White Paper

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It is a hopeful sign that Treasury Secretary Steven Mnuchin has raised privatization of Fannie Mae and Freddie Mac as an early order of business for the new administration. The red ink that poured out of the two companies during the financial crisis has long stopped flowing, but Fannie and Freddie remain in the government-controlled limbo of conservatorship they entered in September 2008. This leaves a situation in which government domination of the housing finance system puts taxpayers on the hook in the event of serious problems, even while many families find it difficult to obtain a mortgage. With the two government-sponsored enterprises (GSEs) still the linchpins of the mortgage system, taxpayer money surely would be used to prop them up again in the event of a future housing downturn. Hence, it is understandable that Mr. Mnuchin would like to privatize the entities as soon as possible, both to reduce taxpayer risk and to improve the effectiveness of the mortgage system at ensuring access to financing for families looking to buy homes.

A pragmatic approach would improve the existing system by increasing the amount of private capital at the two companies while drawing other firms into the mix to share the risk and rewards involved with the business of mortgage securitization and guaranty. Increased competition from other firms is the best way to achieve a privatized system. Bringing Fannie and Freddie out of conservatorship and merely stating that the companies are private and will not be rescued again is not credible if there are only two of them, because the government will not allow the resulting disruption to the housing market if they fail. Any reform plan must leave firms involved in mortgage securitization in solid financial condition, but that alone is not enough. Housing finance reform must also consider what happens if mortgage securitization firms again run into trouble, the situation in which the pre-crisis implicit guarantee on Fannie and Freddie turned into an explicit guarantee and costly taxpayer bailout.

Even with the best reform, it is possible to envision problems that affect the entire housing finance system. Policymakers need to recognize that government intervention is assured

if there is a large enough crisis to cause every firm doing mortgage securitization to fail—the disruption to the housing sector and to the broader economy would be untenable. Policymakers also should be realistic that it will take time to privatize the housing finance system, both to put in place changes at the existing GSEs and for other firms to enter into the market. A looming uncertainty is whether the $5 trillion mortgage market requires some level of government support. Private investors have become accustomed to a government guarantee on most mortgages and might be reluctant to provide liquidity without it. Changing this situation should be the primary goal of reform, but will take some time. The good news is that, regardless of the desired end state in terms of the market structure and extent of government support for housing, key steps along the path to privatization are relatively clear and among the common themes that have emerged from previous housing finance reform proposals. There are at least five actions that should be taken by Congress and the new administration to pave the way to meaningful reform. The first three involve legislation to expand the mortgage securitization industry beyond the current duopoly of Fannie and Freddie while avoiding market disruption. The next requires administrative actions that would protect taxpayers during the transition. The fifth and perhaps the most challenging would involve a holistic assessment of the government's role in the housing market to determine the scope of any federal guarantee and the obligations of private firms that receive even limited government backing. This last step would again likely involve legislation, although the policies could be developed over time as markets evolve.

1. Enable competition by creating a common security and a shared facility for issuing the security.

   Carving up the lucrative mortgage pie among more than just two guarantors would address the current moral hazard associated with the too-important-to-fail status of Fannie and Freddie. Putting in place a common security and securitization platform are especially important to draw more players into the market.

   Under the direction of their regulator, the Federal Housing Finance Agency (FHFA), Fannie and Freddie have formed a joint venture that is developing a shared securitization platform with the ultimate goal of moving to a single security rather than the current separate MBS issued by each company. Freddie Mac has begun to use this new infrastructure; adding Fannie would allow the firms' securities to be bought and sold on a level playing field rather than in two separate trading markets. This infrastructure could then be opened up to new firms to compete in mortgage securitization and guaranty. Without these institutional changes, the securities issued by new market entrants would inevitably trade at a severe disadvantage to securities comprised of mortgages securitized by Fannie and Freddie, making for a barrier to entry that would be difficult to overcome. It would be important for the current joint venture

eventually to be made independent of the two incumbents to ensure that new firms are treated equally in their use of the shared infrastructure. If progress lags on these initiatives, however, the existing capabilities of Ginnie Mae could be adapted instead—as has been proposed by Ed DeMarco and Michael Bright of the Milken Institute.

A common security and securitization platform makes sense regardless of whether Fannie and Freddie remain as shareholder-owned corporations or if they are restructured as regulated utilities or use some other ownership structure such as a cooperative of industry participants. This is because a common pool for all mortgage-backed securities (MBS) with a government guarantee will ensure the greatest liquidity for mortgage-related securities and this will feed through into lower interest rates for homeowners than would be the case in a less liquid market.

