VI. The Federal Mortgage Insurance Corporation: A Remedy to the Fannie and Freddie Moral Hazard Problem?

A. Introduction

For decades, the Federal National Mortgage Association ("Fannie Mae" or "Fannie")[1] and Federal Home Loan Mortgage Corporation ("Freddie Mac" or "Freddie")[2] have promoted liquidity and access to credit in the U.S. mortgage market.[3] Over time, the regulatory frameworks surrounding these Government-Sponsored Enterprises ("GSEs") gave rise to the perception that Fannie and Freddie's business transactions and financial solvency were, at least implicitly, guaranteed by the federal government.[4] That implicit guarantee became explicit during the recent financial crisis, when the two GSEs were taken under federal conservatorship and infused with billions of taxpayer dollars.[5] Since then, governmental agencies and private observers have closely examined the moral hazard[6] presented by Fannie and Freddie and their relationship with the federal government.[7] Some commentators fear that the lingering moral hazard posed by the two GSEs could one day result in the need for

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[1] *See generally* Federal National Mortgage Association Charter Act, 12 U.S.C. §§ 1716–1723 (2008).

[2] *See generally* Federal Home Loan Mortgage Corporation Act, 12 U.S.C. §§ 1451–1459 (2010).

[3] CONG. BUDGET OFF., FANNIE MAE, FREDDIE MAC, AND THE FEDERAL ROLE IN THE SECONDARY MORTGAGE MARKET 1 (2010), *available at* http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12032/12-23-fanniefreddie.pdf.

[4] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 39 (2010), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[5] *See generally* FED. HOUS. FIN. AGENCY, OFF. OF INSPECTOR GEN., FANNIE MAE AND FREDDIE MAC: WHERE THE TAXPAYERS' MONEY WENT (2012), *available at* http://fhfaoig.gov/Content/Files/FannieMaeandFreddieMac-WheretheTaxpayersMoneyWent_0.pdf (examining how and why U.S. Treasury funds were used to address Fannie Mae and Freddie Mac's precarious financial situations during the recent financial crisis).

[6] "Moral hazard is the incentive for parties that are insured, whether implicitly or explicitly, to take greater risks because they no longer bear the full costs of their actions." CONG. BUDGET OFF., *supra* note 3, at 34 n.10 (citing Joseph E. Stiglitz, *Risk, Incentives, and Insurance: The Pure Theory of Moral Hazard*, 8:26 GENEVA PAPERS ON RISK AND INS. 4, 4–33 (1983)).

[7] *See, e.g.*, CONG. BUDGET OFF., *supra* note 3, at 44.

additional government bailouts.[8] As a solution, U.S. Senators Bob Corker, a Republican from Tennessee, and Mark Warner, a Democrat from Virginia, have proposed a bill that would replace Fannie Mae and Freddie Mac with a governmental entity known as the Federal Mortgage Insurance Corporation ("FMIC").[9]

This paper explores the recent histories of Fannie and Freddie, the moral hazard they pose, and how the proposed FMIC might fare in addressing that moral hazard. Part B examines the general business operations of Fannie and Freddie. Part C describes the financial troubles faced by those institutions during the recent financial crisis and the steps taken by the federal government to address those issues. Part D analyzes the proposed FMIC, its ability to address Fannie and Freddie's moral hazard problems, and potential political obstacles facing its creation.

B. Background: The Business of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac are corporations chartered by the federal government to provide liquidity to the U.S. mortgage market and access to affordable housing for low- and medium-income families.[10] Because Fannie and Freddie are "forbidden by their federal charters from originating loans," the institutions aim to achieve these goals through their participation in the secondary mortgage market.[11] Fannie and Freddie purchase mortgages from the originators of those mortgages, such as national banks and thrifts, and pool the mortgages into instruments known as mortgage-backed securities ("MBS").[12] This process allows mortgage originators to "avoid the cost of having to protect themselves from the risks associated with financing long-term mortgages with short-term deposits."[13] Mortgage originators can take the proceeds from the sale of one mortgage and use part of them for the issuance of a new one.[14]

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[8] *See, e.g.*, Edward L. Glaeser, *A Middle Way on Mortgage Subsidies*, THE BOSTON GLOBE, Aug. 23, 2013, at A11.
[9] Housing Finance Reform and Taxpayer Protection Act of 2013, S. 1217, 113th Cong. (2013).
[10] CONG. BUDGET OFF., *supra* note 3, at 1.
[11] *Id.* at 2.
[12] FED. HOUS. FIN. AGENCY, *supra* note 5, at 7.
[13] CONG. BUDGET OFF., *supra* note 3, at 16.
[14] *Id.*

