate on the group obtaining FHA loans will remain relatively high, despite the positive factor that the FHA loans are fixed rate mortgages and will largely replace higher default, variable rate mortgages. For example, in the first quarter of 2008, the FHA loan foreclosure rate was 2.4 percent, about the same as the national average, but double the foreclosure rate on prime mortgages.

There are many other aspects of the housing bill aimed at subsidizing housing activity besides the foreclosure refinancing scheme. The bill provides about $4 billion for local government programs to redevelop abandoned and foreclosed homes, one of the most controversial components of spending in the bill. Other stimulus to the housing market includes a first-time buyer tax credit of up to $7500, funds for housing counseling of about $180 million, improved benefits for veterans, including a moratorium on foreclosures of military mortgages of servicemen returning from foreign conflicts, a one-year property tax deductibility for non-itemizing taxpayers on the first $1000 for taxes, and many others.

Reforming and Reviving the GSEs

The most sweeping and costly actions in the housing bill are aimed at regulatory reform and saving the insolvent housing-related GSEs, Fannie Mae and Freddie Mac. According to Poole (2008), Fannie and Freddie (hereafter Fan and Fred) are already insolvent. These institutions were created by Congress and granted federal charters as privately held corporations, originally to provide liquidity to the nation's housing markets and to provide affordable housing programs desired by the government. Under the bill, Congress granted temporary authority for the Secretary of Treasury to purchase debt or stock in unlimited amounts from Fan and Fred or the Federal Home Loan Banks. This made official the unlimited line of credit backed by the full faith and credit of the United States, which had long been assumed by financial markets.

The bill also provides for a single regulator, the Federal Housing Finance Authority (FHFA), for these organizations, replacing the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board, which had supervised the 12 Federal Home Loan Banks, the orphans of the Federal Home Loan Bank Board which was abolished as part of the Savings and Loan reforms of the early 1990s. The first head of FHFA will be Dennis B. Lockhart III, the current head of OFHEO, until he is replaced by the next president. The expectation is that the new regulator will toughen capital requirements and provide closer scrutiny over the GSEs, especially now that Congress has clarified the legal standing of the GSEs as essentially public enterprises.

Interestingly, the new bill also requires that Fred and Fan pay a tax of 4.2 basis points on each dollar of unpaid balance of each enterprise's total new mortgage purchases. Presumably, this is to remove some of the advantage of their government related low cost of funds, and to offset some of the new higher costs of FHA lending. It is not sufficient to fully offset the lower cost of capital of the GSEs and will continue the disadvantages that private mortgage holders face in competing with them.

One of the greatest problems presented by the new bill's treatment of Fred and Fan is their recapitalization. The GSEs were long believed to be substantially undercapitalized, and plans in Congress as recently as last spring looked for the capital requirements to be substantially raised with the addition of private sector financing. A March 2008 estimate of their capital, at about $80 billion, was far less than banks of equal size would be required to hold. But raising new capital will be difficult so long as the possibility of being taken over by the receiver is possible.

Another major problem is the size of the potential budgetary cost. The Congressional Budget Office (2008) estimates the cost of the GSE exposure to be $25 billion. However, the potential cost is much greater than this. Suppose that the number of foreclosures rises to about 4 percent from the first quarter 2008 level of 2.4 percent, and further suppose that the GSEs are equally exposed, which may be an overstatement of their exposure. Further suppose that, in a typical foreclosure, 50 percent of value is recoverable, a fairly standard assumption. In this event, the GSEs would lose about $30 billion on their books and another $70 billion on outstanding guarantees, a total of $100 billion. The GSEs had capital of about $80 billion in March 2008 and had already taken losses of $11 billion. Thus the expected cost to the Treasury would be about $9 billion under this scenario, ignoring the undercapitalization of the GSEs that would then exist. The latter cost is likely to be over $86 billion for the mortgages on the books of the GSEs; a further 4 percent is necessary to cover the cost of guarantees under the assumed default experience. Thus the total cost to the Treasury could be as much as $230 billion, or more depending on the extent of losses over the next year at the GSEs. The CBO assumes that there is only a five percent chance of a loss greater than $100 billion and a 50 percent chance of no direct cost to the Treasury, but this ignores a reasonable estimate of the expected losses and costs to bring these firms up to private sector standards for capital.

The Future of Fred and Fan

The failure of Fred and Fan prompted many of their critics to rejoice, declaring "I told you so," and in some cases projecting the end of their lives as government sponsored entities or as independent agencies of government. Many financial market leaders, on the other hand, celebrated the recognition that the government stands behind Fan and Fred and expected the enterprises to be refinanced at public and private expense, in the latter case with clear recognition by the government that Fan and Fred would ultimately be going concerns as GSEs with explicit backing of the government. Neither side is likely to be satisfied; indeed, all sides face as much uncertainty about the future of Fred and Fan as they did before the new law was passed. Poole (2008) has called for the eventual privatization of Fred and Fan in five to ten years. If the firms can survive that long, it is most unlikely that they will be as weak as today and that they can be fully privatized. Former Secretary of Treasury Lawrence Summers (2008b) has pointed out the impossibility of sustainable GSEs under the previous arrangements and he has (2008a) called for them to be put in receivership and, in "several years," privatized. "Several years" is likely to be sooner than five or ten years, with the length of time conditioned upon the end of the financial crisis, which is not imminent.

