

BACKGROUND

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Eight Steps to Eliminate Fannie Mae and Freddie Mac Permanently

David C. John

Abstract

It is time to close both Fannie Mae and Freddie Mac—the government-sponsored mortgage giants. Both entities distort the country’s housing finance market by issuing mortgage-backed securities with subsidized government guarantees that the mortgages will be repaid. If guarantees are necessary, they should be priced and issued by the private sector, not by the state. Financial institutions expert David C. John details specific steps to achieve this shutdown carefully and methodically without further upsetting the delicate housing market—and without making the situation worse.

Now that housing is beginning to show signs of a sustained recovery, it is time to create a new and modern private-sector housing finance system to replace the two government-sponsored enterprises (GSEs)—the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac)—that caused many of the problems. Between the time when housing prices peaked in the second quarter of 2007 and the time when housing began to show the first signs of a recovery in 2011, the value of household real estate fell by about \$6.6 trillion,¹ roughly 30 percent. A sustained recovery is not likely until both mortgage giants are replaced by a new housing finance system that does not include government distortion of the market.

The transition will not be easy, but both entities have outlived any usefulness. This *Background* discusses the roles of Fannie Mae and Freddie Mac and recommends ways to eliminate both institutions without dampening the housing recovery. As noted at

KEY POINTS

- Now that the housing market is showing signs of a sustained recovery, the first step in creating a new and modern private-sector housing finance system is to eliminate Fannie Mae and Freddie Mac.
- The housing recovery that is now underway should not be disrupted, so the elimination of Fannie Mae and Freddie Mac must be methodically, but unequivocally, phased in through a series of eight steps.
- These steps include repealing the perpetual federal charters of Fannie Mae and Freddie Mac, increasing their guarantee fees, and moving all low-income housing goals and subsidies to the Department of Housing and Urban Development.
- Creating Fannie Mae and Freddie Mac and subsidizing them through privileged access to federal funds and implicit guarantees were serious policy mistakes. These mistakes should never be repeated.
- Nothing less than the complete elimination of both Fannie Mae and Freddie Mac is acceptable.

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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the end, two ways *not* to fix the current two-GSE system would be to (1) create dozens of new GSEs that issue mortgage-backed securities with a government guarantee or (2) create a new government entity that guarantees mortgages. Either move would only guarantee additional GSE bailouts and the loss of additional hundreds of billions of taxpayer dollars. Further, neither move would increase the pace of the housing recovery, or significantly improve the market.

How to Eliminate Fannie Mae and Freddie Mac: The Big Picture

Both Fannie Mae and Freddie Mac are artificial government creations. It will be impossible to fully create a modern housing finance system as long as they exist. However, the housing recovery is still developing, so their elimination must be handled carefully to avoid further instability.

The specific steps necessary to eliminate both entities are:

- 1. Move** Fannie Mae and Freddie Mac from conservatorship to formal bankruptcy.
- 2. Repeal** both entities' perpetual federal charters and replace them with three-year charters that Congress may renew if necessary.
- 3. Separate** both portfolios of mortgage investments and turn them over for gradual liquidation to a new temporary subsidiary of the Federal Housing Finance Agency (FHFA) modeled after 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 should 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.
- 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, and use that money to repay taxpayers for the cost of their bailout.
- 6. Move** all low-income housing goals and subsidies to the Department of Housing and Urban Development (HUD). Congress should then determine whether each of these policies should be continued, combined with others, or eliminated. Programs that are continued would be funded through the appropriations process.
- 7. Sell** remaining parts of Fannie and Freddie to private entities. Such sales would not be based on geography. Certain parts would be reserved for sale to small banks, credit unions, or smaller mortgage bankers to reduce the chance of the business again being dominated by large companies.
- 8. Require** continuing congressional oversight to monitor these changes and the development of a modern housing finance system.

Fannie Mae and Freddie Mac's Role in Housing Finance

Although Fannie Mae and Freddie Mac are separate companies, they essentially do the same thing: Both of them purchase "conforming" mortgages² that meet certain size and credit requirements and combine them into mortgage-backed securities, which are sold, in turn, to investors of all types. For decades, both GSEs financed these purchases by issuing bonds that were sold to financial institutions and other investors. Before their failure in 2008, both Fannie Mae and Freddie Mac were considered to be extremely safe companies and were able to borrow money at extremely low rates. Although both denied it, many investors assumed that the U.S. government backed the two GSEs, which was another reason for their low borrowing costs.

