Insight

The 5-5-5s of Dodd-Frank at 5: Episode 2

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The Problem: Dodd-Frank Did Nothing About Fannie and Freddie

Contrary to popular opinion, the financial crisis that spurred the passage of Dodd-Frank was not caused entirely by "too big to fail" banks on Wall Street. One of the biggest contributing factors was the government's and other financial companies' extreme exposure to subprime and other inherently risky loans, the majority of which were mortgages acquired by Fannie Mae (Fannie) and Freddie Mac (Freddie). In a March 2007 letter to the board, then CEO Daniel Mudd reported that Fannie's subprime mortgage assets totaled $55 billion. In the same letter, he explained that the market for subprime mortgages is in "partial meltdown." Throughout the duration of the housing bubble Fannie and Freddie continued to increase their market share with subprime mortgages. In August 2008, Fannie reported that those loans from 2006 and 2007 accounted for 60 percent of its second quarter losses that year.

Fannie and Freddie's exposure to subprime loans seems negligent at best, but one could argue that they simply were trying to abide by statutory quotas. Since the Federal Housing Enterprises Financial Safety and Soundness Act was signed in 1992, Fannie and Freddie have been required to abide by strict minimums of mortgages made to low income borrowers. In 1992 that minimum was 30 percent; by 2008 that minimum had risen to 56 percent – a number that Fannie surpassed with incredibly risky loans.

After Federal Housing Finance Agency (FHFA) took over the failed government-sponsored enterprises (GSEs), experts called for a system-wide overhaul, and once Dodd-Frank was in the works, it seemed like it could be the perfect vehicle for that reform. Even the Dodd-Frank Conference Report cites to an amendment that would have put Fannie and Freddie under the same resolution authority as any other large financial institution, but it was struck down. As a result, nothing in Dodd-Frank's 2,315 pages mentioned Fannie and Freddie, and nothing has been done to reform either of the entities that caused the financial crisis.

The Repercussion: Failed Institutions That Caused the Crisis Were Protected, Made Bigger

Since the bailout of Fannie and Freddie occurred before the writing of Dodd-Frank, the policy response should have recognized the correlation between their exposure to high risk mortgages in the U.S. This exposure led to the majority of the GSEs' losses and the steep decline in real estate prices and ensuing market crash. Instead of reforming the GSEs, Dodd-Frank ended up making Fannie and Freddie even bigger.

Section 941 of Dodd-Frank sets strict securitization requirements for mortgages. Specifically, securitizers must keep at least 5 percent of the risk on their books, which, for most smaller financial institutions, is too high to justify originating the mortgage in the first place. As a result, small to mid-size banks end up being priced out of the market. At the same time, Section 941 conveniently exempts "federally insured or guaranteed mortgage loan assets," "securitizations of assets issued, insured, or guaranteed by the government," student loans, and a

handful of other loans insured by FHFA or purchased by the GSEs.

So, to summarize, while Dodd-Frank bolstered the Federal Government's ability to continue to purchase high risk loans and pass off that risk to taxpayers, it simultaneously pushed out of the market many well-intentioned private sector banks from being able to effectively originate mortgages in their communities. Dodd-Frank made the situation worse than it already was.

The Fix: GSE Reform

Nearly four years ago, then Treasury Secretary Timothy Geithner boldly proclaimed that "[they] have started the process of winding down Fannie Mae and Freddie Mac and reforming the overall mortgage market." That process, if it ever really began, was never completed, and Fannie and Freddie are earning more profits now than ever before. The threats that came to fruition in 2008 still loom, and the only way to curtail those is to completely reform the system. Several iterations of reform have been proposed, but the common theme is that it must happen and it must happen soon. The Financial Regulatory Improvement Act of 2015 that was introduced by Senator Shelby contains three sections that would drastically improve the state of GSEs.

First, it would prohibit increases in guarantee fees on consumers that would then be used to offset other government spending. The same section also requires congressional approval before any Treasury-owned preferred shares in the Fannie or Freddie are sold. Second, it requires FHFA to modify the Common Securitization Platform so that it is not only open to GSEs but also to private sector lenders so they may better compete in the secondary mortgage market. Third, it includes a requirement that FHFA, Fannie and Freddie increase their level of risk sharing with the private sector so the private lenders assume more risk.

It's not perfect, but it is a start to a much needed conversation. The International Monetary Fund (IMF) recently released a report urging the United States to complete its post-crisis reforms, and GSEs made up a large part of its discussion. GSE reform is necessary to avoid a repeat of 2008 that is quickly approaching.

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