RSC Republican Study Committee
Financial Services Working Group
Congressman Scott Garrett (R-NJ), Chairman
Congressman Tom Price (R-GA), RSC Chairman

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Financial Services Markup Bonanza

The Financial Services Committee is marking up several bills over the next few weeks that have the potential to expand our government greatly, and the concerns over which are certainly worth highlighting. Beginning next week, the Committee will mark up the Investor Protection Act of 2009; the Private Fund Investment Advisers Registration Act of 2009; the Federal Insurance Office Act of 2009; and the Accountability and Transparency in Rating Agencies Act. This week's edition of the Financial Services Newsletter has a preview of two pieces of legislation; next week, we will preview the other two pieces up for consideration.

Insurance Information Act of 2009

The "Insurance Information Act of 2009" legislative proposal would establish a "Federal Insurance Office" within the Treasury Department. The new Office would have the authority to monitor all aspects of insurance industry regulation (for all lines of insurance except health), identify issues or gaps in regulation that could contribute to a systemic crisis, and recommend insurance companies or affiliates that might pose systemic risks to be subject to "heightened regulation." The original version of this legislation was targeted to facilitate the negotiation of insurance related international trade agreements. There are some concerns that the version now being considered will potentially expand the size and scope of the federal government.

Private Fund Investment Advisers Registration Act of 2009 (Hedge Fund Registration)

The "Private Fund Investment Advisers Registration Act of 2009" would amend the Investment Advisers Act of 1940 to eliminate the private adviser exemption and require advisers to private investment funds to register with the SEC. Under the bill, hedge funds, private equity firms, and other private pools of capital would be included within the definition of a private fund. The registration requirement would be limited to advisers to these private investment funds with more than $30 million in assets under management.

Government Growth Alert! First, let's step back and remember that hedge funds were not the cause of our financial sector difficulties. Second, the due diligence performed by sophisticated institutions that invest in hedge funds is significantly more rigorous than anything they will be subject to under a registration regime. We should be wary that the perceived government imprimatur provided by mandatory registration may undermine or deemphasize due diligence over time. Perhaps more importantly, without mandatory registration there is no current expectation by the financial markets that taxpayers would ever be required to bail out a failed hedge fund. Once you introduce government oversight, expectations change.

On the Horizon

The Next Taxpayer Bailout: The FHA?

Per WSJ: "At a 50 to 1 leverage ratio, the FHA will soon have a smaller capital cushion than did investment bank Bear Stearns on the eve of its crash. Its loan delinquency rate (more than 30 days late in payments) is now above 14%, or from two to three times higher than on conventional mortgages...The reason for this financial deterioration is that FHA is underwriting record numbers of high-risk mortgages. Between 2006 and the end of next year, FHA's insurance portfolio will have expanded to $1 trillion from $410 billion."

Rep. Scott Garrett (R-NJ) introduced legislation to require borrowers under Federal Housing Administration (FHA)-insured mortgages to make down payments of at least 5%. Garrett's bill, the "FHA Taxpayer Protection Act of 2009" is aimed at shielding taxpayers from the risk that the FHA portfolio presents. In addition to the 5% down payment requirement, an increase from the current required rate of 3.5%, Garrett's legislation would also prohibit financing of closing costs under such mortgages, and require a Government Accountability Office (GAO) study of FHA fiscal soundness.

THE WALL STREET JOURNAL.
WSJ.com

WSJ: Barney Frank, Predatory Lender
By PETER J. WALLISON

Almost two-thirds of all bad mortgages in our financial system were bought by government agencies or required by government regulations.

Recent reports that the Federal Housing Administration (FHA) will suffer default rates of more than 20% on the 2007 and 2008 loans it guaranteed has raised questions once again about the government's role in the financial crisis and its efforts to achieve social purposes by distorting the financial system.

The FHA's function is to guarantee mortgages of low-income borrowers (the mortgages are then sold through securitizations by Ginnie Mae) and thus to take reasonable credit risks in the interests of making mortgage credit available to the nation's low-income citizens. Accordingly, the larger than normal losses that will result from the 2007 and 2008 cohort could be justified by Barney Frank, the chairman of the House Financial Services Committee, as "policy"—an effort to ease the housing downturn through the application of government credit. The FHA, he argued, is buying more weak mortgages in order to help put a floor under the housing market. Eventually, the taxpayers will have to judge whether this policy was justified.