1. Bill McBride, "Q1 Flow of Funds: Household Real Estate Assets Off \$6.6 Trillion from Peak," Calculated Risk, June 6, 2011, <http://www.calculatedriskblog.com/2011/06/q1-flow-of-funds-household-real-estate.html> (accessed March 27, 2013).

2. A conforming mortgage is the maximum-size mortgage for one-unit properties that Fannie Mae and Freddie Mac are allowed to purchase for inclusion in mortgage-backed securities. Until September 30, 2011, the maximum conforming mortgage in high-cost areas was \$729,750. After that date, it dropped to \$625,500, the level that remains in force. In other, lower-cost, areas of the country, the conforming loan limit is \$417,000 through December 31, 2013.

Mortgage-backed securities are shares of large pools of mortgages, mainly all of a set type of loan and credit quality. Fannie Mae and Freddie Mac purchase the mortgages from banks and other loan originators, which use the cash to finance additional mortgages, which they often also sell to the GSEs. Sometimes, the originators receive mortgage-backed securities in payment for their mortgages, which they can hold or sell to another investor.

Once the pool of mortgages is established, both entities guarantee that the interest and principal will be repaid on schedule to bondholders and then divide the pool into bonds with a set face value and sell them. The investor receives a continuing cash flow from the mortgage payments made by the homeowners and can resell the bonds at any time to other investors. Fannie Mae and Freddie Mac earn fees both for creating the mortgage-backed securities, their guarantee and for other services. The guarantee fee is subtracted from the homeowner's mortgage payments before the money is sent to the bondholders.

For decades, mortgage-backed securities issued by the two mortgage giants were considered to be extremely safe. Analysts had figured out almost precisely which percentage of homeowners in a pool would default on their mortgages or repay or refinance them early, and the bond underwriters took these figures into consideration when they priced the bonds. This allowed Fannie Mae and Freddie Mac, as well as the bond purchasers, to closely estimate the level of cash flow that would result from a set issuance of bonds and, thus, that issue's value.

However, these valuations depended on knowing the credit quality of the mortgages underlying the bonds. Once the housing bubble burst and investors learned that credit quality had slipped, bond owners were uncertain about the proportion of the mortgages that would be repaid on time. Without certainty about the repayment of the underlying mortgages, investors were unable to determine the actual value of their bonds.

Since Fannie Mae and Freddie Mac were guaranteeing the repayment of the mortgages, they were subject to huge losses. Some of those losses have

been recaptured from the loan originators, who presented their loans as being of a certain quality when Fannie Mae and Freddie Mac purchased them. Since certain loans were not of that credit quality, both entities could (and did) legally sell them back to the originators. However, many originators have since gone out of business. Today, Fannie Mae and Freddie Mac claim to be very careful about checking the quality of mortgages before purchasing them, but some level of caution is in order to ensure that they do not fall back into their past bad practices.

Mortgage-backed securities still play a key role in mortgage finance. While demand and prices are down from earlier years, loan originators still expect to sell new mortgages rather than hold on to them. Before 2008, a majority of mortgage-backed securities were originated by private companies, but most of them have left the market, and today, almost all mortgage-backed securities are issued by Fannie Mae and Freddie Mac.

Fannie Mae was created to encourage additional mortgage lending, especially for moderate-income Americans. Purchased mortgages were either held by Fannie Mae or sold to other investors.

A Short History: How Fannie Mae and Freddie Mac Became Mortgage Giants

Fannie Mae and Freddie Mac are well-intentioned government programs gone wrong. The Federal National Mortgage Association (its popular name "Fannie Mae" stems from its acronym, FNMA) was chartered in 1938 as a government-owned entity designed to purchase home mortgages from banks and savings and loan associations³ so that those entities could essentially recycle the money to underwrite additional housing loans. The purchased mortgages were insured by the Federal Housing Administration (FHA), although later

3. A savings and loan (S&L) is a special type of financial institution that takes in deposits and loans them out as small loans and mortgages. The government, which controlled the interest rate that could be paid on savings, allowed the S&Ls to pay depositors an additional 0.25 percent over the rate that banks could pay, in order to attract more money for housing. All S&Ls were initially owned cooperatively but were later allowed to have the same ownership structure as banks. Most S&Ls disappeared in the 1980s and 1990s, but a few still exist today.

mortgages might be insured by other government agencies.