Once Fannie and Freddie have securitized the mortgages, they will generally sell the resulting MBS to capital market investors or retain the MBS in their own investment portfolios.[15]

For those MBS that Fannie and Freddie sell to investors, the two GSEs guarantee full payment of the principal underlying each individual mortgage and any interest due on those mortgages.[16] In exchange for that guarantee, Fannie and Freddie collect a regular fee from the originators of the mortgages.[17] This fee "is intended to cover that small portion of loans that are expected to default."[18] Fannie and Freddie similarly set aside reserves to cover potential losses on the loans retained in their own portfolios.[19]

C. The Recent Financial Crisis

1. Fannie Mae and Freddie Mac's Financial Troubles

For many years, Fannie and Freddie were able to remain financially solvent within the frameworks of their business models largely because of the quality of the mortgages that they owned and guaranteed.[20] However, the two GSEs eventually lowered their purchasing standards, due in part to their shrinking market share in the early- to mid-2000s.[21] During that time period, commercial banks, thrifts, and investment banks significantly expanded their presence in the secondary mortgage market.[22] According to a 2010 report by the Financial Crisis Inquiry Commission, "[b]y 2005 and 2006, [those financial institutions] were securitizing one-third more

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[15] *Id.* at 2.
[16] FED. HOUS. FIN. AGENCY, *supra* note 5, at 9.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] Until the early- to mid-2000s, Fannie and Freddie maintained relatively strict standards on the mortgages they purchased compared with many other private participants in the secondary mortgage market. CONG. BUDGET OFF., *supra* note 3, at 8.
[21] FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 122 ("In 2004, Fannie and Freddie . . . were losing market share to Wall Street, which was beginning to dominate the securitization market. Struggling to remain dominant, they loosened their underwriting standards, purchasing and guaranteeing riskier loans, and increasing their securities purchases.").
[22] *Id.* at 102.

loans than Fannie and Freddie."[23] Seventy-one percent of the so-called private-label MBS generated by those institutions were composed of subprime or Alt-A loans.[24] Fannie and Freddie eventually opted to purchase and guarantee many of the newly-originated subprime and Alt-A loans, and to purchase privately-issued subprime MBS for their own portfolios.[25] In 2004, Fannie and Freddie purchased 40% of all new privately-issued subprime MBS.[26] By 2008, that percentage had dropped to 28% of new privately-issued subprime MBS.[27] According to the Financial Crisis Inquiry Commission, "Fannie and Freddie owned or guaranteed $5.3 trillion of mortgage-related assets [prime, sub-prime, or otherwise] at the end of 2007 against just $70.7 billion of capital, a ratio of 75:1."[28]

By 2007, housing prices had dropped substantially and loan delinquencies had risen dramatically.[29] The Financial Crisis Inquiry Commission indicated that "[w]ith $5 trillion in mortgages resting on razor-thin capital, the GSEs were doomed if the market did not stabilize."[30]

2. 2008 Government Bailout and Takeover

Cognizant of Fannie and Freddie's precarious financial situations, Congress passed the Housing and Economic Recovery

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[23] *Id.* The Financial Crisis Inquiry Commission "was created [pursuant to Public Law 111-21] to examine the causes of the [recent] financial and economic crisis in the United States." *Id.* at xi.

[24] *Id.* at 102. "Subprime" refers to loans that were issued to borrowers with weak credit; "Alt-A" refers to loans that were issued to borrowers with strong credit, but had characteristics riskier than prime loans. *Id.*

[25] *Id.* at 125 ("Fannie and Freddie continued to purchase subprime and Alt-A mortgage-backed securities from 2005 to 2008 and also bought and securitized greater numbers of riskier mortgages.").

[26] *Id.* at 123.

[27] *Id.*

[28] *Id.* at 65. In comparison, "[f]rom 2000 to 2007, large banks and thrifts generally had . . . leverage ratios between 16:1 and 22:1." *Id*.

