Backgrounder

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Free the Housing Finance Market from Fannie Mae and Freddie Mac

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Abstract: *Fannie Mae and Freddie Mac—the government-sponsored mortgage giants—must be shut down. Both entities distort the market by issuing mortgage-backed securities with subsidized government guarantees that the mortgages will be repaid. If such guarantees are necessary, they should be priced and issued by the private sector, not by the state. Fannie Mae and Freddie Mac must be closed down completely and permanently. Heritage Foundation expert on financial institutions 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.*

Talking Points

- In the years since housing prices peaked in 2007, the value of household real estate has fallen by $6.6 trillion—30 percent—and it continues to fall.
- Fannie Mae and Freddie Mac are creations of government, not the market. It is impossible to have a modern housing finance system as long as they exist.
- Fannie Mae and Freddie Mac should be phased out carefully and methodically to avoid further upsetting the delicate housing market.
- This is not a development to be feared, but rather the first step in rebuilding a modern housing finance industry. Private-sector companies can provide the same services and guarantees as are provided by Fannie Mae and Freddie Mac—if those services and guarantees are actually needed.
- Nothing less than the complete elimination of both Fannie Mae and Freddie Mac is acceptable.

This paper, in its entirety, can be found at: *http://report.heritage.org/bg2577*

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The housing crisis that continues to affect housing prices across the country is due in large part to the activities of two special government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac. In the years since housing prices peaked in the second quarter of 2007, the value of household real estate has fallen by about $6.6 trillion[1]—30 percent—and it continues to fall. Real recovery is not likely until both Fannie Mae and Freddie Mac are replaced by a new housing finance system that does not include government distortions of the market.

The transition will not be easy, but both entities have outlived their usefulness. This paper discusses the roles of Fannie Mae and Freddie Mac and recommends ways to eliminate both institutions without further damaging an already weak housing market. As noted at the end, one way *not* to fix the current system

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of two GSEs would be a proposal that would create dozens of new GSEs issuing mortgage-backed securities with a government guarantee. Such a move would only guarantee additional GSE bailouts and the loss of additional hundreds of billions of taxpayer dollars.

How to Eliminate Fannie Mae and Freddie Mac

Both Fannie Mae and Freddie Mac are creations of government, not the market. It is impossible to create a modern housing finance system while they continue to exist. However, the housing market is currently very weak, 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) 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.
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 (HUD). 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. Such sales would not be based on geography, and certain parts would be reserved for sale to small banks or credit unions or smaller mortgage bankers to reduce the chance of the business's being dominated by large companies.
8. **Require** continuing congressional oversight to monitor these changes and the development of a modern housing finance system.

How Fannie Mae and Freddie Mac Became Mortgage Giants

Fannie Mae and Freddie Mac are two stories of government programs gone wrong. The Federal National Mortgage Association (its popular name "Fannie Mae" comes from its acronym, FNMA) was chartered in 1938 as a government-owned entity designed to purchase home mortgages from banks and savings and loan associations[2] so that they would be able to underwrite additional housing loans. The purchased mortgages were insured by the Federal Housing Administration (FHA), and later mortgages were 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.

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1. "Q1 Flow of Funds: Household Real Estate Assets off $6.6 Trillion from Peak," CalculatedRisk, June 6, 2011, at *http://www.calculatedriskblog.com/2011/06/q1-flow-of-funds-household-real-estate.html* (July 5, 2011).
2. A savings and loan (S&L) was a special type of financial institution that took in deposits and loaned them out as small loans and mortgages. The government, which then 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.

Fannie Mae and Freddie Mac are two stories of government programs gone wrong.

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 -guaranteed loans.

By 1970, Fannie Mae was allowed to purchase any privately originated mortgages, but Congress was concerned about its potential for monopoly powers. As a result, Congress also created the Federal Home Loan Mortgage Corporation (which became Freddie Mac) as a competitor designed 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), which was the regulator of savings and loans and similar financial institutions and charged with promoting the industry.

During this time, the mortgage-backed security, whereby an investor could purchase a piece 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" (the mortgage payments being passed through the originator of the bond issue to the investor) or participation certificates. Freddie Mac issued its first pass-through certificate in 1971, with Fannie Mae following suit in 1981.

In 1989, Freddie Mac was removed from FHLBB ownership and made a fully private corporation like Fannie Mae. However, the market recognized that both entities have a special relationship with the government and that both are therefore known as government-sponsored enterprises.

In 1992, Congress decided to use 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, when both suffered such severe losses from their investments that they did not have sufficient liquidity to remain in business. 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 Alt-A 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.

As private companies, both GSEs were under pressure to have continuously growing earnings, which led them into accounting scandals, and to direct some of their resources into investments in various types of mortgage-related securities. Essentially, both companies became hedge funds in addition to their role in the mortgage financing industry.

Fannie Mae and Freddie Mac's Role in Housing Finance

Although Fannie Mae and Freddie Mac are separate companies, both housing finance giants essentially do the same thing: Both of them purchase "conforming" mortgages[3] that meet certain size and credit quality 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 inves-

3. A conforming mortgage is smaller than the maximum-size mortgage 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 will be $729,750. After that date, it will drop to $625,500. In other areas of the country, the conforming loan limit is $417,000 throughout 2011.

tors. 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 them, which was another reason for their very low borrowing costs.

Both government-sponsored entities were under pressure to have continuously growing earnings, which led them into accounting scandals, and to direct some of their resources into investments in various types of mortgage-related securities.

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 pieces 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 and for their guarantee and other services. The guarantee fee is subtracted from the 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 precisely what 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 know almost exactly what cash flow would come from a set issuance of bonds and, thus, what their value was.

