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Reforming Fannie Mae and Freddie Mac: Current Legislative Proposals

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Related Author

- N. Eric Weiss

N. Eric Weiss, Specialist in Financial Economics (eweiss@crs.loc.gov, 7-6209)

This *Insight* takes a brief look at legislation in the 114th Congress related to reform of the housing finance system.

Background. Fannie Mae and Freddie Mac are two government-sponsored enterprises (GSEs) that were created by Congress to support homeownership. By law, Fannie Mae and Freddie Mac cannot make mortgages; they can only buy existing mortgages that *conform* to certain requirements. Once a GSE purchases a mortgage, it packages it with others into a mortgage-backed security (MBS), which it either guarantees and sells to institutional investors or retains as a portfolio investment.

During the housing collapse in 2008, Fannie Mae and Freddie Mac entered voluntary *conservatorship* overseen by their regulator, the Federal Housing Finance Agency (FHFA). As part of the conservatorship, the Treasury Department has contracted to inject a maximum of approximately $200 billion by purchasing new senior preferred stock from each of the GSEs. To date, Treasury has purchased a total of nearly $188 billion of senior preferred stock from the two and has received a total of $241 billion in dividends. Since June 2012, neither GSE has needed any additional support from Treasury, but both have paid quarterly stock dividends to Treasury. (Only in the third quarter of 2015 did one GSE (Freddie Mac) forego dividends because of losses.) These dividends paid to Treasury become general revenues.

Legislation introduced in the 114th Congress would make targeted reforms to the GSEs. Some of these reforms would focus on the terms of the GSEs' conservatorship, while others would attempt to advance some of the larger goals of housing finance reform, such as increasing the role of private capital in the housing finance system. More specifically, legislation introduced in the 114th Congress would restrict the use of the GSEs' dividends paid to Treasury to offset other spending and would prevent the Treasury from disposing of the senior preferred stock without enabling legislation. Proposed legislation would also mandate that the GSEs share mortgage risks with the private sector and encourage improvements to the secondary mortgage market through a common platform for mortgage securitization. Each of these issues is discussed in turn.

The Financial Regulatory Improvement Act of 2015 (S. 1484) and the Financial Services and General Government Appropriations Act, 2016 (S. 1910) contain identical GSE provisions. H.R. 2995, the Financial Services and General Government (FSGG) Appropriations Act, as reported out of committee, does not contain such language.

Executive Compensation. In July 2015, FHFA approved Fannie Mae's and Freddie Mac's requests to raise the annual target compensation of their chief executive officers to $4 million from $600,000. Similar bills were introduced in the House and Senate to reduce the executive compensation to $600,000. On November 25, 2015, the Senate version, the Equity in Government Compensation Act of 2015 (S. 2036), became P.L. 114-93.

Legislation Requiring Treasury to Hold Senior Preferred Stock Indefinitely. S. 1484 and S. 1910 would prohibit the Secretary of the Treasury from disposing of the senior preferred stock unless future legislation authorizing such action is signed into law. This could give Congress input into the future of the GSEs. Some Members are concerned that the GSEs could be recapitalized and reprivatized without congressional input.

Technically, the GSEs' conservatorship and the senior preferred stock are separate issues. The conservatorship could be ended and control returned to the common stockholders without disposing of the senior preferred stock. The Treasury agreements limit the amount of capital that the GSEs can retain and require all profits in excess of this to be paid to Treasury. This prevents the GSEs from accumulating reserves to offset losses significantly greater than quarterly earnings. Under conservatorship, the Treasury's support agreements are substitutes for such reserves. Outside of conservatorship, with no capital and no ability to pay dividends, the GSEs would likely be of limited value to stockholders.

Legislation on Risk Sharing. In 2012, FHFA directed Fannie Mae and Freddie Mac to develop programs to share mortgage credit risk with the private sector to reduce the risk to the federal government. Both GSEs have developed programs under which they, in effect, purchase MBS insurance from the private sector. S. 1484 and S. 1910 set goals for the GSEs risk sharing.

Legislation on the Common Securitization Platform. Fannie Mae and Freddie Mac issue their own MBS, which differ from each other. FHFA has determined both GSEs' computer systems supporting the MBS must be modernized, which would improve the efficiency of the secondary mortgage market if the GSEs adopted a common MBS. This MBS system modernization is being developed by a jointly owned subsidiary known as Common Securitization Solutions (CSS).

S. 1484 and S. 1910 would direct FHFA to allow private-label MBS issuers to use CSS and to charge for this use. The bills would require reports to Congress, revise the composition of the CSS' board of directors, establish a timetable for issuing the new type of MBS, and restrict the risks that CSS can take.

Legislation Affecting GSE Profits. When GSEs purchase a mortgage, they charge the seller a fee for guaranteeing timely payment of principal and interest to the ultimate investor. Unless offset by reduced mortgage purchases or increased losses due to foreclosure, increasing guarantee fees increases GSE profits. Under the terms of Treasury's support agreements, all profits from whatever sources—including those arising from increased guarantee fees—are paid as dividends to Treasury.

Congress has used a portion of increases to these fees as offsets for other types of government spending. In the 114th Congress, the Senate highway bill, but not the House bill (H.R. 22), proposes extending the guarantee fee increase for four years, until 2025 as a partial offset to spending in that bill.

S. 1484 and S. 1910 would prohibit the use of GSEs' guarantee fees in scoring appropriations under the Congressional Budget Act of 1974. Both bills contain exceptions. First, the fees can be scored if they result from the disposition of the senior preferred stock. Second, the fees can be scored if the proceeds are used to finance reforms of the secondary mortgage market.