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Housing Finance Reform: No Need for a New Fannie Mae and Freddie Mac

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Given the task of producing a plan to develop a new housing finance system in light of the 2008 crisis and the failure of both Fannie Mae and Freddie Mac—a task that everyone agrees will be extremely complex—the Obama Administration decided to punt. Rather than one detailed plan, it produced brief summaries of three very different ones, leaving the nation to wonder what the Administration really wants.

Option One: After Fannie Mae, No Government Involvement. The new Treasury-HUD report[1] clearly supports ending both Fannie and Freddie, but what happens next is unclear. The three proposals for the future after Fannie and Freddie involve the role of the federal government in providing housing finance. Of them, the first essentially calls for no role at all, leaving the matter in the hands of the private sector. This is clearly the best proposal of the three. In the report's words, it "would minimize distortions in capital allocation across sectors, reduce moral hazard in mortgage lending and drastically reduce direct taxpayer exposure to private lenders' losses."[2]

However, the Administration signals that it really does not like this option, claiming that it will cause mortgage rates to increase, make traditional 30-year mortgages "more difficult for many Americans to afford," and make it harder for smaller financial institutions to compete with larger ones.

This concern is not unfounded, but it misrepresents the facts. Regardless, mortgage costs will go up as the recovering economy increases lending and the inflationary pressure of massive government deficits hitting the economy pushes interest rates higher. Borrowing costs are the largest part of a mortgage payment. A return to proper underwriting standards simply means that people without sufficient assets or income to pay their mortgages will not receive one.

Another key point often conveniently left out of the discussions is that in the past, mortgages appeared to be cheap. The actual cost to homebuyers and taxpayers was much higher than what appeared on monthly mortgage bills, when you factor in the $150 billion in taxpayer dollars needed so far to pay for losses at Fannie Mae and Freddie Mac and the severe drop in home values because of the 2008 crisis.

Options Two and Three: Reinventing Fannie Mae. The Obama Administration's second option proposes to use a federal government guarantee that a mortgage will be repaid on schedule as the basis of its "standby" involvement in housing finance. This type of guarantee is currently being sold by both Fannie Mae and Freddie Mac, but could also be provided by private entities. Under the second option, this guarantee would be priced higher than

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those available through private providers, but could be priced lower if there were a financial crisis where the private guarantee was unavailable. Unfortunately, such a system just invites either Congress or the executive branch to increase the government's presence gradually until what is essentially a new Fannie Mae is created. It would be virtually impossible to keep the guarantee or federal presence in the housing finance market in a "backup" role.

The third option, obviously preferred by the Obama Administration, would be for the government to offer reinsurance to the market at all times, regardless of whether the private sector has the capability to provide funding without such interference in the market. The reality of this option would be to recreate a new Fannie Mae and Freddie Mac (probably with a different name) at the same time that the failed originals are being phased out. This option ignores the lessons of the 2008 crash and sets up a new round of housing bubbles and massive taxpayer bailouts.

End Fannie Mae and Freddie Mac. Although the Administration punted with its presentation of three different options, it does reveal its preference when it says, "As Fannie Mae and Freddie Mac are wound down, we must design a transition that allows for continued support of the housing market, so that Americans continue to have the ability to take out a mortgage to buy a home or refinance their existing mortgage."[3] A full reading of the page makes it clear that the support would come from a continued government presence in housing markets. These are steps that all policymakers must guard against.

The one bit of good news is that the Administration proposes measures that will "ultimately wind down" both Fannie and Freddie using practical methods. It appears that the goal is to complete the process in five to seven years, which is achievable and gives the private sector time to replace them while avoiding any immediate change that could shock the still-weak housing market.

The report makes it very clear where the fault for Fannie's and Freddie's failure lies, saying that "as their combined market share declined—from nearly 70 percent of new originations in 2003 to 40 percent in 2006—Fannie Mae and Freddie Mac pursued riskier business to raise their market share and increase profits. Not only did they expand their guarantees to new and riskier products, but they also increased their holdings of some of these riskier mortgages on their own balance sheets."[4]

The lesson from this experience should be very clear. Both Fannie Mae and Freddie Mac must be permanently and completely closed as quickly as the process can be responsibly completed. And under no circumstances should they be replaced with a program that would inevitably grow into a new Fannie Mae.

Other Important Mortgage Reforms. In addition to the three options for Fannie and Freddie, the report includes several other needed housing finance reforms. Many of these are already being implemented, so their inclusion here is more a reminder than a call to action. These include better underwriting standards for mortgages, to reduce the possibility that low-quality mortgages will again contaminate mortgage-backed securities, and improved consumer protection designed to ensure workers are not sold mortgages they ultimately cannot afford.

In addition, the Administration proposes to return the Federal Housing Administration (FHA) to its traditional role as a provider of targeted mortgage credit for low-income and moderate-income workers. Since 2008, the FHA has played a much larger role in housing markets, and it is likely to sustain higher losses as a result. However, Congress should use this as an invitation to reassess the role of the FHA and its place (if any) in the housing finance system of the future.

Finally, the report brings up the 12 Federal Home Loan banks, which have structures that are very close to those of Fannie and Freddie and are likely

1. U.S. Departments of the Treasury and Housing and Urban Development, *Reforming America's Housing Market: A Report to Congress* (Washington, D.C.: U.S. Government Printing Office, February 2011), at *http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf* (February 24, 2011).
2. *Ibid.*, p. 28.
3. *Ibid.*, p. 23.
4. *Ibid.*, p. 7.

to sustain major losses in their mortgage investments. The Administration proposes to refocus the 12 banks to assisting smaller financial institutions and to reduce their portfolio investments. These steps do not go far enough; instead, policymakers should use this as an opportunity to close them down in an orderly fashion.

A Private-Sector Future. Of course, the actual effects of any of the three future alternatives that the Administration proposes for housing finance will depend on the details and implementation plan. Unfortunately, the report does not include details for any of the options. Eliminating Fannie Mae and Freddie Mac is a major step in the right direction; however, it will do no good to eliminate them only to fill their places with some clone of the failed government-subsidized system that caused so much of the 2008 crash. The private sector is more than capable of creating mortgage-backed securities and pricing an appropriate guarantee. In the future, the housing finance system should not contain anything similar to Fannie Mae, Freddie Mac, or any clone of either. That should be the guiding principle of housing finance reform.

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