[29] *See* FED. HOUS. FIN. AGENCY, *supra* note 5, at 12 ("The financial crisis has produced unprecedented losses for [Fannie and Freddie]. Fannie Mae lost $5 billion in the second half of 2007 and another $4.5 billion through the first half of 2008. Freddie Mac lost $3.7 billion in the second half of 2007 and $1 billion during the first half of 2008 . . . from 2008 through the end of the third quarter of 2011, [Fannie and Freddie] lost $261 billion.").

[30] FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 312.

Act of 2008 in July of that year, giving the Secretary of the Treasury "the ability to extend secured lines of credit to the GSEs, to purchase their mortgage securities, and to inject capital."[31] On September 6, 2008, Fannie and Freddie entered conservatorships overseen by the Federal Housing Finance Agency, the GSEs' newly-created regulator.[32] The Treasury, under authority granted to it in the Housing and Economic Recovery Act of 2008, entered into Preferred Stock Purchase Agreements with Fannie and Freddie, whereby the Treasury agreed to infuse the GSEs with capital in exchange for senior preferred stock.[33] A fear held by many in the federal government at the time was that the collapse of Fannie Mae and Freddie Mac would have a devastating impact on nearly all sectors of the economy.[34] By the end of 2011, the Treasury had infused $185 billion into the two institutions to ensure their continued solvency.[35] Nevertheless, according to the Federal Housing Finance Agency and the GSEs, "the likelihood of [Fannie and Freddie] ever earning enough to repay the full amount invested is remote."[36]

D. The Federal Mortgage Insurance Corporation

1. The Proposal

In June 2013, Senators Corker and Warner introduced the Housing Finance Reform and Taxpayer Protection Act of 2013 (the "Act").[37] In part, the Act would establish a timeline for winding down, and eventually abolishing, Fannie Mae and Freddie Mac.[38] In their stead would be a federal agency known as the Federal Mortgage

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[31] *Id.* at 317.
[32] FED. HOUS. FIN. AGENCY, *supra* note 5, at 12.
[33] *Id.* at 13.
[34] *See, e.g.*, Press Release, Fed. Housing Fin. Agency, Statement of FHFA Director James B. Lockhart (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/fhfa_statement_090708hp1128.pdf).
[35] FED. HOUS. FIN. AGENCY, *supra* note 5, at 7.
[36] *Id.* at 15.
[37] *Housing Finance Reform and Taxpayer Protection Act,* ISSUES & LEGISLATION (2013), http://www.corker.senate.gov/public/index.cfm/housing-finance-reform.
[38] Housing Finance Reform and Taxpayer Protection Act of 2013, S. 1217, 113th Cong. §§ 501–02 (2013).

Insurance Corporation.[39] The purpose of the FMIC would be to "(1) provide liquidity, transparency, and access to mortgage credit by supporting a robust secondary mortgage market and the production of residential mortgage-backed securities; and (2) protect the taxpayer from having to absorb losses incurred in the secondary mortgage market during periods of economic stress."[40] To promote these goals, the FMIC would essentially serve as reinsurer on qualified MBS issued by approved issuers.[41] The FMIC would "insure the payment of principal and interest" with respect to any losses incurred on covered MBS.[42] In order for a mortgage to qualify for securitization insured by the FMIC, the loan must adhere to "conforming loan limits" and underwriting criteria, such as the borrower's ability to repay.[43] Other criteria may include "requirements related to down payment, private mortgage insurance, maximum amount," or any other conditions selected by the FMIC.[44] While lenders could still make and securitize mortgages that did not conform to the FMIC standards, such mortgages would not be insured by the FMIC.[45] Additionally, the FMIC would not be obligated to guarantee a particular mortgage simply because it meets the FMIC's criteria.[46]

Moreover, the FMIC would be charged with "develop[ing] standard form credit risk-sharing mechanisms, products, structures, contracts, or other security agreements that require private market holders of a covered security . . . to assume the first loss position with respect to losses incurred on such securities . . . ."[47] In general, private market holders of a security insured by the FMIC would have to assume a first loss position of "not less than 10 percent of the

