May 15, 2014

Senate Banking Committee Approves Sweeping Housing Finance Reform Bill on Bipartisan 13-9 Vote

Key Bloc of Six Democrats Votes Against Bill, Citing Concerns About Affordable Loans, Big Banks; Bill Seen as Unlikely to Get Senate Floor Vote Without More Democratic Support

The Senate Banking Committee today (Thursday, May 15) today approved S. 1272, the Housing Finance Reform and Taxpayer Protection Act -- an ambitious overhaul of the U.S. housing finance system that would wind down and ultimately replace Fannie Mae and Freddie Mac, the housing government-sponsored enterprises (GSEs) that were placed into federal conservatorship during the 2009-09 financial crisis. The bipartisan vote was 13-9, with seven Republicans joining six Democrats in voting to report the bill to the Senate floor. Despite weeks of negotiations, however, the bill's sponsors, Chairman Tim Johnson (D-SD) and Ranking Member Mike Crapo (R-ID), were unable to secure the support of a key group of six progressive Democrats, making it uncertain at best whether Democratic leaders will make time for the bill on the Senate floor during the remainder of this Congress. Majority Leader Harry Reid (D-NV) has previously said he would budget floor time for the bill only if it received substantial support from the panel's Democrats.

Nonetheless, both Johnson and Crapo vowed to continue to seek compromise changes to the bill with an eye toward gaining more support and a floor vote. Even if the bill were to be considered and passed in the full Senate, a competing GSE reform bill sponsored by House Financial Services Committee Chairman Jeb Hensarling (R-TX) and other Republicans – which, unlike S. 1272, would give the federal government no role in guaranteeing mortgage securities – has not yet secured enough support for GOP leaders to schedule a vote for it on the House floor. The Financial Services Committee approved that bill, HR 2767 (the "PATH Act"), in July 2013.

Attached with this alert please find PDF files with:

* A short staff summary of the Housing Finance Reform and Taxpayer Protection Act (8 pages);
* A detailed section-by-section summary of the bill (15 pages);
* The underlying text of the original draft of S. 1272 (442 pages);
* The text of the first manager's amendment (No. 2) assembled by Sens. Johnson and Crapo (84 pages);
* The text of a second manager's amendment (No. 98), which incorporates a series of amendments offered by other senators (60 pages); and
* The text of amendment No. 28, offered by Pat Toomey (R-PA), relating to municipalities that use powers of eminent domain to seize mortgages.

Administration Statement. The White House, which has worked closely with Sens. Johnson and Crapo to negotiate the bill's provisions and had urged support for the legislation, hailed the committee's action today, with press secretary Jay Carney calling the vote "important progress toward completing one of the biggest remaining pieces of post-Recession reform of the financial system."

Senators Voting to Advance the Bill. The six Democrats voting in support of the bill were Chairman Johnson and Sens. Kay Hagan (NC), Joe Manchin (WV), Heidi Heitkamp (ND), Jon Tester (MT) and Mark Warner (VA). The Republicans voting for the bill were Ranking Member Crapo and Sens. Tom Coburn (OK), Bob Corker (TN), Dean Heller (NV), Mike Johanns (NE), Mark Kirk (IL) and Jerry Moran (KS). The six Democrats who last week announced they would not support the bill in committee are Sherrod Brown (OH), Robert Menendez (NJ), Jeff

Merkley (OR), Jack Reed (RI), Charles Schumer (NY) and Elizabeth Warren (MA). The latter group generally cited concerns with the bill's provisions on affordable housing, prospects for larger banks dominating the new housing finance system, and the bill's potential effect on the availability and cost of mortgages, especially for low-income borrowers.

During a markup session that was kept to a little over an hour because most amendments had either been withdrawn or incorporated into the larger manager's amendments, the committee approved both manager's amendment No. 2 and manager's amendment No. 98 by voice votes (see below). The committee also rejected, 8-14, an amendment on municipalities' use of eminent domain powers offered by Sen. Toomey.

Overall Structure of the Bill

Much of S. 1272 is built around a previous bipartisan bill offered by Sens. Corker and Warner that would eventually replace Fannie Mae and Freddie Mac with a new industry-financed agency, the Federal Mortgage Insurance Corporation (FMIC), that would offer a government guarantee on mortgage bonds (in the form of reinsurance) in the event of a crisis that caused cascading losses. Importantly, however, that guarantee would kick in only after private investors had suffered the first 10 percent of losses. Those initial private losses would be absorbed either through certain structures of each security or by companies known as "guarantors" in the new system. The FMIC, which the sponsors said would be modeled on the FDIC, would establish how much capital those guarantors would have to raise and how they would raise it, in order to participate in the new securitization market. Reinsurance would be provided by a new Mortgage Insurance Fund.

The bill aims to preserve smaller lenders' access to the secondary mortgage market by including an option to sell individual mortgages through a small-lender mutual facility jointly owned by community banks, credit unions and other small lenders. The bill also includes numerous provisions designed to standardize procedures and improve market liquidity. (For additional detail on the bill's provisions, please see the two staff summaries attached with this alert.)