However, these valuations depended on knowing the credit quality of the mortgages underlying the bonds, and when credit quality slipped, bond owners were uncertain what proportion of the mortgages 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 can 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.

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 are issued by Fannie Mae and Freddie Mac.

The 2008 Government Takeover of Fannie Mae and Freddie Mac

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 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 they 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.

For decades, mortgage-backed securities issued by the two mortgage giants were considered to be extremely safe, but when credit quality slipped, bond owners were uncertain what proportion of the mortgages would be repaid on time.

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 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 it would be 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

If all goes well, 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 slow recovery. While they are understandably reacting to the past few years, they are not looking toward the future. A careful and considered phaseout 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 slow 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 recovers, there is a growing consensus that neither organization will be necessary in the future. The private sector is more than capable of producing mortgage-backed securities and other innovative ways to finance 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, 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 ensuring that mortgages still meet strict underwriting standards and protecting consumers from predatory lending practices.

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 they allow new money from investors who buy the securities to finance additional mortgages. Restoring private issuers will take time, and policymakers should encourage this restoration by following these 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,[4] their government regulator (the FHFA) placed them into conservatorship, not bankruptcy. When the con-

4. 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, at *http://fpc.state.gov/documents/organization/110097.pdf* (July 5, 2011).

servatorship 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 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 requires that if the FHFA closes either GSE, it must be replaced with a newly chartered version. Instead, the law should be changed to allow the FHFA to take complete legal and formal control of both. This will eliminate the shareholders and give the agency a free hand to phase out both entities without endangering the legal status of bonds that are already outstanding.

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 four renewals. This will allow Congress both 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 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.

To avoid disrupting the housing market's slow 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.

Both GSEs 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 taxpayers' money that has been spent on covering the GSEs' losses.

The first step in the process would be to require Fannie Mae and Freddie Mac 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 multi-family structures for securitization. Thus, purchases of mortgages on multi-family structures could continue if the goal is to include them in securities.

Next, both portfolios should be transferred to a new and temporary subsidiary of the FHFA that is patterned on the old Resolution Trust Corporation, which liquidated the assets of failed savings and loans between 1989 and 1993.[5] 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 assets could be sold for whatever the FHFA can get for them—again, over time to avoid flooding the market.

5. 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), at *http://www.fdic.gov/bank/analytical/banking/2005jul/article2.pdf* (July 5, 2010).

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,[6] these are currently set at $417,000 for single-family dwellings in normal-cost areas and $729,750 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.

The conforming loan limits are already scheduled to decline this fall to a maximum of $625,500, but that should be only the first step toward further reductions. Rather than a legislatively established schedule for reducing these limits, 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 phaseout 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.

5. Increase the guarantee fee. 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. Typically, guarantee fees run between 15 and 25 basis points (one basis point is 1/100th of 1 percent).

As with the conforming loan limits, the FHFA should have the authority to increase the guarantee fees gradually over time, using an announced schedule that can be altered as market conditions change. 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.

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 private companies at an affordable cost.

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,[7] 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.

6. Move low-income housing subsidies and policy goals to HUD. Low-income housing policy goals and subsidies that are currently imposed upon 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.

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6. Fannie Mae, "2011 Single-Family Mortgage Loan Limits," January 11, 2011, at *http://www.fanniemae.com/aboutfm/loanlimits.jhtml* (July 5, 2011).
7. 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, at *http://mercatus.org/sites/default/files/publication/Do%20We%20Need%2030yr%20FRM.Sanders.3.14.11.pdf* (July 5, 2011).

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 pieces of the two GSEs' underwriting activities to private companies.

Congress should not sell pieces that are geographically based, since these could be reattached 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 phaseout 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, or industry fears and other political pressures could stall efforts to end Fannie Mae and Freddie Mac. A regular congressional re-examination of the phaseout process would also allow Congress to see whether market conditions allow for 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 this country. In addition, Congress should be alert to innovative housing finance methods that could arise as Fannie Mae and Freddie Mac reduce their role and should ensure that artificial restraints do not inhibit their growth.

How to Guarantee Future Housing Bailouts: What *Not* To Do

Some Members of Congress have 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. This would do nothing other than to guarantee that more GSE bailouts will be necessary, costing additional hundreds of billions of taxpayer dollars.

Policies contained in the Housing Finance Reform Act of 2011, H.R. 1859,[8] introduced by Representatives John Campbell (R–CA) and Gary Peters (D–MI), while well intentioned, would cause much more damage than the current system. The bill would allow the creation of any number of GSE clones with carefully delineated powers and capital requirements. Each would be empowered to issue mortgage-backed securities with a govern-

8. Housing Finance Reform Act of 2011, H.R. 1859, 112th Congress, at *http://www.govtrack.us/congress/bill.xpd?bill=h112-1859* (July 5, 2011).

ment guarantee that both the principal and interest from the underlying mortgages would be repaid as promised. Supporters believe both that a government guarantee is essential if the 30-year fixed-rate mortgage is to survive and that its survival is the key to a healthy housing market.

There are many explicit 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 proven 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 of the late 1980s by mixing the Federal Housing Finance Agency'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 dozens of clones with the power to attach a government guarantee to their mortgage-backed securities would guarantee that more GSE bailouts will be necessary, costing additional hundreds of billions of taxpayer dollars.

Finally, the proposed legislation would create a moral hazard as some of the new GSEs use the government 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 is a genuine attempt to solve a very real problem. However, it would create 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 this 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 the current weakness in 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 creating 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.

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