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CEI.ORG**

August 31, 2020

Alfred M. Pollard

General Counsel

Federal Housing Finance Agency

ATTN: Comments/RIN 2590-AA95

400 Seventh Street SW, Eighth Floor

Washington, DC 20219

Re: Notice of Proposed Rulemaking—Enterprise Regulatory Capital Framework

Dear Mr. Pollard:

On behalf of the Competitive Enterprise Institute (“CEI”), I am pleased to submit the following comment letter on the Federal Housing Finance Agency’s (“FHFA”) Proposed Regulatory Capital Framework (“Framework”).<sup>1</sup> We support the Framework’s imposition of capital requirements as a means to move the government-sponsored enterprises (“GSEs”) Fannie Mae and Freddie Mac out of conservatorship, shrink their footprints to create a more competitive marketplace in housing finance, and reduce their risk to taxpayers and the economy as a whole. We also offer constructive suggestions on improving the framework by allowing products of financial innovation to enable the GSEs to raise capital and exit conservatorship more swiftly.

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<sup>1</sup> John Berlau, the author of this comment letter, is a senior fellow at the Competitive Enterprise Institute. CEI policy analyst Matthew Adams contributed to this comment letter.

## Background

Founded in 1984, the Competitive Enterprise Institute is a non-profit research and advocacy organization that focuses on regulatory policy from a pro-market perspective. A strong focus of CEI is on removing regulatory barriers that inhibit choice and innovation, including financial innovation, and on repealing policies that skew the playing field through government favoritism of certain firms or through direct government competition with certain industries. We believe both government favoritism and overregulation harm a competitive marketplace and limit options for consumers, investors, and entrepreneurs

Since its founding 36 years ago, CEI has done extensive work on the comparative value of government insurance and guarantees borne by taxpayers as opposed to private insurance borne by private actors. We have questioned consistently the need for governmental and government-backed entities to minimize financial risk. To cite some specific cases, we have pointed out the inability of the International Monetary Fund to act as “credit doctor” to the sick economies of the world, showed the shortcomings of the U.S. International Development Finance Corporation (formerly the Overseas Private Investment Corporation) in addressing the risks of overseas investment, and urged Congress to decline reauthorization of the Export-Import Bank due to its risks to taxpayers and favoritism of some businesses over others<sup>2</sup>

CEI has also been relentless in critiquing the GSEs, questioning the need for their existence and making prescient warnings years before the 2008 financial crisis that led to their becoming nearly insolvent and the government taking them into conservatorship. When CEI came on the policy scene in the 1980s, Fannie and Freddie were operating under a quasi-private structure with government privileges. Fannie was created as a government agency in 1938 and spun off as a government-sponsored enterprise in 1968. Freddie was created as a sister -- or “little brother” -- GSE two years later. Even though they had private shareholders, they had always retained government privileges. They were exempt from state and local taxes, and, importantly, each had a \$2 billion line of credit with the U.S. Treasury.

In 2000, CEI’s founder, Fred L Smith Jr., predicted in his testimony before the House Banking and Financial Services Committee that “as long as the [government] pipeline is there, it’s very expandable. ... It could be \$200 billion tomorrow” if the GSEs were to implode.<sup>3</sup> Although he was accused of wildly exaggerating the GSEs’ future price tag to taxpayers at the time, it turned out Smith

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<sup>2</sup> Daniel Press, “World Bank And IMF Get African Development Wrong, Again,” *Investor’s Business Daily*, April 27, 2017, <https://cei.org/content/world-bank-and-imf-get-african-development-wrong-again>; Ryan Young, “A New Front in the Trade War: Overseas Private Investment,” Competitive Enterprise Institute blog; September 26, 2018, <https://cei.org/blog/new-front-trade-war-overseas-private-investment>; Ryan Young, “Ten Reasons to Abolish the Export-Import Bank,” *OnPoint* No. 195, Competitive Enterprise Institute, July 15, 2014, <https://cei.org/sites/default/files/Ryan%20Young%20-%20Top%2010%20Reasons%20to%20Abolish%20Ex-Im%20%282%29.pdf>.