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[39] *Id.*
[40] *Id.* § 101(b).
[41] SEAN M. HOSKINS ET AL., SELECTED LEGISLATIVE PROPOSALS TO REFORM THE HOUSING FINANCE SYSTEM 9–10 (2013), *available at* https://www.fas.org/sgp/crs/misc/R43219.pdf.
[42] S. 1217 § 204(a).
[43] HOSKINS ET AL., *supra* note 41, at 10. For specific details on conforming loan limits, see S. 1217 § 504. For a more in-depth discussion on the Ability-to-Repay Rule, see generally SEAN M. HOSKINS, THE ABILITY-TO-REPAY RULE: POSSIBLE EFFECTS OF THE QUALIFIED MORTGAGE DEFINITION ON CREDIT AVAILABILITY AND OTHER SELECTED ISSUES (2013).
[44] HOSKINS ET AL., *supra* note 41, at 10.
[45] *Id.*
[46] *Id.*
[47] S. 1217 § 201(a).

principal or face value of the covered security."[48] Additionally, the FMIC would oversee "the Mortgage Insurance Fund," which would be paid for by insurance fees and serve to cover losses when they surpass first position losses.[49] While compliance with the risk-sharing requirements in section 202(a) of the Act would generally be required for FMIC insurance, that requirement may be waived for up to six months for covered securities if "unusual and exigent circumstances" arise.[50]

2. Moving Forward: Current Political Obstacles and Future Moral Hazard Implications of the FMIC

As of December 10, 2013, the Home Finance Reform and Taxpayer Protection Act of 2013 remains under consideration by the Senate Committee on Banking, Housing, and Urban Affairs.[51] The bill faces challenges from both inside and outside Congress.[52] However, President Obama has voiced his optimism that the Act will help to address the moral hazard posed by Fannie and Freddie.[53]

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[48] *Id.* § 201(a)(2). This portion of the Act "was revised from an earlier version that would have had lenders take an even sharper loss on bad mortgages." Mark Maurer, *Federal Measure Would Replace Fannie, Freddie with Reinsurer*, THE REAL DEAL (June 25, 2013, 12:30 PM), http://therealdeal.com/blog/2013/06/25/federal-measure-would-replace-fannie-freddie-with-reinsurer. As Congressional Research Service analysis explains, "[t]o be eligible for the FMIC guarantee, an MBS would require a private market holder to be in a first-loss position with sufficient capital to withstand losses associated with a significant economic downturn, which is defined as being able to cover at least a 10% decline in the face value of the security." HOSKINS ET AL., *supra* note 41, at 10.

[49] S. 1217 § 203.

[50] *Id.* § 205.

[51] *Bill Summary & Status, 113th Congress (2013–2014), S.1217, All Congressional Actions*, LIBRARY OF CONG., http://thomas.loc.gov/cgi-bin/bdquery/z?d113:S.1217:@@@X (last updated Dec. 10, 2013).

[52] *See infra* notes 54–56 and accompanying text.

[53] "For too long [Fannie and Freddie] were allowed to make huge profits buying mortgages, knowing that if their bets went bad, taxpayers would be left holding the bag. . . . The good news is right now there's a bipartisan group of senators working to end Fannie and Freddie as we know them. And I support these kinds of reform efforts." Robert Kuttner, *Mortgage Reform: Watch Your Fannie*, THE AMERICAN PROSPECT (Aug. 8, 2013),

Two competing bills have been introduced that would also have an impact on the housing finance system in the United States.[54] Additionally, some community banks fear that "they will be shut out of a new system," and that "'the process of gaining access to the secondary [mortgage] market would be more difficult than it is today.'"[55] Moreover, strong performances by Fannie and Freddie in recent years may have already begun to temper political willingness to embrace such a substantial change in the U.S. housing finance system.[56]

One of the risks inherent in the current system is that its success is entirely dependent upon the underlying borrowers' ability to pay back principal and interest in full.[57] While "[i]n theory, borrowers are the first defense against abusive lending," many do not understand the details of their mortgage agreement."[58] Moreover, mortgage originators today may not have adequate incentive to ensure the underlying integrity of the mortgages that they issue.[59] When Fannie Mae and Freddie Mac purchase mortgages, the credit

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http://prospect.org/article/mortgage-reform-watch-your-fannie (quoting President Obama).

[54] *See* Protecting American Taxpayers and Homeowners Act of 2013, H.R. 2767, 113th Cong. (2013) (eliminating Fannie Mae and Freddie Mac and facilitating a purely private secondary mortgage market); FHA Solvency Act of 2013, S. 1376, 113th Cong. (2013) (focusing on adjustments to various practices of the Federal Housing Administration).

