April 9, 2014

Senator Tim Johnson
136 Hart Senate Office Building
Washington, DC 20510

Dear Senator Johnson,

A few weeks ago, Senator Crapo and you unveiled their proposal for housing finance reform. This is a critically important issue that has remained unresolved for far too long. For that reason, I thank you and Senator Crapo for at least sparking a discussion. But we have serious concerns about your proposal. Unfortunately, this is an issue that is complex, and thus, difficult for many people to understand. I am writing you today to express some criticisms about your legislation.

Taxpayers, consumers and shareholders should have serious reservations about this proposal for housing finance reform. It does not adequately solve some of the issues with the government sponsored enterprises (GSEs) that contributed to the financial crisis and their conservatorship – and indeed potentially creates new problems. It does not sufficiently protect taxpayer dollars from being devoted to another bailout. It does not advance adequate support for affordable and low-income housing for underserved communities. It sets an objectionable precedent for shareholder rights and treatment in this country. And it leaves far too many regulatory decisions up in the air.

When the broad strokes of this legislative framework were announced in mid-March, I warned that by completely eliminating the GSEs as a part of housing finance reform, Congress could be further opening the flood gates to Wall Street abuses and excesses. Now that the legislative language has been released, we see that this serious risk is contained therein.

The proposals in the Senate and the House do not adequately anticipate the greed and power embedded on Wall Street in its incentive structure. And without laying out a strict regulatory structure, they seem to wrongfully assume that private capital will regulate itself. Do we really want to give even more power to the 'Too Big to Fail' banks that were principally responsible for this crisis to begin with?

The GSEs were certainly not blameless for transgressions similar to those larger ones committed by the Wall Street crowd prior to the financial crisis in 2008. But to eliminate them and unravel this intricate market further, could open the door wide for runaway corporate exploitation. We don't argue that the GSEs should be maintained as is; but instead that they should be strongly regulated to prevent their previous missteps and abuses, and that shareholders should be allowed to participate in any future recovery.

In fact, many – if not almost all – of the reforms contained in the Johnson-Crapo housing finance reform legislative draft could be enacted within the framework of the current system and applied to the GSEs' structure. It seems to unnecessarily complicate the reform by eliminating the GSEs completely and hoping a new entity in their place would purport to serve a similar purpose – all in order to advance a form of housing finance reform that could instead be applied simply to the otherwise functioning and experienced GSEs.

It is our understanding that the Senate Banking Committee will be meeting in April to discuss your legislative draft. Based on our understanding of the legislative language, our concerns are laid out below. Although the list is long, please do not misunderstand it as a comprehensive list of problems that we have with the legislation – but rather that it includes some of the most glaring issues. During the Committee's discussion in April, it is hoped that you will address the concerns that follow.

<u>Johnson-Crapo does not solve many of the problems that contributed to financial crisis:</u>

- The legislation maintains a government guarantee. Albeit instituting a requirement that private capital take the first ten percent of losses. But this still leaves taxpayers on the hook for the other 90 percent. This does not go far enough, and maintains the problems with out-of-control moral hazard that existed prior to the 2008 financial crisis.

- Securities insured or guaranteed by the proposed Federal Mortgage Insurance Corporation (FMIC) are exempt from the laws administered by the Securities and Exchange Commission. Why should these securities be treated differently? Will this not distort the market and invite exploitation?

- FMIC is not adequately regulated. While the GSEs were regulated poorly, they did at least have regulators overseeing them prior to the financial crisis. This legislation would place the Federal Housing Finance Agency (FHFA) inside of the FMIC and leave it, and the products it approves, virtually unregulated. With such a large and powerful entity – even if it is a part of the federal government – one must be concerned about regulatory capture. Or, as its market share grows, about the FMIC turning into another iteration of the GSEs prior to the financial crisis.

- The board, officers, and employees of the FMIC are exempt from any liability under the Securities Act of 1933. Why? There should be consequences for flouting the law; government officials should not be exempt.

- The consumer voice is virtually absent from any executive or high-level positions within the FMIC – just one slot on a 9-member advisory committee to the board is vaguely dedicated to someone who can represent the consumers' voices.

- The legislative draft exempts the FMIC and its counterparties from far too many potentially crucial regulatory frameworks currently in existence. Strong regulation of this complex market is crucial to avoiding future financial crises:

    - There is an exemption for counterparties involved in approved credit risk-sharing mechanisms from being considered a commodity pool as defined in the Commodity Exchange Act.

- There is an exemption for approved credit risk-sharing mechanisms from section 27B of the Securities Act of 1933, a section which deals with concerns about conflicts of interest. Why?

Johnson-Crapo does not protect taxpayer dollars:

- The legislation sets up a Mortgage Insurance Fund (MIF), through fees, to protect taxpayers in the case of a future financial crisis. While it is good news that the legislation walls off these funds from the federal government, it doesn't do the same for the FMIC. Instead of protecting and preserving these funds, the legislation authorizes the use of MIF funds for items other than a catastrophic scenario. It allows MIF funds to be used to pay FMIC employees, for establishing the common securitization platform (CSP), for funding the CSP, and for "all other expenses of the FMIC."