Two Manager's Amendments Adopted

The committee adopted, by voice vote, a manager's amendment (#2) that gathers a number of changes Sens. Johnson and Crapo had made to address senators' concerns before the original markup date of April 29, which ended up consisting only of the sponsors' opening statements with other action postponed until today. Among other provisions, the changes in this amendment, broadly, would:

* Limit the role played by larger banks in the new system by prohibiting approved guarantors from being affiliated with mortgage originators.
* Make it easier for smaller banks to access the secondary mortgage market.
* Clarify that state regulators have primary authority over private mortgage insurance firms.
* Strike section 332 of the original bill regarding investor immunity.
* Add language requiring the FMIC to set provisional capital standards for guarantors "to ensure an orderly transition" away from the GSEs to the new system, instead of ensuring "the safety and soundness of the approved guarantor." The effective date for these changes would also now be based when the first guarantors are approved, rather than when the new housing system is considered operational. The changes are intended to control mortgage costs as the new market develops.
* Require that certain minimum allocations of affordable housing funds be sent to the states.

* Require that state and federal regulators alert the FMIC if a participating bank is threatening the housing market.
* Ensure that businesses follow certain fair housing laws.

Notably, the amendment also strengthens language in a previous version of the amendment clarifying that the bill will not interfere with future court rulings in lawsuits filed by holders of preferred stock in Fannie and Freddie. (Fairholme Capital, Perry Capital and other funds have sued the Treasury Department, alleging that the administration's August 2012 changes to its conservatorship agreement for the GSEs constituted an illegal taking from Fannie and Freddie's shareholders.)

Second Manager's Amendment. The committee also adopted, by voice vote, a second manager's amendment (#98) that packaged together later changes requested by holdout Democrats, including Sens. Reed, Brown, Merkley and Warren (though it was not enough to attract their votes for the overall bill). The amendment also reflects changes sought by Sens. Coburn, Moran, Manchin, Pryor and Vitter.

Many of the changes included in this amendment were aimed at promoting affordable housing and the continued, wide availability of the 30-year fixed-rate mortgage. Some of the specific provisions would:

* Aim to prevent excessive concentration in the secondary mortgage market;
* Preserve non-eligible mortgages backed by Ginnie Mae;
* Prevent preferential treatment for a guarantor's investors;
* Prevent abusive practices in the use of credit risk-sharing mechanisms;
* Safeguard against the participation of "bad actors" with a history of offenses from serving as officers in the new system's guarantors and loan aggregators; and
* Preserve the legal enforceability of existing fair-housing laws.

Toomey Eminent Domain Amendment is Defeated

The committee rejected, 9-13, an amendment by Sen. Toomey that would have prohibited the FMIC from purchasing or guaranteeing any residential mortgage that was obtained by a local government through the use of eminent domain during the preceding 120 months. Toomey cited the example of Richmond, Calif., and 26 other cities that have said they planned to adopt such an approach. But Sen. Corker said that while he sympathized with Toomey on the issue of municipalities' use of eminent domain powers, his remedy was "a terrible idea" that he strongly opposed. "Today 90 percent of mortgages go through a government entity," Corker said. "If you're a real estate agent out there, under this amendment, if a county commissioner does something idiotic, she can't make a living for a decade."

Senators' Statements and Other Reaction

Chairman Johnson said, "I would like to thank Ranking Member Crapo for his partnership throughout this process to draft a serious, bipartisan product. Neither of us got everything we wanted, but our primary goal was to create a new system that would be built to last. I would also like to thank the Administration – specifically, the NEC, HUD, and Treasury - for their work with Senators Corker and Warner on S. 1217 and their input regarding various pieces of the discussion draft.... After exhausting every option to try and strike a deal quickly that would add votes at the committee level, I have concluded it is best to move forward with the majority we have now in committee and continue working to build support for the bill as it moves to the floor.... Even though the support [for this bill] was not unanimous, every member on the committee was actively engaged in this collaborative

process, and passing this legislation out of committee is only the first step. I look forward to continue working with my colleagues to keep this important process moving forward…

"This is not the final product. This is only the first step toward real reform, and we will continue to work together to improve the bill and attract additional support…. I remain committed to working with Members of the Committee to get to a place where more of you can support this important legislation on the floor. I believe that is a commitment shared by many of my colleagues here today, and I would be interested to hear from Members about their interests in continuing to work together on this effort."

Ranking Member Crapo said, "Today is an important day and one of which we should all be proud…. For the first time in the nearly six-year conservatorship of Fannie Mae and Freddie Mac, both the House Financial Services Committee and the Senate Banking Committee will have passed legislation to reform this system. This is an important milestone. The Chairman and I will continue to grow support for this important legislation to repair our broken housing economy. We have the opportunity to fix our flawed system and set up a more sustainable, efficient, permanent housing finance system that will provide future economic opportunities for millions of families and individuals throughout America."