Fannie Mae was created to encourage additional mortgage lending, especially for moderate-income Americans. Purchased mortgages were either held by Fannie Mae or sold to other investors. As time went on, this mortgage purchase program developed into a secondary market for mortgages.

In 1954, Fannie Mae was converted into a mixed-ownership corporation in which individuals owned the common stock while the federal government retained preferred stock. In 1968, budget pressures, due in part to the Vietnam War, caused the government to convert Fannie Mae into a publicly held corporation in order to remove its debt and finances from the federal budget. At that point, Fannie Mae was divided into two entities, the now-private corporation still named Fannie Mae, which continued its activities in the secondary market, and a government entity, the Government National Mortgage Association (Ginnie Mae), which retained certain management functions and insured FHA and other government-issued and government-guaranteed loans.

By 1970, Fannie Mae was allowed to purchase any privately originated mortgages, but there were concerns about its potential for monopoly powers. As a result, Congress also created the Federal Home Loan Mortgage Corporation (Freddie Mac) as both a competitor to Fannie Mae and to provide additional support for housing. Freddie Mac is now a private corporation, but it was initially owned by the Federal Home Loan Bank Board (FHLBB), the independent agency that both regulated savings and loans and similar financial institutions and promoted the industry.

During this time, the mortgage-backed security, whereby an investor could purchase part of a pool of mortgages rather than having to purchase entire mortgages, developed when a private-sector issue was guaranteed by Ginnie Mae. The new securities were much easier to sell to other investors than entire mortgages, while the pooling of many securities reduced the risk of default. Initially, these securities were known as “pass through” certificates (the mortgage payments being passed through the originator of the bond issued to the investor) or as

participation certificates. Freddie Mac issued its first pass through certificate in 1971, with Fannie Mae following suit in 1981.

In 1989, Congress removed Freddie Mac from FHLBB ownership and turned it into a fully private corporation like Fannie Mae. However, the market recognized that both entities had a special relationship with the government, and both became known as government-sponsored enterprises.

In 1992, Congress used this special relationship as a way to meet affordable housing goals without having to appropriate funds for them by requiring both Fannie Mae and Freddie Mac to buy a set proportion of mortgages that were made to lower-income and moderate-income homeowners. This proportion grew steadily over the years before 2008. At the same time, both GSEs began to invest in and issue mortgage-backed securities that consisted of mortgages of lower credit quality, such as Alternative A-paper (Alt-A)⁴ and subprime mortgages. Congress encouraged this trend by allowing these lower-quality mortgages to be counted toward Fannie Mae and Freddie Mac’s affordable housing goals.

The 2008 Government Takeover of Fannie and Freddie

In addition to their traditional role of packaging and issuing mortgage-backed securities, the pre-2008 Fannie Mae and Freddie Mac also built an extensive portfolio of mortgages and mortgage-backed securities. Under their former management, both Fannie Mae and Freddie Mac responded to pressure from investors in Fannie Mae and Freddie Mac to have continuous growth in earnings by investing in mortgage assets (issued by them as well as by other companies). Essentially, both acted as hedge funds, betting on the movement of interest rates and the value of specific types of mortgage investments. Together, the two amassed a portfolio totaling about \$1.5 trillion worth of these assets. While these investments helped to build earnings before the sudden collapse of the housing bubble, afterwards, they contributed to the substantial losses that put both GSEs into serious financial difficulties.

By mid-2008, both firms had very low capital levels compared to their assets and liabilities. While both were still solvent, these capital levels and

4. Alt-A mortgages are an intermediate-risk category, considered to have a higher risk of not being repaid than traditional mortgages, but not as risky as subprime mortgages.

growing liquidity problems raised serious concerns about their ability to cover the growing losses as the housing bubble continued to shrink and delinquent loans grew. Faced with a situation that was similar to the earlier failure of Bear Stearns, and growing concerns about the health of Lehman Brothers, federal regulators determined that it would be better to take corrective action before Fannie Mae and Freddie Mac defaulted than to deal with the aftermath of such a situation.

As a result, on September 6, 2008, the Federal Housing Finance Agency took both firms into conservatorship. While this action allowed both entities to continue in business without defaulting on their obligations, it also placed complete control of their activities—and thus much of the housing finance market itself—in the government’s hands.