The recent actions and prospects are largely affected by perceptions of the effects of the imposing size of Fred and Fan. They hold about 15 percent of all mortgages and they guarantee another 35 percent or so of the remainder of mortgages. Their exit from the market would be a catastrophic event for the U.S. and global financial markets, in the minds of many observers. Certainly in the current financial environment, any such large change could have serious ramifications. As recently as 2007, Fred and Fan restricted their purchases of mortgages to about 15 percent of the market, as noted by Poole (2008), with no obvious effect on housing, mortgage or financial markets. A further cut to zero would have had little more effect, except perhaps for a temporary one based on expectations or announcement. The threat to ending guarantees is more serious according to many analysts. The most credible estimates suggest that Fred and Fan have lowered conforming mortgage interest rates by less than 10 basis points and may have had no significant effects on primary or secondary market spreads; the latter result is independent of whether the firms have added to their own "owned" portfolio or securitized loans with a guarantee (see Passmore, Sherlund and Burgess 2005 and Lehnert, Passmore and Sherlund 2006).

The exposure of the government to the insolvency of Fred and Fan creates an unsustainable situation. The firms are still private, in the sense that they have listed stock, stockholders and pay dividends. As Poole has noted, they have very large lobbying and political contribution budgets and they also pay very large salaries that are competitive with private financial institutions. The new bill gives the FHFA power to influence salaries and other operating expenditures. The biggest problem going forward is that there is a strong case to privatize the activities of Fred and Fan, though the recent insolvency complicates this effort. Presumably the new regulator could declare the firms to be insolvent and take control as the receiver under newly defined receivership powers. Problematic budgets could be eliminated immediately, and the claims of common and preferred stockholders and subordinated debt holders could be wiped out. Restrictions on new business and an orderly process reducing the exposure could begin immediately, as well as efforts to privatize components of the firms with sufficient capital to be attractive to private sector bidders. Eventually the receiver would have to sell off the less desirable remaining assets and assume the remaining liabilities of the firms.

One putative problem, taking the debt of Fred and Fan on the federal budget, is an issue in the minds of some analysts, but taking them on budget would simply be a clear recognition of what was already known with a high degree of certainty. Moreover, those debts come with assets that are nearly as large, so that the creditworthiness of the U.S. government would not likely be impaired.

For those fooled by accounting constructs, the initial structure (but not the extended life) of the Resolution Trust Company could be emulated, under the FHFA to keep the gross debt of Fred and Fan off the books.

Working against such an effort is the fact that Fan and Fred have long standing and strong political support in Congress because of their bureaucratic and political largess, as well as their support for political agendas. Numerous efforts over the past two decades, at least, have failed to reign in or to privatize their activities. The current weakness of Fan and Fred could eventually be overcome under government control and pressures would be exceedingly strong to remove some of the federal oversight from these firms, especially if the existing board and ownership structure remain in place. It is far too premature to believe that the problems of Fan and Fred for financial markets, housing markets and politicians are about to end. Indeed, without immediate attention to ending the federal charter and link to the nation's Treasury, Fan and Fred are likely to rise again.

The new housing bill has been debated for almost a year, but it has become a symbol of a much larger effort to enhance government regulation and its role in the economy, especially since July 13, 2008 when the Secretary Paulson announced the importance of making official the government backing of GSE debt (2008a). This appeared to be a major departure from the U.S. Treasury's (2008b and c) call for regulatory modernization and improvement of private sector competitiveness in the blueprint announced less than four months earlier, at least in the sense that the plan called for streamlining and simplifying regulation and role of the government in order to lessen its burden and improve the competitiveness of the nation's financial industry. It may be premature to suggest that regulatory reform to lighten the burden of regulation is no longer on Treasury's agenda (see Davis et al 2008), but the tone and content of recent discussions call for an enhanced role of the Federal Reserve (Fed) and the Securities and Exchange Commission in regulating products and market activities in ways not seen before in the United States. For example, the Treasury and the Fed endorsed Fed lending to Fred and Fan, though the Fed was quick to indicate that this is not likely because it is incompatible with their "lender-of-last-resort" policy and is not likely to be necessary. The latter policy has been changed dramatically in the past year, however (see Tatom 2008). The Treasury Secretary insists that a new consultative role for the Fed in setting capital requirements and prudential standards that require new congressional authority in the housing bill is consistent with the "*de facto* market stability regulator" role envisioned in the Blueprint. Perhaps the new role of financial market stability czar is the exception to the government restraint otherwise envisioned in the Treasury's blueprint. In any event, recent emergency steps may simply disguise the new course of the nation's financial leadership.

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