Far more interesting than the FHA's prospective losses on its 2007 and 2008 book are the agency's losses on its 2005 and 2006 guarantees, when the housing bubble was inflating at its fastest rate and there was no need for government support. FHA-backed loans during those years also have delinquency rates between 20% and 30%. These adverse results—not the result of a "policy" effort to shore up markets—pose a significant challenge to those who are trying to absolve the U.S. government of responsibility for the financial crisis.

When the crisis first arose, the left's explanation was that it was caused by corporate greed, primarily on Wall Street, and by deregulation of the financial system during the Bush administration. The implicit charge was that the financial system was flawed and required broader regulation to keep it out of trouble. As it became clear that there was no financial deregulation during the Bush administration and that the financial crisis was caused by the meltdown of almost 25 million subprime and other nonprime mortgages—almost half of all U.S. mortgages—the narrative changed. The new villains were the unregulated mortgage brokers who allegedly earned enormous fees through a new form of "predatory" lending—by putting unsuspecting home buyers into subprime mortgages when they could have afforded prime mortgages. This idea underlies the Obama administration's proposal for a Consumer Financial Protection Agency. The link to the financial crisis—recently emphasized by President Obama—is that these mortgages would not have been made if regulators had been watching those fly-by-night mortgage brokers.

There was always a problem with this theory. Mortgage brokers had to be able to sell their mortgages to someone. They could only produce what those above them in the distribution chain wanted to buy. In other words, they could only respond to demand, not create it themselves. Who wanted these dicey loans? The data shows that the principal buyers were insured banks, government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac, and the FHA—all government agencies or private companies forced to comply with government mandates about mortgage lending. When Fannie and Freddie were finally taken over by the government in 2008, more than 10 million subprime and other weak loans were either on their books or were in mortgage-backed securities they had guaranteed. An additional 4.5 million were guaranteed by the FHA and sold through Ginnie Mae before 2008, and a further 2.5 million loans were made under the rubric of the Community Reinvestment Act (CRA), which required insured banks to provide mortgage credit to home buyers who were at or below 80% of median income. Thus, almost two-thirds of all the bad mortgages in our financial system, many of which are now defaulting at unprecedented rates, were bought by government agencies or required by government regulations.

The role of the FHA is particularly difficult to fit into the narrative that the left has been selling. While it might be argued that Fannie and Freddie and insured banks were profit-seekers because they were shareholder-owned, what can explain the fact that the FHA—a government agency—was guaranteeing the same bad mortgages that the unregulated mortgage brokers were supposedly creating through predatory lending?

The answer, of course, is that it was government policy for these poor quality loans to be made. Since the early 1990s, the government has been attempting to expand home ownership in full disregard of the prudent lending principles that had previously governed the U.S. mortgage market. Now the motives of the GSEs fall into place. Fannie and Freddie were subject to "affordable housing" regulations, issued by the Department of Housing and Urban Development (HUD), which required them to buy mortgages made to home buyers who were at or below the median income. This quota began at 30% of all purchases in the early 1990s, and was gradually ratcheted up until it called for 55% of all mortgage purchases to be "affordable" in 2007, including 25% that had to be made to low-income home buyers.

It was not easy to find candidates for traditional mortgages—loans to people with good credit records or the resources for a substantial downpayment—among home buyers who qualified under HUD's guidelines. To meet their affordable housing requirements, therefore, Fannie and Freddie reduced their lending standards and reached into the FHA's turf. The FHA, although it lost market share, continued to guarantee what it could, adding to the demand that the unregulated mortgage brokers filled. If they were engaged in predatory lending, it was ultimately driven by the government's own requirements. The mortgages that resulted are now problem loans for the GSEs, the FHA and the big banks that were required to make them in order to burnish their CRA credentials.

The significance of the FHA's troubles is that this agency had no profit motive. Yet it dipped into the same pool of subprime and other nontraditional mortgages that the GSEs and Wall Street were fishing in. The left cannot have it both ways, blaming the private sector for subprime lending while absolving the government policies that created the demand for subprime loans. If the financial crisis was caused by subprime mortgages and predatory lending, the government's own policies made it happen.

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