How to Eliminate Fannie Mae and Freddie Mac: The Details

By the time that Fannie Mae and Freddie Mac are completely eliminated, the housing market should be fully recovered from the 2008 crash. Most of those involved in the housing and mortgage finance industry fear that eliminating the two GSEs could crimp that market’s gradually accelerating recovery. While they are understandably reacting to the past few years, they are not looking toward the future. A careful and considered phase out should create conditions that encourage private companies to package mortgages into securities, and credit should be available to all creditworthy potential home buyers.

To avoid disrupting the housing market’s growing recovery, the end of Fannie Mae and Freddie Mac should come gradually—but with a clear, unambiguous understanding that they will be phased out completely and permanently. While some level of presence may be necessary while the housing sector continues to recover, there is a growing consensus that both organizations are unnecessary beyond that time. The private sector is more than capable of producing mortgage-backed securities and other innovative ways of financing mortgages 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 a government guarantee.

As the crash of 2008 showed, the old structure of housing finance was a spectacular and expensive failure. Allowing it to remain in place—or, even worse, recreating it—is the very last thing that homeowners or taxpayers need to bequeath to future generations. Instead, legislators and the Obama Administration should structure a mortgage finance system based in the private sector that has both the flexibility to meet market needs and can ensure that mortgages meet strict underwriting standards and protect consumers from predatory lending practices.

To avoid disrupting the housing market’s growing recovery, the end of Fannie Mae and Freddie Mac should come gradually—but with an unambiguous understanding that both will be phased out completely and permanently.

Since 2008, privately issued mortgage-backed securities, which once had a market share in excess of 50 percent, have virtually disappeared. These securities are important components of housing finance because private issuers are more likely to innovate new ways to encourage investors to finance additional mortgage lending. Restoring the role of private issuers will take time, and policymakers should encourage this process by following these eight steps:

1. End the conservatorship and start the liquidation of Fannie Mae and Freddie Mac.

Although Fannie Mae and Freddie Mac suffered such huge losses that they did not have enough cash to continue in business by September 2008,⁵ their government regulator (the FHFA) placed them into conservatorship, not bankruptcy. When the conservatorship began, policymakers felt that any alternative would contribute to the massive loss of confidence in the financial system and make obtaining a mortgage nearly impossible. As conservator, the FHFA has full control of both entities’ assets and operations, while any

5. For an explanation of the conservatorship, see Mark Jickling, “Fannie Mae and Freddie Mac in Conservatorship,” Congressional Research Service Report for Congress, September 15, 2008, <http://fpc.state.gov/documents/organization/110097.pdf> (accessed March 27, 2013).

dividends to common or preferred shareholders are suspended. The FHFA operates both GSEs in a manner that ensures that they meet their obligations to the owners of the bonds that they have either issued or guaranteed.

A conservatorship, however, is an interim step. It is time to move to the formal end of Fannie Mae and Freddie Mac. Currently, the Housing and Economic Recovery Act of 2008⁶ requires that if the FHFA closes either GSE, it must be replaced with a newly chartered version. The law should be changed to allow the FHFA to take complete legal and formal control of both. This will eliminate the shareholders and allow the agency to phase out both entities without endangering the legal status of any outstanding bonds.

2. Repeal perpetual charters. Currently, Fannie Mae and Freddie Mac operate under federal charters that never expire. This allowed them to undertake risky activities with minimal or no congressional oversight. Both charters should be amended to expire after three years with a maximum of three renewals, thus permanently expiring after no more than 12 years. This will allow Congress to review the progress being made in closing them at scheduled intervals, and to speed it up if possible.

3. Eliminate the portfolios of Fannie Mae and Freddie Mac. Eliminating Fannie Mae and Freddie Mac involves 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 own existing portfolios of similar securities. Rather than placing equal weight on both, Congress should emphasize fostering the growth of private-sector companies that will securitize new mortgages. The task of liquidating Fannie Mae's and Freddie Mac's portfolios is of secondary importance and should be handled separately.

Both GSEs still have huge portfolios. As of June 2012, Fannie Mae's portfolio remained at \$673 billion, down from about \$789 billion in 2010.⁷ Freddie Mac held about \$581 billion worth of mortgage investments, down from about \$697 billion in 2010. In both cases, the portfolios consisted mainly of mortgages originated before 2008. 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 taxpayers' money that has been spent on covering the GSEs' losses.