- Standards are instructed to be set for first loss credit-risk sharing mechanisms that are designed to absorb the first 10 percent of losses. But the legislation then allows the FMIC to exempt these standards in the event of a financial crisis. Does this not create perverse incentives in which aggregators, guarantors, and securitizers know that they do not necessarily need to meet the requirements to be approved and insured with a government backstop? Does this not create the same type of moral hazard that existed with the GSEs and their implicit government guarantee?

- The legislation allows approved guarantors to fulfill their capital standards through the use of credit risk-sharing mechanisms approved by the FMIC. But it does nothing to delineate that the counterparties in these risk-sharing mechanisms need be approved or meet certain standards. Would this not risk the integrity, safety, and soundness of these risk-sharing mechanisms? This could potentially inject an unknown amount of risk and would seem to not be a safe and secure means of protecting the FMIC or the MIF against losses. We would imagine that this opens up an exploitable loophole.

Johnson-Crapo is not good for affordable housing:

- The affordable housing goals of the GSEs are eradicated when the legislation eliminates the GSEs. This is not replaced by any new goals or incentives for the FMIC that compensate for this significant blow to affordable housing.

- Though the legislation broadly instructs FMIC to support underserved areas, it provides no adequate framework or goals whatsoever to ensure that this happens.

- In fact, the legislation specifically prohibits the FMIC from putting in place regulations that would require approved aggregators or guarantors to include loans to underserved areas as a portion of their business. It explicitly states that the FMIC's standards for approving aggregators or guarantors cannot interfere with the guarantor's or aggregator's exercise of "business judgment" in mortgage loans. This is one of the ripest areas for incentivizing affordable housing – and the legislation summarily prohibits it! Why?

- In this sense, the legislation does little more than pay lip service to the importance of affordable housing, low-income housing, and serving underserved areas. Senator Elizabeth Warren was right, when speaking at a recent National Community Reinvestment Coalition conference, to warn that we should pump the brakes and not rush into a housing reform proposal that we will end up regretting. Senator Warren made the point that, “if we get housing finance wrong, the impact will be felt throughout America’s middle class.” And lower income Americans as well.

Johnson-Crapo leaves too many regulatory decisions up in the air, without a baseline:

- The legislation consistently lays out the type of regulations FMIC should adopt. But it does not proscribe a baseline regulatory structure. Allowing the FMIC flexibility in setting its own regulations and some adaptability to be able to adjust to changing market conditions can be considered within limits. But there are certainly some basic regulations that we can agree on and simple baselines that should be outlined in this bill for many of the regulations it instructs the FMIC to codify on its own, besieged as it would be by corporate law firms.

- In the proposed legislation there are instructions for the FMIC to set things like “capital and solvency standards for covered entities” without the legislation setting a baseline for what would be a minimally acceptable level.

- Leaving the specifics of regulatory structure completely up to the FMIC seems like a recipe for these regulations being weakened under corporate pressure in the administrative and rulemaking process.

Johnson-Crapo sets an objectionable precedent for shareholder rights:

- Fannie Mae and Freddie Mac are unjustly and unnecessarily wiped out. Many, if not almost all, of these reforms could be enacted within the current housing finance system.

- Fannie Mae and Freddie Mac shareholders are left in limbo with this legislation, and it ignores them in the process of winding down the agencies. The FHFA is directed to sell off and liquidate the GSEs’ assets.

- The federal government has used and abused the GSEs’ shareholders since putting them into conservatorship and not allowed them any ability to share in the GSEs’ recovery. The taxpayers should certainly be paid back first. But once that happens, with interest for the taxpayers’ investment, there is no reason that the shareholders (of whom I am one) should not be allowed to benefit from the recovery of the GSEs much in the same way that shareholders of other bailed out large corporations did – like those of AIG and Citi. This legislation would seemingly prevent this from happening.

- When the FHFA established the conservatorship for Fannie Mae and Freddie Mac and assumed control of these two GSEs on September 7, 2008, shareholders lost their voting rights, dividends on preferred and common stock were suspended, and annual shareholder meetings were canceled. The federal government received warrants to buy up to 79.9 percent of GSE common stock for $0.00001 per share – just shy of the 80 percent threshold to be reflected in the government's budget. These actions turned the non-government shareholders into, in essence, zombie stockholders with no rights and no remedies against the GSEs or the FHFA.

- Further, just as the GSEs began a swift turnaround and were on the verge of repaying the taxpayers for their investment, the Treasury in 2012, arbitrarily amended the government's preferred stock purchase agreement to indefinitely sweep all profits of the GSEs into the Treasury's coffers. This arrangement has allowed the federal government, and the budget, to benefit from the GSEs' recoveries while at the same time keeping the GSEs' liabilities off of the federal government's books. Meanwhile, the shareholders continue to be used and remain beaten down.

- By unilaterally winding down the GSEs, the legislation continues the federal government's unfortunate precedent of using and abusing the GSEs' shareholders.

Please consider these comments in your consideration of any new legislative framework for housing finance reform. I hope you will engage with all stakeholders in your deliberation on this important issue. I look forward to your thoughts and comments.

Sincerely,

Ralph Nader

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