PALs WASHINGTON REPORT

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Introduction

Despite intense criticism from Democrats on policy and process, and concerns that it will add over $1 trillion to the deficit, congressional Republicans raced against a self-imposed deadline to deliver a comprehensive tax reform bill before Christmas. The Senate and House met in a conference to reconcile the differences in their two bills and get a final product to the president's desk. The conferees had to resolve a number of issues, including the new corporate tax rate, the number of income brackets for individuals, and treatment of certain deductions. In addition to tax reform, there have also been significant developments regarding regulatory relief and housing finance reform. Mixed in with the legislative and policy developments, there has been significant national attention given to the numerous allegations of inappropriate conduct leveled against a number of elected officials and public figures. This report details the issues topping our watch list.

Tax Reform

On December 13, House Ways and Means Committee Chairman Kevin Brady (R-Texas) and Senate Finance Committee Chairman Orrin Hatch (R-Utah) announced that the conference committee had reached an agreement in principle on the tax reform legislation. On December 15, House-Senate tax conferees signed off on a conference report resolving the differences between the tax reform bills that passed each chamber. The House and Senate are expected to vote on the final measure the week of December 18. The final bill contains a number of provisions that will have implications for the housing and banking sectors. The mortgage interest deduction would be changed to only allow deductions of interest paid on home loans up to $750,000, which is a decrease from the current $1 million limit. Regarding state and local taxes, the final bill would allow individuals to deduct up $10,000 in property or income taxes. Although the House bill repealed the tax-exempt status of private activity bonds, the final conference report left those bonds unchanged. However, advance refunding bonds and tax credit bonds were stripped of their tax-exempt status. The laws regarding low-income housing tax credits and new market tax credits were also left unchanged. In the area of compensation, the bill imposes an excise tax of 20 percent on salaries above $1 million for executives of tax-exempt organizations, but there was no change to the status of non-qualified deferred compensation.

Regulatory Relief

On December 5, the Senate Banking Committee approved a targeted regulatory relief bill that has the support of committee Chairman Mike Crapo (R-Idaho) and at least twelve Democratic cosponsors, including four members of the panel. Although committee Ranking Member Sherrod Brown (D-Ohio) and influential senator Elizabeth Warren (D-Mass.) oppose the bill, it appears to have enough bipartisan support to muster 60 votes and pass on the Senate floor. In fact, the committee cosponsors of the bill agreed to oppose amendments – even those that proposed changes they favored – during the markup. The bill is not as comprehensive as the House-passed Financial Choice Act, but it attempts to strike a balance between providing regulatory relief for community and regional banks while also providing some consumer protections. The bill raises the asset threshold for being declared a systemically important financial institution from $50 billion to $100 billion immediately, and then to $250 billion after eighteen months. Further, the threshold for banks to complete company-run stress tests was raised from $10 billion to $250 billion. For community banks under $10 billion in assets, regulatory relief comes in the form of simplified capital requirements, shorter call reports, exemptions from the Volcker Rule, and Qualified Mortgage treatment for mortgage loans held in portfolio. The bill also includes a provision allowing financial institutions to verify a customer's identity with a photo identification scan when opening an online account.

The House has passed a number of individual regulatory relief measures approved by the House Financial Services Committee, increasing the likelihood of an agreement between the House and Senate on a regulatory relief measure.

Housing Finance Reform

In a noteworthy development, House Financial Services Committee Chairman Jeb Hensarling (R-Texas) announced that he is open to working on bipartisan housing finance reform. Hensarling made clear that his previously introduced bill, the PATH Act, was his favored option, but he did acknowledge that the proposal does not have enough support to pass the House or the Senate. In a speech before the National Association of Realtors, Hensarling specifically endorsed the DeMarco-Bright proposal, which would utilize the Ginnie Mae securitization platform to issue mortgage-backed securities that carry an explicit government guarantee. He also extended an olive branch to committee Democrats and said that he would be willing to negotiate proposals to support affordable housing.

Media reports also indicated that Senators Bob Corker (R-Tenn.) and Mark Warner (D-Va.) have renewed their efforts to craft a bipartisan housing finance bill. The new proposal would keep Fannie Mae and Freddie Mac (the Enterprises) under conservatorship until other lenders and issuers enter the securitization market for mortgage loans. FHFA would remain as regulator of Fannie Mar and Freddie Mac and approve pricing and returns. However, the two Enterprises would lose their government charters and their investment portfolios. Small lenders would have improved access to the secondary market, and there would be continued support for affordable housing. The draft contemplates a “paid-for” government backstop to prevent catastrophic losses to investors in mortgage backed securities in case of widespread homeowner default. The proposal is not yet public, but it is being vetted by the Treasury Department and some industry participants.

Fannie Mae and Freddie Mac

An unintended consequence of tax reform would be its effect on tax-deferred assets of Fannie Mae and Freddie Mac, which rise and fall in value based on corporate tax rates. Following the mortgage crisis of 2008, the Enterprises were able to write down losses on mortgage loans in their portfolios to reduce future corporate tax obligations. However, those write-downs were conducted using the current 35 percent corporate tax rate. Lowering the rate would result in a reduction in the value of those assets and could result in a $20 billion combined loss for the Enterprises. This accounting loss, combined with the Enterprises’ declining capital buffers and inability to retain profits to build them back up, could contribute to the need for one (or both) of them to draw on their $258 billion credit line with the Treasury in the coming year, potentially increasing the urgency of the housing finance reform effort.

Flood Insurance

Congress voted to extend the National Flood Insurance Program (NFIP) through December 22 in its most recent two-week gap spending bill. This extension was geared to allow Congress more time to consider and adopt a long term bill to reauthorize and reform the program. In November, the House passed a five-year reauthorization bill in a largely party-line vote after months of negotiations. That bill included provisions to encourage private companies to compete in the flood insurance space, increase NFIP premiums, and limit the government’s ability to insure certain homes that repeatedly flood.

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