

# WebMemo



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## End Fannie Mae and Freddie Mac to Build Tomorrow's Housing Finance System

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The era of Fannie Mae and Freddie Mac is over, and it is time to formally close them down. The activities of the two government-sponsored enterprises (GSEs) played a major role in the 2008 financial crash and have so far cost taxpayers over \$150 billion to cover their losses; more is yet to come. Efforts to reform or refine their roles are misguided at best. Nothing short of Fannie Mae and Freddie Mac's complete elimination will enable a healthy housing market to reappear.

Today, the two GSEs control about 90 percent of the mortgage-backed securities market, and this must not become a permanent situation. Over time, the private sector is more than capable of taking over their securitization functions without causing major disruptions to the housing market or delaying its recovery. The Obama Administration should propose clear and unambiguous steps that will phase out the role of both organizations in the mortgage finance markets while also gradually selling off their portfolios of mortgage securities.

**Building for Tomorrow's Opportunities, Not Today's Fears.** By the time that Fannie Mae and Freddie Mac should completely disappear in several years time, the housing market should be fully recovered from the 2008 crash. Parts of the housing and mortgage finance industry fear that eliminating the two GSEs could crimp that market's slow recovery, but they are reacting to the past few years and not looking towards the future. They fear that no private companies are ready to package mortgages into securities and worry that without the explicit government guarantee of those mortgages, credit

will be unavailable to many borrowers and that certain products such as the 30-year mortgage will become hard to find.

To avoid these problems, the end of Fannie Mae and Freddie Mac should come gradually—but with a clear, unambiguous understanding that they will be completely and permanently phased out. While some level of presence may be necessary while the housing sector recovers, there is a growing consensus that neither organization is necessary in the future. As noted in *The Washington Post*,<sup>1</sup> the private sector is more than capable of producing mortgage-backed securities and appropriately pricing a guarantee that should satisfy investors. There are plenty of investors who would be willing to buy mortgage-backed securities with a private guarantee instead of one by the government.

As the crash of 2008 showed, the old structure of housing finance was a spectacular and expensive failure. Recreating it is the very last thing that either homeowners or taxpayers need to bequeath to future generations. Instead, both legislators and the Obama Administration should work to structure a mortgage-finance system based in the private sector that has the flexibility to meet market needs while

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still ensuring that mortgages meet strict underwriting standards and to protect consumers from predatory lending practices.

**Separating Three Functions.** Currently, Fannie Mae and Freddie Mac have three responsibilities that should be handled separately. First, they purchase and package mortgages from banks and other originators, packaging them into mortgage-backed securities with a guaranty against credit risk. Second, both organizations purchase mortgage-backed securities and hold them as investments. Third, they are required to meet a variety of housing policy goals aimed at ensuring that Americans of all income levels are able to own a home. These are three separate and distinct functions, and each of the three solutions should be handled apart from the other two.

**1. Encourage Private-Sector Replacement of the GSEs' Financial Activities.** Since 2008, privately issued mortgage-backed securities, which once had over half of the market, have virtually disappeared. These securities are important components of housing finance because they allow new money from investors who buy the securities to finance additional mortgages. Restoring their presence will take time, and policymakers should encourage this with specific steps mentioned below.

In addition to the conventional forms of securitized mortgages, Congress should also encourage the use of covered bonds—a mortgage-financing mechanism used successfully in other countries to finance additional mortgages instead of mortgage-backed securities—and similar innovative financing methods. While ideally the transition to private financing mechanisms should be as rapid as possible, policymakers should avoid the temptation to put firm deadlines on the complete phase-out of Fannie Mae and Freddie Mac given the still fragile state of the housing market. Instead, specific steps to encourage that transition should be clearly described and scheduled, with the Federal Housing Finance Agency being given the job of monitoring the situation under close oversight and charged with ending the two GSEs as market conditions allow.

Private providers of mortgage-backed securities will reappear if the subsidized fees that the two GSEs charge for guaranteeing the credit quality of mortgages included in mortgage-backed securities gradually rise using a set and unambiguous schedule. In addition, the emergency legislation that allowed Fannie Mae and Freddie Mac to purchase mortgages of up to \$729,750 to include in their securities should be allowed to expire. This would drop the maximum to \$625,500, which should then be further reduced over time.

**2. Gradually Resolve Existing Portfolios.** To allow the housing market to recover, the portfolios of the two GSEs should be sold off over time as promptly as market conditions allow. There is no need to place a firm deadline of its sale, as that is more likely to distort prices and compete with newly originated mortgage-backed securities. However, there should be a firm and binding commitment to their eventual sale, combined with close oversight to ensure that this goal is met. The healthy portions of the portfolios could be sold off as is, while the toxic debt could be gradually resolved over a longer time.

**3. Move Subsidies and Policy Goals to HUD.** Housing policy goals and subsidies should be separated from the market-oriented activity so that they do not distort incentives and decision making. The actual cost of the subsidies should be made transparent and placed on budget and then transferred to the Department of Housing and Urban Development (HUD). At the same time, the Financial Housing Enterprise Safety and Soundness Act of 1992, which imposes affordable housing goals on the GSEs, should be repealed, while other housing policy goals that were the responsibility of Fannie Mae and Freddie Mac should be moved to HUD. Once the subsidies and policy responsibilities are in HUD, Congress can eliminate those that are not necessary, cost effective, or affordable.

**Congressional Oversight.** In order to monitor that these changes are taking place, Congress should place explicit sunsets on the charters of both Fannie Mae and Freddie Mac. These would replace the perpetual charters that the two GSEs have today

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1. Editorial, "Averting Another Mortgage Crisis," *The Washington Post*, February 6, 2011, at <http://www.washingtonpost.com/wp-dyn/content/article/2011/02/06/AR2011020603413.html> (February 10, 2011).

and force a congressional reexamination of the phase-out process to ensure that market conditions do not allow for the process to be conducted faster.

Fannie Mae and Freddie Mac have great expertise in issuing mortgage-backed securities that would be extremely valuable to the private sector. As the move toward private-sector mortgage-backed securities grows, Congress should also sell off pieces of the two GSEs' underwriting activities to private companies. However, Congress should not sell pieces that are geographically based, since these pieces could be reattached to recreate the two GSEs. Instead, portions that are sold should contain a geographically dispersed share of mortgages and should be sold to purchasers of different sizes and in differing locations, including at least some smaller banks or other financial entities.

**Making Housing GSE-Free.** Creating Fannie Mae and Freddie Mac were serious policy mistakes, as were subsidizing them through privileged access to federal funds and implicit guarantees. These mistakes should never be repeated. Nothing less than their complete elimination is acceptable. However, this is not a development to fear but rather the first step in rebuilding a modern housing finance industry that would provide Americans with greater opportunities to own their own home without the risk of another multi-hundred-billion-dollar bailout.

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