The FHFA has already taken the first step in the process by requiring both entities to reduce their portfolios by 15 percent annually with a goal of reaching \$250 billion by 2018. In addition, Fannie Mae and Freddie Mac should be required to stop any and all purchases of mortgages that are not part of the securitization process. This step would recognize that, while most housing mortgages are securitized very quickly, it may take time to accumulate mortgages on multifamily structures for securitization. Thus, purchases of mortgages on multifamily structures could continue if the goal is to include them in securities.

Both portfolios should be transferred to a new and temporary subsidiary of the FHFA that is modeled after the old Resolution Trust Corporation (RTC), which liquidated the assets of failed savings and loans between 1989 and 1993.⁸ 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 tie liquidation of the two GSEs to the fate of their portfolios. Moving them under the FHFA subsidiary staffed with liquidation and investment professionals would ensure that the taxpayers received the maximum amount possible. This subsidiary would separate the quality investments from the rest and sell them off as the market for them gradually firms up. At the same time, the low-quality

6. Housing and Economic Recovery Act of 2008, <http://www.gpo.gov/fdsys/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf> (accessed March 27, 2013).

7. Rachele Younglai, "U.S. Tightens Reins on Fannie Mae, Freddie Mac," Reuters, August 17, 2012, <http://www.reuters.com/article/2012/08/17/us-usa-housing-idUSBRE87GOEN20120817> (accessed March 27, 2013).

8. For a history of the Resolution Trust Corporation, see Lee Davison, "Politics and Policy: The Creation of the Resolution Trust Corporation," *FDIC Banking Review*, Vol. 17, No. 2 (2005), <http://www.fdic.gov/bank/analytical/banking/2005jul/article2.pdf> (accessed March 1, 2013).

assets could be sold for whatever the FHFA can get for them—again, over time to avoid flooding the market. Once its job is finished, the FHFA subsidiary should be closed down just as the RTC was after it completed its task.

- 4. Reduce conforming loan limits.** Fannie Mae and Freddie Mac are limited by law to purchasing housing mortgages that are below a set dollar size for repackaging into mortgage-backed securities. Known as conforming loan limits,⁹ these are currently set at \$417,000 for single-family dwellings in normal-cost areas¹⁰ and \$625,500 for areas that the FHFA has designated as high-cost areas where the average housing price is well above the national average. Higher amounts are allowed for multi-family dwellings, depending on the number of units contained in the building.

At one time, the conforming loan limit was temporarily as high as \$729,750 in high-cost areas. On September 30, 2011, the limit dropped back to its current levels, but this should be only the first step toward further reductions. However, rather than establishing a schedule for reducing these limits legislatively, Congress should give the job to the FHFA along with clear and unequivocal instructions to reduce the conforming loan limits gradually as market conditions allow and as mortgage-backed securities issued by private competitors appear. In order to avoid seriously disadvantaging certain high-cost housing markets, the phase out of the loan limits should be based as much as possible on the median housing cost in each local housing market rather than simply on the national average. The length of the phase out would be constrained by the three-year limit on the GSEs' federal charters, which could be renewed by Congress only three times, for a maximum of 12 years.

- 5. Continue to increase the guarantee fees and use the money to repay taxpayers.** Private providers of mortgage-backed securities will reappear if the artificially low fees that the two GSEs charge for guaranteeing the credit quality

of mortgages included in mortgage-backed securities gradually rise on a set and unambiguous schedule. These fees, along with other, smaller fees that Fannie Mae and Freddie Mac charge for managing and administering the mortgage pools that underlie mortgage-backed securities and creating and selling the securities, are subtracted from revenues received when homeowners repay their mortgages. Purchasers of the mortgage-backed securities receive a promised “coupon rate” of return, which is the average interest rate on the underlying mortgages minus the guarantee fees. On average, guarantee fees charged by the two GSEs were about 28 basis points in 2011. (One basis point is 1/100th of 1 percent.)