<sup>3</sup> Testimony of Fred L. Smith Jr. before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises of the Committee on Banking and Financial Services, June 21, 2000, [http://commdocs.house.gov/committees/bank/hba65224.000/hba65224\\_1.HTM](http://commdocs.house.gov/committees/bank/hba65224.000/hba65224_1.HTM).

had estimated their liability to taxpayers about right, as the federal government spent nearly \$200 billion of taxpayer funds to prop them up.<sup>4</sup>

Smith and CEI scholars have called for the GSEs to be wound down or stripped of government guarantees, arguing that housing doesn't need to be propped up by the government any more than any other economic sector. As Smith testified, "there are other American dreams" besides housing. "Getting a job, starting your own business, having a better school for your kids, and those dreams also require capital," he continued. "Fannie and Freddie create no new capital. They simply move it around the political game board."<sup>5</sup>

Yet recognizing that a phaseout of GSEs likely wouldn't happen immediately, Smith and others at CEI have proposed short-term reforms to reduce their footprint in the housing market and their risk to taxpayers. One of these is a requirement for Fannie and Freddie to have a solid capital cushion. In his testimony in 2000, Smith called for the GSEs to "increase their capital reserves" and lent his support to a bill that would have strengthened their capital requirements.<sup>6</sup>

CEI scholars have allowed for different ways the GSEs could meet capital requirements, and did not rule out instruments of financial innovation, such as derivatives, to help the GSEs achieve this goal. The late Christopher Culp, who served as senior fellow at CEI and as an adjunct professor of finance at the University of Chicago, wrote that the GSEs and other financial firms should use derivatives to "help manage interest rates and keep funding costs down."<sup>7</sup> Culp observed that "people have feared what they don't understand, and financial instruments are no exception." Yet, by "helping market participants manage their risk profiles," these instruments create "a stronger and more resilient financial system."<sup>8</sup>

### **The Current Conservatorship and the Capital Framework's Promise**

The proposed Framework does several important things. Most importantly, it fulfills the statutory mandate of the Housing and Economic Recovery Act of 2008 ("HERA"). As Federal Housing Finance Agency Director Mark Calabria has noted, HERA states that if the GSEs are taken into conservatorship, the FHFA must work toward restoring them to financial health and release them from conservatorship—and accompanying government ownership stakes—as quickly as possible.<sup>9</sup>

The "Third Amendment" to the GSE's conservatorship, promulgated by the Obama administration FHFA and Treasury Department in 2012, abrogated HERA's mandate and imposed costs on taxpayers, the housing market, and ordinary investors. The Third Amendment allowed the Treasury Department to siphon off 100 percent of the GSEs' profits in perpetuity. In turn, the government began "sweeping" virtually all of the GSEs' profits—well exceeding the cost of the 2008 rescue—into its coffers, leaving the GSEs with very little capital.

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<sup>4</sup> "Fannie Mae and Freddie Mac post profits and pay dividends to U.S.," Associated Press, August 7, 2014, <http://www.latimes.com/business/la-fi-fannie-freddie-earns-20140807-story.html>.

<sup>5</sup> Testimony of Fred L. Smith Jr.

<sup>6</sup> *Ibid.*

<sup>7</sup> Christopher L. Culp, "Demystifying Derivatives in Mortgage Markets and at Fannie Mae," in *Housing Matters: Issues in American Housing Policy* (Washington, DC: Fannie Mae, 2004), p. 218.

<sup>8</sup> *Ibid.*, p. 212.

<sup>9</sup> "Discussing GSE Reform with Mark Calabria, Director of the FHFA,"

<https://www.walkerduunlop.com/insights/2020/03/18/discussing-gse-reform-mark-calabria-director-fhfa/>.

This arbitrary government action posed a risk to taxpayers of being on the hook for another bailout should there be any volatility in the housing market. It also deterred competitors, such as banks, which faced their own increasingly rigid capital requirements from laws like Dodd-Frank, from getting into the secondary market of buying and selling mortgages, thus reducing beneficial innovation and liquidity in the mortgage market.

Finally, the Third Amendment's unprecedented assertion of the government's right to confiscate the two firms' profits in perpetuity (now subject to several court challenges from the GSEs' private shareholders, including the *Collins v. Mnuchin* case currently before the Supreme Court) may have reduced investment in the mortgage market by making mortgage investors nervous. If investors see any market as prone to arbitrary government takeovers, they will be reluctant to invest in that sector.<sup>10</sup>

Compensation issues for the shareholder victims regarding the profits taken by the "sweep" will need to be addressed at some point by the FHFA and the Treasury, as a matter of justice and because the courts may force the government's hand. The Framework, however, is itself an important victory for the rule of law by effectively ending the Third Amendment and setting forth a permanent capital structure for the GSEs to exit the conservatorship. For that, the FHFA should be applauded.

### **The Merits of Credit Risk Transfer in Building the GSEs' Capital**

The proposed Framework directs the GSEs to build and maintain capital primarily by raising equity through the sale of stock and by retaining some cash from their own profits. For the GSEs to exit conservatorship and reduce the risk to taxpayers more swiftly, CEI suggests that FHFA add to this capital mix the financial instrument of credit risk transfer securities ("CRTs").