Sen. Corker said, "After more than a year of discussions and a dozen hearings, I am extremely proud the Banking Committee took a significant step toward building a modern and more efficient housing finance system that provides access to creditworthy borrowers while protecting taxpayers from writing massive checks in the heat of a future financial crisis. This bill serves as a model of how we can tackle the major challenges in our economy and should become the framework for how our housing finance system will ultimately look… I hope the Senate Majority Leader recognizes this tremendous opportunity to address the unfinished business of the 2008 financial crisis and schedules a floor vote on this important, bipartisan bill. The Senate should not let this moment pass by, allowing the status quo of private gains and public losses to continue."

Richard Shelby (R-AL) said, "Few would disagree that Fannie Mae and Freddie Mac are in an untenable position. While they continue to provide the lion's share of housing guarantees, they possess virtually no capital and remain wards of the state. Also, their renewed profitability remains vulnerable to future Congressional spending sprees. There is no doubt that housing finance reform is long overdue. And, the legislation before us is in many ways commendable. It winds down Fannie and Freddie and aims to do so without disrupting market liquidity and the flow of credit to households and businesses. The question remains, however: Is it a better mousetrap? I fear that while this legislation is well intended, it may further complicate an already complex problem by expanding the role of the federal government in our private housing finance market and creating, yet again, another massive regulator…

"I believe that the threshold question before us is whether we will continue to provide a GSE-like guarantee in any form. I do not think that this debate has been settled….If we are to accept the need for a government guarantee in housing, which this legislation would codify, a number of questions remain unanswered: First, is it the proper role of government to be the micro-manager of a complex architecture for housing finance? Do we really need a new super-regulator? … The centerpiece of this bill, the Federal Mortgage Insurance Corporation, would have a broad swath of regulatory authorities rivaled only by the Federal Reserve. Not only would it provide mortgage insurance for trillions of dollars of new mortgages, it would also be responsible for maintaining a liquid housing market, regulating financial entities big and small and facilitating credit availability across the spectrum, including during economic downturns… Will the new regulatory framework, where government would have a hand in almost every aspect of mortgage finance, be able to resist those who would compel it to make bad loans that are underpriced? … While it is clear that there are many concessions in this bill

for the so-called stakeholders in the process, it is less clear that the most important stakeholder, the American taxpayer, even had a seat at the table… In my view, capital in the "first loss" position should be no riskier than a Treasury security. I am not optimistic that regulators agree with me, given their past propensity to allow watered-down assets to serve as capital… For these and other reasons, I intend to oppose this bill. My opposition, however, should not be interpreted as opposition to reform of any kind. Rather, it is a vote against a complicated, government-run framework that, I believe, overexposes the American taxpayer and creates more problems than it solves."

Sherrod Brown (D-OH) said that leading up to the financial crisis, Fannie and Freddie "had a deeply flawed business model as publicly traded corporations with the implicit backing of and subsidies from the federal government and with a public mission. They were allowed to invest in toxic private-label mortgage-backed securities with lax underwriting standards; and they were leveraged 75 times their capital. Any legislation to reform the Enterprises must address these three critical issues. While the legislation before the Committee has improved substantially, I am concerned that it has not yet addressed these flawed incentives, and I am not ready to support it today. I am concerned that the guarantors and aggregators in the new system will be motivated by the same combination of private profit and public guarantee as the Enterprises. I am concerned that the 'senior-subordinated' structure of the 'capital markets execution' system will recreate the features of toxic structured securities that caused losses at the Enterprises, as well as some bailed out Wall Street banks. And I am concerned that the definition of 'capital' in the bill is too weak, that regulators can waive capital requirements during crisis, and that regulators can still bail out companies that are too important to the mortgage financing market…

"We should not turn over the [GSEs'] business to the same Wall Street banks that triggered the financial crisis and taxpayer bailouts…. I am also not convinced that it is time to do away with the Enterprises' affordable housing goals and duty to serve. Simpler reform is better reform. I am concerned that the complexity of the legislation before us could: create opportunities for arbitrage; distort pricing; increase concentration; and exacerbate systemic risk."

In a statement responding to the Banking Committee's vote, House Financial Services Chairman Jeb Hensarling (R-TX) said, "It is always good to see members of Congress working to move the complicated and contentious issue of housing finance reform forward… I congratulate Sens. Johnson and Crapo for their efforts… The fact remains the window for action this year is quickly closing, and I fear it may already be too late during this Congress with an already-full agenda to get meaningful reform bills through both chambers. Additionally, while there are several common-sense provisions in Senate bill that are similar to those we included in the PATH Act, the Senate bill features a controversial and irresponsible new politicization of mortgage credit insisted by Senate Democrats under the guise of affordable housing. This wealth redistribution scheme, far worse than that of the current system, would be a multibillion-dollar annual invitation to return to the lower credit standards, higher risks, and unsustainable lending that created the crisis in the first place."

If you have questions, or need additional information, please contact Will Heyniger or Bob Schellhas at Washington Council Ernst & Young at (202) 293-7474.