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Ryan Budget Plan Promotes Housing Recovery by Ending Fannie Mae and Freddie Mac

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While much of the press attention has focused on other parts of the budget plan put forth by Representative Paul Ryan (R–WI), a key provision is its call for an end to Fannie Mae and Freddie Mac, the two housing giants that essentially failed and were taken over by their regulator in 2008. In their place, Ryan proposes to "allow private-market secondary lenders to fairly, freely and transparently compete, with the knowledge that they will ultimately bear appropriate risk for the loans they guarantee. Their viability and profitability will be determined by the soundness of their practices and the value of their services."[1]

Just eliminating Fannie Mae and Freddie Mac is a huge step in the right direction. So far, the two have cost taxpayers about $150 billion to cover their pre-2008 losses on mortgages and related securities. However, not all of those losses have surfaced; the Federal Housing Finance Agency (FHFA) estimates that when they do, the total cost will be double that amount. Sadly, these costs are unavoidable, but eliminating the two housing giants and their government guarantee would protect taxpayers from similar losses in the next housing downturn.

How to Eliminate Fannie Mae and Freddie Mac. To gradually eliminate both Fannie Mae and Freddie Mac, Ryan's budget proposes "winding down their government guarantee and ending taxpayer subsidies. It supports increasing the guarantee fees Fannie and Freddie charge lenders in order to bring private capital back, shrinking their retained portfolios, and enacting various measures that would bring transparency and accountability to the GSEs. At the same time, it will put in place measures to discourage shifting of taxpayer risk to the Federal Housing Administration and other government-backed entities as Fannie and Freddie are dismantled."[2] This approach should achieve Ryan's goal of abolishing Fannie and Freddie without seriously disrupting still fragile housing markets.

Since 2008, privately issued mortgage-backed securities, which were once over half the market, have virtually disappeared. Restoring their presence will take time and should be encouraged with specific steps mentioned below. 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 and Freddie. Instead, specific steps to encourage that transition should be clearly described and scheduled, with the FHFA being given the job of monitoring the situation under close oversight and ending the two government-sponsored enterprises (GSEs) as market conditions allow.

As Ryan's budget noted, private providers of mortgage-backed securities will reappear if the fees

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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. These fees guarantee that if the homebuyer defaults on a mortgage, Fannie Mae or Freddie Mac will replace them with other similar quality mortgages or take other steps to ensure that the mortgage bond holders do not suffer losses. 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.[3]

Focus on the Future, Not the Past. Eliminating Fannie Mae and Freddie Mac includes two tasks, but only one of them concerns future housing growth. The two housing giants both package new mortgages into securities that can be sold to investors and manage their existing portfolios of similar securities. Rather than placing equal weight on both, Congress should place a strong emphasis on fostering the growth of private-sector companies that will securitize new mortgages. The task of liquidating Fannie Mae and Freddie Mac's portfolios is of secondary importance and should be handled separately.

Both have huge portfolios. As of 2010, Fannie Mae had about $789 billion worth of mortgage investments, while Freddie Mac had about $697 billion. Some of each entity's investments are of such poor quality that they are essentially worthless; the rest should be sold off to recoup as much as possible of the taxpayer money that has been spent on covering the GSEs' losses. However, to avoid flooding a still shaky market for these securities, the sales should be handled over a number of years, and there is no reason to delay liquidating the two until it is completed. Both Fannie and Freddie would almost certainly have to be placed in a formal receivership instead of their current conservatorship status in order to transfer the portfolios.

The sale of the portfolios should be handled by a temporary subsidiary of the FHFA staffed with liquidation and investment professionals. This subsidiary would separate the good quality investments from the rest and sell them off as the market for them gradually firms up. At the same time, the poor quality assets could be sold for whatever the FHFA can get for them—again over time to avoid flooding the market.

A Good First Step. Ryan's budget is just the latest indication of the growing consensus that Fannie Mae and Freddie Mac should be eliminated. It joins both a report from the Obama Administration[4] and House legislation by Representatives Scott Garrett (R–NJ) and Jeb Hensarling (R–TX).[5]

A budget is important, but it is a planning document that requires other committees' action to meet its targets. The House Financial Services Committee has already started hearings on reforming housing finance, but they are merely the next step out of many that will be necessary.

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1. *The Path to Prosperity*, Fiscal Year 2012 Budget Resolution, Committee on the Budget, U.S. House of Representatives,112th Cong., 1st Sess., April 5, 2011, p. 35, at *http://budget.house.gov/UploadedFiles/PathToProsperityFY2012.pdf* (April 14, 2011).
2. *Ibid.*
3. See David C. John, "End Fannie Mae and Freddie Mac to Build Tomorrow's Housing Finance System," Heritage Foundation *WebMemo* No. 3147, February 10, 2011, at *http://www.heritage.org/Research/Reports/2011/02/End-Fannie-Mae-and-Freddie-Mac-to-Build-Tomorrows-Housing-Finance-System*.
4. 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* (April 14, 2011).
5. David C. John, "Two Promising Starts towards Ending Fannie Mae and Freddie Mac," The Foundry, March 31, 2011, at *http://blog.heritage.org/2011/03/31/two-promising-starts-towards-ending-fannie-mae-and-freddie-mac*.