

# ISSUE BRIEF

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## Johnson–Crapo Housing Finance Reform Misguided

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Senators Tim Johnson (D–SD) and Mike Crapo (R–ID) have released a new housing finance reform bill, and as expected, it is very similar to the bill that Senators Bob Corker (R–TN) and Mark Warner (D–VA) released last June.

Both Senate proposals would wind down the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, but both would also replace the GSEs with a new government agency. Both bills magnify the problems that contributed to the 2008 financial crisis, but the Johnson–Crapo bill goes even further than the Corker–Warner approach.

**The Federal Mortgage Insurance Corporation (FMIC).** The centerpiece of the Johnson–Crapo legislation is the Federal Mortgage Insurance Corporation (FMIC), a new government entity that serves several purposes. First, the FMIC acts as a new federal regulator of the mortgage industry, designed to monitor the safety and soundness of various financial institutions. The current regulator of the GSEs, the Federal Housing Finance Agency, would become an independent agency within the FMIC.

Another key FMIC function is to administer a special fund to cover losses on mortgage-backed securities (MBS). Essentially, the FMIC is designed

to take over the insurance function that the current GSEs provide on MBS. The FMIC would provide an explicit taxpayer guarantee of 90 percent of losses on these securities, whereas Fannie and Freddie provided an implicit federal backing of losses. Proponents of this new approach argue that it improves the old system because the FMIC requires private capital to share in the losses.

In particular, Johnson–Crapo requires a 10 percent first-loss provision. The idea is that the FMIC picks up the tab only after losses exceed the amount put up by private investors, thus providing a “risk-sharing mechanism.”

There are at least two problems with this logic. First, this mechanism allows private investors to price their own risk knowing that their losses are capped, thus leading to more risk taking. Second, Section 305 of Johnson–Crapo allows the FMIC to waive the risk-sharing provision in the event of a financial crisis (up to three times in any three-year period).

In other words, 90 percent of private investors’ losses will be covered unless there is a national crisis, in which case they would lose nothing.<sup>1</sup> As the 2008 crisis made clear, these are the kinds of government guarantees that lead to more leverage in the economy, thus magnifying underlying economic risks.

Advocates of this approach claim that such risk sharing does not amount to a taxpayer-funded bailout because the FMIC provides loss coverage through a federal mortgage insurance fund, which in turn is funded by user fees that MBS investors would pay. The reality, though, is that these types of government funds merely amount to obligations that, in the event of a crisis, would simply be paid from tax revenue. In fact, Section 303(d)(9) states:

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The full faith and credit of the United States is pledged to the payment of all amounts from the Mortgage Insurance Fund which may be required to be paid under any insurance provided under this title.

This provision is more than a minor footnote to the first-loss provision and the supposed taxpayer protections in the Johnson–Crapo bill. The bill makes it clear to all investors that taxpayers will be on the hook for losses in a crisis, just as they were under the old GSE system. But now there is an explicit statement and a known maximum loss.

**The FMIC and Affordable Housing Goals.** The Johnson–Crapo bill claims to end the affordable housing goals of the old GSE system, and technically it does.<sup>2</sup> However, it replaces these goals with a more nebulous mandate. Section 210 gives the FMIC the explicit purpose of ensuring “equitable access to lenders and borrowers.” This section of the bill even requires the FMIC to define segments of the “primary mortgage market in which lenders and eligible borrowers have been determined to lack equitable access to the housing finance system.”<sup>3</sup> The bill then provides an example of the “traditionally” underserved markets that the FMIC *may* define, a list that closely follows the groups included in the GSEs’ housing goals.

In addition to this general expansion of the idea behind the affordable housing goals, the Johnson–Crapo bill makes several specific changes ostensibly related to low-income housing. The bill expands both the base and the rate for the national Housing Trust Fund and the Capital Magnet Fund.<sup>4</sup> While current law would apply a 4.2 basis point fee to the GSEs’ new purchases of mortgages, the Senate bills increase the fee to 10 basis points and apply that rate

to the outstanding principal of mortgages eligible for FMIC purchase.

In other words, money would be supplied to both of these housing funds at a higher rate than under current law, and the annual amount would be sure to grow because each year’s purchases raise the outstanding principal. Aside from these specific increases, Title V of Johnson–Crapo also gives the FMIC the flexibility to adjust the fees it charges individual participants in the secondary market based (partly) on their record in underserved markets.

Section 504 also creates the new Market Access Fund with the explicit purpose of providing grants “to address the homeownership and rental housing needs of extremely low-, very low-, low-, and moderate-income and underserved or hard-to-serve populations.” Collectively, these funds would result in even more money being doled out as block grants to so-called affordable housing groups for programs that are difficult to monitor and nearly impossible to evaluate. Compounding this problem is the fact that the FMIC would serve both as the overseer of this affordable housing mission and as the industry’s safety and soundness regulator—a feature of the old system that failed miserably.

**What Congress Should Do.** Congress should:

- Reject the approaches being offered in the Senate bills. Both of these policies provide explicit taxpayer guarantees that are not necessary.
- Adopt a policy that gets the federal government out of the U.S. housing finance market. One good example of such a plan is in House Financial Services Committee Chairman Jeb Hensarling’s (R–TX) Protecting American Taxpayers and Homeowners (PATH) Act.

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1. It could be argued that certain companies in the system envisioned under Johnson–Crapo would not receive full protection, but exactly how such a scenario would work is unclear.

2. Press release, “Johnson, Crapo Announce Agreement on Housing Finance Reform,” Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 11, 2014, [http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord\\_id=ef6c85f2-9ba5-ccf0-6a01-1d83fcf2f502](http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=ef6c85f2-9ba5-ccf0-6a01-1d83fcf2f502) (accessed March 23, 2014.)

3. The FMIC can define up to eight such segments in the primary market (i.e., the market where individuals borrow money to purchase a home as opposed to the secondary market, where those mortgages are sold as part of MBS).

4. Corker–Warner also proposes to expand these funds. See Norbert Michel and John Ligon, “GSE Reform: Trust Funds or Slush Funds?” Heritage Foundation *Issue Brief* No. 4080, November 7, 2013, <http://www.heritage.org/research/reports/2013/11/gse-reform-affordable-housing-trust-funds-or-slush-funds>.

**Prevent a Government Takeover.** The Johnson–Crapo bill, like the Corker–Warner proposal, contains policy that is misguided for numerous reasons. Johnson–Crapo creates a new government entity with an ill-defined affordable housing mandate and the explicit authority to protect MBS investors in the event of a financial crisis. If the Senate’s approach is adopted, banks will be the only segment of the market left without an explicit guarantee against mortgage losses.

The Senate bills would not help people buy homes; they would only protect investors and special interests at taxpayers’ expense.

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