The goal is to enable privately issued mortgage-backed securities without a government guarantee to become more competitive and gradually increase their market share until they dominate the market and the GSEs are no longer needed. As the conservator of Fannie Mae and Freddie Mac, the FHFA already has the authority to increase the guarantee fees, and has already announced 10 basis point increases on two recent occasions. After an initial increase in April 2012, the FHFA announced another 10 basis point rise at the end of August 2012 that went into effect in November and December of that year. Additional increases are expected. Together, the two existing increases could cause the guarantee fees rise to as much as 49 basis points. This is close to the level at which private-sector mortgage bond underwriters should begin to reappear.

There is an open question about whether a guarantee fee is essential to the existence of the 30-year mortgage and also whether such a guarantee could be provided just as easily by the private sector as by the government. There is no reason why a credit-quality guarantee could not be provided by either private companies or by a central cooperative guarantee entity at an affordable cost.

9. Fannie Mae, “2013 Single-Family Mortgage Loan Limits,” <https://www.fanniemae.com/singlefamily/loan-limits> (accessed March 27, 2013).
10. Normal-cost areas are defined by the Federal Housing Finance Agency as any area other than where the median sales price of a home significantly exceeds the national median price. Currently, there are 106 high-cost areas covering about 6 percent of the country. The remaining 94 percent are considered normal-cost areas.

In fact, gradually increasing the federal guarantee fee will also provide valuable information about the actual size of the subsidy provided by Fannie Mae and Freddie Mac, which in turn will enable the market to determine whether such a fee is essential. As some academics have noted,¹¹ the United States is one of very few countries where a 30-year fixed-rate mortgage is widely available, and there is no reason to assume that this type of mortgage is essential either to the health of the housing market or to the ability of most consumers to purchase a house.

Some worry that as the guarantee fees increase, Congress may get used to the revenue from them and become even more reluctant to end Fannie Mae and Freddie Mac. This is a legitimate concern especially at a time when budget deficits are such a concern. To avoid this trap, Congress should clearly designate that all such revenues be used exclusively to repay taxpayers for the cost to the two entities' bailouts. Any additional revenues should go only to the costs of winding down Fannie Mae and Freddie Mac.

- 6. Move low-income housing subsidies and policy goals to HUD.** Low-income housing policy goals and subsidies that are currently imposed on Fannie Mae and Freddie Mac should be separated from their market-oriented activity so that they do not distort incentives and decision making. The actual cost of these subsidies should be made transparent and placed on the federal budget and then transferred to the Department of Housing and Urban Development.

The Financial Housing Enterprise Safety and Soundness Act of 1992, which imposes affordable housing goals on the GSEs, including funding for the Affordable Housing Trust Fund, should be repealed, and 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 under the purview of HUD, Congress can eliminate those that are not necessary, cost-effective, or affordable.

- 7. Sell off remaining parts, including underwriting expertise, to the private sector.** 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 parts of the two GSEs' underwriting activities to private companies.

Congress should not sell parts that are geographically based, since these could be re-attached to recreate Fannie Mae and Freddie Mac. 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, credit unions, or other financial entities. If the housing finance system had been allowed to develop naturally, firms that handle the specific needs of small financial institutions and other entities would have developed naturally.

However, cleaning up the current distorted market by selling off pieces of the two GSEs' existing operations could lead to large financial firms outbidding everyone else, with the result that the mortgage finance market would be dominated by those large firms. Creating an open and competitive market requires measures such as setting aside pieces of the existing GSEs for smaller firms to ensure that the new system is healthy, competitive, and innovative.

- 8. Continue congressional oversight and consideration of alternative mortgage-financing methods.** To ensure that these changes are taking place, Congress should hold regular detailed oversight hearings on both the phase out of the two existing GSEs and the development of a modern housing finance system. This is an area where Congress must continue to be actively involved; And guard against industry and other political pressures to stall efforts to end Fannie Mae and Freddie Mac. A regular congressional re-examination of the phase-out process would also allow

11. Michael Lea and Anthony Sanders, "Do We Need the 30-Year Fixed-Rate Mortgage?" Mercatus Center *Working Paper* No. 11-15, March 2011, pp. 9-10, <http://mercatus.org/sites/default/files/Do-We-Need-30yr-FRM.Sanders.3.14.11.pdf> (accessed March 27, 2013).

Congress to see whether market conditions allow the process to be conducted faster.

In addition to the conventional forms of securitized mortgages, Congress should encourage further exploration 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 U.S. market conditions differ from those of other countries, certain financing mechanisms could be adapted to the United States. In addition, Congress should be alert to innovative housing finance methods that could arise as Fannie Mae and Freddie Mac reduce their role, and ensure that artificial restraints do not inhibit the growth of these alternatives.