[55] Clea Benson & Cheyenne Hopkins, *Fannie Mae Survival is Back on the Table in Washington*, BLOOMBERG (Oct. 15, 2013, 4:30 PM), http://www.bloomberg.com/news/2013-10-15/fannie-mae-survival-is-back-on-the-table-in-washington.html (quoting Camden Fine, President of the Independent Community Bankers of America).

[56] *Id.*

[57] *Cf.* FED. HOUS. FIN. AGENCY, *supra* note 5, at 12.

[58] FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 90 ("A study by two Federal Reserve economists estimated at least 38% of borrowers with adjustable-rate mortgages did not understand how much their rates could change.").

[59] For instance, with regard to the "originate-to-distribute" lending model, in which mortgage originators lend with the intention of collecting fees and quickly selling their loans in the secondary mortgage market, the Financial Crisis Inquiry Commission noted, "[a]s long as [the originators of mortgages make] accurate representations and warranties, the only risk [is] to their reputations if a lot of their loans [go] bad . . . ." Mortgage originators suffer no direct pecuniary loss on defaulting loans that they have already sold. *Id.* at 89.

risk accompanying those loans shifts entirely from their originators to the GSEs.[60] If borrowers on underlying mortgages default on their loans, either as a result of uninformed borrowing, imprudent lending, or a combination of both, Fannie and Freddie immediately suffer the impact.[61] The results, as evidenced in the recent financial crisis, can be devastating to the GSEs and expensive for the federal government, which has demonstrated a commitment to keeping Fannie and Freddie financially solvent.[62]

The proposed FMIC could help to address the moral hazard that is inherent in the current housing finance framework. For instance, the requirement that private market holders assume a first loss position of at least ten percent of the principal or face value of a covered MBS may incentivize all participants in the primary and secondary mortgage markets to operate more cautiously and to ensure that all mortgages originated are sound.[63] Additionally, because the first loss position is meant to "withstand losses associated with a significant economic downturn," the FMIC Mortgage Insurance Fund may not be adversely impacted by many reductions in performance of insured MBS.[64] Moreover, the strict proposed guidelines governing which MBS the FMIC could insure may further limit potential FMIC exposure.

Still, several important questions remain. First, it is unclear whether private institutions could effectively fill the void that would be left by Fannie Mae and Freddie Mac.[65] Currently, "[p]rivate-label securities can support about $500 billion of annual housing finance, while the U.S. housing market needs between $1.5 trillion and $4 trillion in annual financing depending on interest-rate conditions."[66] Additionally, risk-sharing MBS recently developed by Fannie and Freddie may attract enough new capital to sufficiently reduce the GSEs' "exposure" by dispersing risk among private sector

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[60] *Id.*
[61] *See* FIN. HOUS. FIN. AGENCY, *supra* note 5, at 12.
[62] *See* FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 317.
[63] *See* Housing Finance Reform and Taxpayer Protection Act of 2013, S. 1217, 113th Cong. § 201(a)(2) (2013).
[64] HOSKINS ET AL., *supra* note 41, at 10.
[65] Benson & Hopkins, *supra* note 55.
[66] *Id.* (quoting Georgetown University Law Professor Adam Levitin).

investors,[67] meaning that a complete overhaul of the housing finance system would be unnecessary.

Finally, it is unclear whether, despite significant efforts to the contrary, situations may arise in the future that once again require the federal government to bail out ailing institutions that hold troubled MBS. So long as private institutions are perceived as "too big to fail," participants in the housing finance system will recall the federal government's implicit guarantee of Fannie and Freddie, and how that guarantee was realized when the GSEs' financial situations deteriorated.[68] This knowledge alone could encourage private participants in the secondary mortgage market to take greater risks on the mortgages with which they choose to interact, knowing that another federal bailout could be induced if their gambles become toxic. Moreover, the creation of the FMIC may further exacerbate this moral hazard. Rather than an implicit guarantee, FMIC insurance would carry the full faith and credit of the United States,[69] and that could ultimately mean more risk-taking by market participants, and more payouts by the federal government.

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[67] Christina Mlynski, *Freddie Mac Sells $500M risk-sharing MBS*, HOUSINGWIRE (July 24, 2013, 3:48 AM), http://www.housingwire.com/articles/25691-freddie-mac-sells-500m-risk-sharing-mbs.
[68] FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 317.
[69] Housing Finance Reform and Taxpayer Protection Act of 2013, S. 1217, 113th Cong. § 203(g) (2013).
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