Like bonds, "CRTs pool thousands of different mortgages into a single security; investors receive regular payments based on the performance of the underlying loans. But there is a key difference: CRTs carry no government guarantee. Investors could absorb losses if a large number of the loans default."<sup>11</sup>

Since 2013, Fannie and Freddie have utilized CRTs to offload some of their risk—and risks to taxpayers—to private parties who buy CRTs. A study by scholars from the Federal Reserve Bank of New York and Annaly Capital Management found that "the CRT programs have meaningfully reduced the federal government's exposure to mortgage credit risk without disrupting the liquidity or stability of secondary mortgage markets."<sup>12</sup> From 2013 to 2018, CRTs have transferred \$102 billion in risks of losses from the GSEs to private-sector investors.<sup>13</sup> Even with the stress of the COVID-19 pandemic on the housing

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<sup>10</sup> John Berlau, "Fannie Mae and Freddie Mac Still Endanger U.S. Economy," *OnPoint* No. 236, November 8, 2017, <https://cei.org/sites/default/files/John%20Berlau%20-%20Fannie%20Mae%20and%20Freddie%20Mac%20Still%20Endanger%20U.S.%20Economy.pdf>.

<sup>11</sup> Janaki Rao and Monika Carlson, "Credit Risk-Transfer Securities: Finding the Way Forward," AllianceBernstein Blog, May 21, 2020, <https://www.alliancebernstein.com/library/credit-risk-transfer-securities-finding-the-way-forward.htm>.

<sup>12</sup> David Finkelstein, Andreas Strzodka, and James Vickery, "Credit Risk Transfer and De Facto GSE Reform," *Federal Reserve Bank of New York Economic Policy Review* Vol. 24, No. 3 (December 2018), P. 89, [https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr\\_2018\\_credit-risk\\_finkelstein.pdf](https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_credit-risk_finkelstein.pdf).

<sup>13</sup> Federal Housing Finance Agency, "FHFA Updates Progress on Fannie Mae and Freddie Mac Credit Risk Transfer Programs," news release, November 12, 2019, <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Updates-Progress-on-FNM-and-FRE-Transfer-Programs-111219.aspx>

market, Freddie Mac reports that CRTs are expected to absorb around \$688 million of the GSEs' losses this year.<sup>14</sup>

Credit risk transfer securities do impose more debt on the GSEs. For that reason, they should be given a greater risk weight as capital than equity shares or cash. However, the Framework should not make it prohibitively costly for Fannie and Freddie to hold these instruments. If the financial crisis can teach us anything, it is that there are many types of risk the GSEs can take on. If Fannie and Freddie are discouraged from issuing CRTs that offer a net risk reduction, it may result in the GSEs (perhaps under the supervision of a different FHFA director) issuing riskier loans to raise the cash to meet their capital requirements.

It is also important to remember that it wasn't securitization at the GSEs and other financial institutions that caused the mortgage meltdown. It was the poor quality of mortgages within these securities.

As American Enterprise Institute scholars Peter Wallison and Edward Pinto have documented, Fannie and Freddie began in the 1990s to classify as "prime" many loans earlier classified as "subprime," because the borrowers had FICO credit scores of less than 660. They contend that these looser standards spread across the mortgage market, leading private banks to make loans of even lower quality, paving the way for the financial crisis.<sup>15</sup> Deterring the GSEs from purchasing such poor-quality loans, while they receive any form of government backing, should be a key objective of any reform plan.

#### **Conclusion: Regulatory Capital Framework Is a Needed and Positive Step Forward**

For more than a decade after the financial crisis, Fannie and Freddie were the two elephants in the room that no one wanted to tame, and conservatorship only saw the elephants grow even larger with less accountability to shareholders, taxpayers, and policymakers. While there is room for improvement in the Framework, the FHFA deserves kudos for moving forward to reduce risks to the taxpayer and the economy and to create a more competitive market for housing finance. Most importantly, with the Framework, the FHFA is at last adhering to the rule of law and fulfilling HERA's statutory mandate to exit the GSEs from the conservatorship.

Thank you for this opportunity to present the views of the Competitive Enterprise Institute. If you should have any questions or comments, please contact me by phone, (202) 331-2272, or email, [john.berlau@cei.org](mailto:john.berlau@cei.org).

Sincerely,

John Berlau, Senior Fellow

Competitive Enterprise Institute

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<sup>14</sup> Freddie Mac, Form 10-Q, June 30, 2020, [http://www.freddiemac.com/investors/financials/pdf/10q\\_2q20.pdf](http://www.freddiemac.com/investors/financials/pdf/10q_2q20.pdf).

<sup>15</sup> Peter J. Wallison, "The Price for Fannie and Freddie Keeps Going Up," *Wall Street Journal*, December 29, 2009, <https://www.wsj.com/articles/SB10001424052748703278604574624681873427574>.