The Danger of Doing Nothing

The worst approach to the two housing finance giants would be to assume that since housing is recovering, nothing need be done. Major elements of the housing industry have been very comfortable with the existing structure and see no reason why their government-subsidized and government-supported industry should be subjected to the vagaries of change.

However, not only would inertia retain the major government role in housing finance, it would inevitably result in yet another massive taxpayer bailout at the next major housing downturn. In addition, the conservatorship under which both entities function is intended to be a temporary situation.

Recent FHFA Activities

Luckily, the FHFA is already taking steps to gradually end operations of both Fannie Mae and Freddie Mac. As mentioned above, the FHFA has already started to reduce the two investment portfolios, and on March 4, 2013, announced plans¹² to create a new infrastructure for the mortgage-backed securities. This new structure will essentially merge and replace the existing outmoded underwriting functions of

Fannie Mae and Freddie Mac in a new entity that is initially jointly owned by them. Once it is established, it would be possible to completely separate it, allowing both existing GSEs to be gradually eliminated.

Even more important, the FHFA is already taking steps similar to those mentioned above to re-establish private-sector bond originators and to reduce the pervasive presence of Fannie Mae and Freddie Mac. These steps will make Congress's job easier and should be supported, but they do not substitute for a policy-driven legislative restructuring of housing finance. The new underwriting structure should be developed in a way that it can be broken up and sold to a variety of private companies to avoid its domination of the mortgage market.

Given Congress's complete inability to address the issue, the FHFA's actions are a welcome alternative to complete inertia, but both Congress and the Obama Administration still need to take the lead in building a new housing finance system.

What Not to Do: Two Approaches that Guarantee More Housing Bailouts

Wrong Approach No. 1: The Housing Finance Sections of the Bipartisan Policy Center's "Housing America's Future" Plan. The Bipartisan Policy Center's "Housing America's Future: New Directions for National Policy"¹³ is a comprehensive series of recommendations created by a panel of experts and former officeholders. Its housing finance section is absolutely correct when it calls for the gradual elimination of both Fannie Mae and Freddie Mac and its call for the private sector to play a far greater role in bearing credit risk.

However, the report's authors then make a major policy error by recommending the creation of a "Public Guarantor" that would take over Fannie Mae and Freddie Mac's role of guaranteeing that mortgages are repaid. The new entity would charge premiums for these guarantees just as the two existing entities do, and have catastrophic-risk funds designed to cover its losses in a major downturn. Such a Public Guarantor would inevitably result in more taxpayer bailouts in the future.

12. Edward J. DeMarco, "FHFA's Conservatorship Priorities for 2013," National Association for Business Economics 29th Annual Economic Policy Conference, Washington, DC, March 4, 2013, <http://www.fhfa.gov/webfiles/25024/EJDNABESpeech.pdf> (accessed March 25, 2013).

13. Bipartisan Policy Center, "Housing America's Future: New Directions for National Policy," February 2013, http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf (accessed March 25, 2013). This discussion only deals with the housing finance portion of the report.

Under the proposal, the guarantor would be liable for the residual losses that remain after three layers of private and personal entities had already sustained losses. Thus, the new entity would be partially protected and would only be liable after the homeowner, private mortgage insurers and similar credit enhancement products, and private issuers and mortgage servicers had already exhausted their capital. This structure would be a major improvement over the current system, but in major housing crashes the Public Guarantor would both sustain major losses and face the possibility of a taxpayer bailout. A 30 percent drop in the value of real estate would inevitably produce major losses that would eat through the new entity's capital cushion and require another bailout. These losses would be more likely after issuers and servicers attempted to structure their business models to limit the amount of their liability.

To prevent, at least partially, such corporate efforts to limit their losses, the Public Guarantor would also have to institute major safeguards. These would include establishing capital standards and limiting the types of private-sector firms that could use its services. While the Public Guarantor would not face some of the demands for earnings growth that played a role in the failure of Fannie Mae and Freddie Mac, as a government entity, it would face pressures from politicians and its users to water down standards so that housing could grow.

Government-sponsored enterprises, whether two, or dozens, are a market distortion that taxpayers cannot afford.

