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Stop the Menendez–Boxer Sideshow: End Fannie Mae and Freddie Mac Now

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It is time to end Fannie Mae and Freddie Mac. For over four years, Congress has failed to start the process of phasing out the two failed mortgage finance giants and replace them with a private-sector mortgage finance system. Most of the time, opponents used the excuse that housing markets were just too weak to do anything that might delay the housing recovery, leaving both entities to languish under the control of the Federal Housing Finance Agency (FHFA).

Instead, some in Congress and the Obama Administration have focused on a series of generally unsuccessful efforts to enable borrowers whose homes are now worth less than they owe to refinance the loans.[1] Undeterred by the underperformance of these programs, several Senators have decided to try again. Senate Majority Leader Harry Reid (D–NV) is expected to schedule Senate consideration in the lame-duck session of another refinancing bill by Senators Robert Menendez (D–NJ) and Barbara Boxer (D–CA).

As with past efforts, their approach would be a policy mistake. Congress should skip the sideshow and move instead to the main event of ending Fannie Mae and Freddie Mac.

Rationale for Mass Refinancing Is Ending. Driven by housing activists, Congress, and the executive branch, government agencies have focused on encouraging lenders to refinance underwater mortgages since mid-2007. Supporters justified their approach by noting that falling housing prices made it virtually impossible for borrowers to reduce the loans to a point where the worth of their houses would equal the amount that they owed. This has led many homeowners to simply walk away from their obligations, leaving their houses to be repossessed and further lowering property values in the area.

However, most of these programs have actually helped only a relatively small number of borrowers.[2] A recovering market with gradually rising prices will do much more to enable underwater borrowers to return to building equity. And there are firm signs that the long-awaited housing recovery is well underway, which would further obviate the need for mass refinancing.

In the third quarter, median sales prices increased over those of last year in 120 of 149 metropolitan areas,[3] with prices increasing an average of 5 percent over those of a year ago, the largest 12-month gain since July 2006. In addition, inventories are shrinking, with only 2.32 million existing homes available, a 20 percent drop from the same period in 2011, while the national median price of a single-family home has risen by 7.6 percent over the past 12 months.

Housing is not yet completely out of the woods, but the share of home sales that involved either short sales or foreclosures continues to drop. At the same time, September new-home sales rose by 27 percent over the number sold in September 2011.[4]

Menendez–Boxer Is No Solution. While billed as a moderate approach that avoids weaknesses in past refinancing efforts, Menendez–Boxer is no better than the Obama Administration's several mass refinancing efforts. It would potentially cost taxpayers additional billions of dollars, as Fannie Mae and Freddie

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Mac would be stuck with more losses. Under the Menendez–Boxer legislation, loans refinanced under the Home Affordable Refinance Program would include a liability waiver that would exempt lenders from having to take back poor-quality defaulting loans. The waiver would apply even if the loan had been originally written below Fannie Mae and Freddie Mac standards.

This means that loans of just about any quality could be refinanced, and Fannie Mae and Freddie Mac—and the taxpayers—would end up eating the cost of any defaults. This would continue to pass the costs of past irresponsible borrowing and lending on to the taxpayers rather than having any effect on those who caused the problem. In addition, Menendez–Boxer allows any loan that is up-to-date in payments to be refinanced regardless of the loan-to-value ratio of the house, eliminates up-front fees and any appraisal costs, sets penalties for any lender with a second mortgage or mortgage insurer who blocks a refinancing, and removes barriers for lenders who want to compete with the existing mortgage handler.

The bill focuses on the wrong goal and is doomed to fail. It would have little or no effect on either stimulating housing sales or improving prices and would not speed the recovery. All that Menendez–Boxer would really do is to enable many homeowners who do not really need the aid to benefit at the ultimate expense of the taxpayers.

Ending Fannie Mae and Freddie Mac. With the housing market increasing in strength with almost every monthly report, the process of phasing out Fannie Mae and Freddie Mac should begin without delay. Both housing finance giants should gradually shrink as the cost of their services is gradually increased to encourage private-sector competitors to develop and fill their current roles. This would allow the transition to take place without disrupting the housing markets and causing yet more instability.

The specific steps necessary to eliminate both entities are[5]:

1. **Move** Fannie Mae and Freddie Mac from conservatorship to formal bankruptcy. This would give their regulator the legal authority to close them down and replace them with a better housing finance model.

2. **Repeal** both entities' perpetual federal charters and replace them with three-year charters that Congress may renew for a limited number of times if necessary and based on specific conditions.

3. **Separate** both portfolios of mortgage investments and turn them over for gradual liquidation to a new temporary subsidiary of the FHFA patterned on the Resolution Trust Corporation, which handled the assets of failed savings and loans in the 1980s and 1990s. Liquidation should proceed as the market allows, and neither entity would be allowed to make any further portfolio purchases.

4. **Reduce** the conforming loan limits. These limits indicate the maximum size of the mortgages that Fannie Mae and Freddie Mac are allowed to purchase for inclusion in mortgage-backed securities. Reducing the limit would enable private-sector alternatives to replace the two giants.

5. **Increase** the fee that is charged for a federal guarantee that mortgages will be repaid if they are included in bonds issued by Fannie Mae and Freddie Mac.

6. **Move** all low-income housing goals and subsidies to the Department of Housing and Urban Development. Congress should then determine whether each of these policies should be continued or eliminated. Programs that are continued would be funded through the appropriations process.

7. **Sell** remaining parts of Fannie and Freddie to private entities.

1. See David C. John, "Obama's New Mortgage Program Is Full of Disappointing Details," Heritage Foundation *Commentary*, November 11, 2011, http://www.heritage.org/research/commentary/2011/11/obamas-new-mortgage-program-is-full-of-disappointing-details.
2. Ibid.
3. Prashant Gopal, "Home Prices Rise in 81% of U.S. Cities as Markets Recover," Bloomberg, November 7, 2012, http://www.bloomberg.com/news/2012-11-07/home-prices-rise-in-81-of-u-s-cities-as-markets-recover.html (accessed November 21, 2012).
4. Tim Mullany, "New-Home Sales Jump 5.7% in September," *USA Today*, October 24, 2012, http://www.usatoday.com/story/money/business/2012/10/24/new-home-sales-september/1654073 (accessed November 21, 2012). As of this writing, these data are the latest available.
5. For details, see David C. John, "Free the Housing Finance Market from Fannie Mae and Freddie Mac," Heritage Foundation *Backgrounder* No. 2577, July 12, 2011, http://www.heritage.org/research/reports/2011/07/free-the-housing-finance-market-from-fannie-mae-and-freddie-mac.

Such sales would not be based on geography, and certain parts would be reserved for sale to small banks, credit unions, or smaller mortgage bankers to reduce the chance of housing finance being dominated by large companies.

8. **Require** continuing congressional oversight to monitor these changes and the development of a modern housing finance system.

Fix the Real Problem. Congress needs to focus on creating a modern housing finance system that would enable a healthy housing industry to better meet the needs of future generations of homebuyers. Menendez–Boxer is just another step in the wrong direction and would not improve an already recovering housing sector.

Instead, shrinking and ultimately eliminating Fannie Mae and Freddie Mac while enabling true private-sector entities to replace them would free housing from its Depression-era financing system. It would encourage innovations that would provide better financing options without the threat that taxpayers would have to foot the bill for another multi-hundred-billion-dollar bailout.

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