An alternative model would be to establish such a guarantor as a cooperative owned by its users. This would give them the incentive to police each other so that their own capital would be less at risk. In addition, such a structure would be located entirely in the private sector without an explicit or implicit call on tax dollars. An even better structure would consist of several such cooperatively owned guarantors that could compete against each other and encourage innovation.

Wrong Approach No. 2: The Campbell-Peters Multiple GSE Approach of 2011. In the last Congress, some Members decided that if two GSEs are a problem, that problem should be solved by creating dozens of clones with the power to attach a government guarantee to their mortgage-backed securities. Policies contained in the Housing Finance Reform Act of 2011, H.R. 1859,¹⁴ introduced by Representatives John Campbell (R-CA) and Gary Peters (D-MI), while well intentioned, would have caused much more damage than the current system. The bill would have allowed the creation of any number of GSE clones empowered to issue mortgage-backed securities with a government guarantee that both the principal and interest from the underlying mortgages would be repaid as promised.

There are many problems with this approach. The first is that, rather than allowing the private market to price a guarantee of the underlying mortgages (or to decide whether such a guarantee is even necessary), the proposal would price the guarantee by government fiat. Putting aside for the moment the fact that governments have proved time and time again that they cannot accurately price any guarantees, the proposed legislation states that these guarantees would be priced by the FHFA based on the results of a study by the Government Accountability Office of the mortgage-backed securities market. But, in Section 1387(d)(2), the bill then states that the FHFA should create "a pricing structure for guarantee fees by associations that provides for a reasonable rate of return to associations." Thus, the purpose of the pricing structure is to ensure the success of the dozens of new GSEs rather than to accurately reflect the potential risk to the taxpayer of providing such an ill-conceived guarantee in the first place.

In theory, taxpayers would be further protected by a reserve fund made up of fees paid by the new GSEs, but Section 1388(c)(3) of the bill says that the fees should be set after taking into consideration "general economic conditions," "trends in housing prices," and "other such factors that the director deems appropriate." Again, this indicates that the real purpose of the Campbell-Peters bill is to ensure the profitability of the new GSEs.

The legislation recreates the same serious policy error that helped to cause the savings and loan crisis

14. Housing Finance Reform Act of 2011, H.R. 1859, 112th Congress, <http://www.govtrack.us/congress/bill.xpd?bill=h112-1859> (accessed March 27, 2013). As of March 27, the bill has not been reintroduced into the 113th Congress.

of the late 1980s by mixing the FHFA's current regulatory functions with the duty of pricing and providing the federal guarantees. A similar confusion in the role of the old Federal Home Loan Bank Board caused it to fail to regulate the financial institutions under its care adequately, thus enabling them to engage in a host of risky and often illegal practices.

Creating Fannie Mae and Freddie Mac, and forcing taxpayers to subsidize both, were serious policy mistakes. These mistakes should never be repeated.

Finally, the 112th Congress legislation would have created a moral hazard, as some of the new GSEs use the government's guarantee to hide the poor credit quality of the mortgages underlying their mortgage-backed securities. While the bill requires the new GSEs to have fairly high capitalization, neither it nor the proposed reserve fund would cover the potential losses. Instead, taxpayers would again be at risk.

The Campbell-Peters bill was a genuine attempt to solve a very real problem. However, it would have created a system of corporate welfare for both the new GSEs and the housing industry as a whole, which would eventually cost taxpayers much more than would solving the problem by eliminating Fannie Mae and Freddie Mac. GSEs, whether there are two, or dozens, are a market distortion that taxpayers cannot afford.

Fannie Mae et Freddie Mac Delenda Est

Around 157 B.C., the Roman statesman Cato the Elder began to conclude all of his public speeches, regardless of what the topic of the talk was, with the phrase "Carthago delenda est"—"Carthage must be destroyed." Cato did so in order to keep the focus on the ultimate goal of eliminating the major threat to Rome's supremacy. In 146 B.C., Carthage was destroyed.

While "Fannie Mae et Freddie Mac delenda est" is certainly questionable Latin, it is important to keep the focus on the end result: a housing market free of the massive distortion that is Fannie Mae and Freddie Mac. Although prudence and the fragile recovery of the housing market requires that both GSEs be eliminated slowly and methodically, Congress should not allow itself to be distracted by unreasonable fears or bureaucratic inertia.

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

—*David C. John* authored this paper as Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.