2. Amend the GSEs' charters and allow other qualified companies to compete.

The best way to ensure a competitive secondary market is to amend (or possibly revoke) the GSE charters to eliminate their special privileges (e.g., line of credit with the U.S. Treasury) and to authorize their regulator to ensure that other qualified firms are allowed to enter the government-backed mortgage securitization market. The eventual goal should be to allow Fannie and Freddie to be returned to private ownership, relying on competition overseen by a capable regulator to ensure that the benefits of any government support flow to homebuyers in the form of lower interest rates rather than to shareholders or firm management. This framework is possible so long as there are enough entrants so that some can be allowed to fail without putting housing market activity and the overall economy at risk, keeping in mind that new firms can enter to supersede both ongoing incumbents and any that fail. With billions of dollars in profits to be had, there is every reason to expect entry. We recognize, however, that the key question is whether and how many additional private firms will enter the market to compete with Fannie and Freddie if the new competitors are assured of a level playing field. One must certainly consider the possibility that no other firms will be willing to compete with the two existing GSEs. If this turns out to be the case, the government would instead have to treat Fannie and Freddie like heavily-regulated utilities that cannot be allowed to fail. A utility model would still involve firms that fund themselves with much more capital than was the case for Fannie and Freddie in the past, but would add additional constraints on the risks and returns they are allowed to take, including continued oversight on decisions such as the introduction of new products. Capital markets transactions and an expanded role for private mortgage insurance could also be used to bring in additional private capital,

building on what is currently done by Fannie and Freddie using risk-sharing securities and reinsurance contracts.

While such a "utility model" approach would help reduce taxpayer risk, it would leave the government backing a large part of the mortgage market, increasing the possibility of a future bailout. Such an outcome is difficult to avoid without the entry and competition that makes no firm in an industry too big or important to fail. A utility model would also sacrifice some of the benefits of competition and innovation that come from having an industry with multiple private firms. As a result, a housing finance system with a heavily regulated utility strikes us as a distinctly second-best outcome compared to a scenario with open entry. But even what we see as the second-best outcome of a regulated utility would be a meaningful improvement over an approach of "recap-and-release" that effectively revives the implicit guarantee of the pre-crisis system.

An alternative to (or perhaps a variant of) the utility model would be for Fannie and Freddie to be restructured as cooperatives owned by firms engaged in mortgage origination. This would involve private capital supplied directly by the participants in the cooperative (that is, by the owners) with a secondary government guarantee in case the cooperative suffers large enough losses. Considering the governance of the cooperative would be important, as well as ensuring that a private ownership structure of a firm that is not allowed to fail does not give rise to the moral hazard and excessive risktaking that marred the pre-crisis housing finance system.

3. Provide an explicit guarantee on the security in exchange for a fee.

In principle, it would be attractive for the housing finance system to be independent of government ties, other than programs that target specific groups such as veterans and low-income or first-time homebuyers. Moving to such a system requires narrowing the scope of mortgages supported by the government so that fully-private lending can revive. With the vast majority of mortgages today receiving a government guarantee, the shift from a government-centric approach to one with a larger share of private risk-taking and incentives must take place over time to avoid an abrupt shift that would mean disruption for families and the economy.

A key step in undertaking the transition away from a government-dominated housing finance system is to switch from the current framework in which the government supports the Fannie and Freddie as ongoing entities to instead having the government provide a secondary backstop on the mortgagebacked securities issued by the firms. The backstop would be secondary because substantial amounts of private capital would be required to take losses from

mortgage problems ahead of any government payout. In exchange for the government backstop, Fannie and Freddie would be required to pay a fee to cover the government's risk—much like banks pay on FDIC-insured deposit accounts. Further, to promote competition, the guarantee would be made available to other qualified market entrants. Investors in MBS would still have clarity on their exposure in the event that Fannie or Freddie (or any subsequent guarantors) were to fail, while the government would be compensated for taking on risks. This contrasts with the system before the crisis, in which the government guarantee was implicit—and then costly when the bailout was actually needed.

A challenge with the arrangement of having firms pay for an explicit guarantee that kicks in after substantial private capital takes first losses is that it is difficult for the government to price the insurance—indeed, the history of such schemes is that the government charges too little for the guarantee. An innovative approach to addressing this challenge would be to follow the suggestion of Representative John Delaney (D-Maryland) by requiring firms to arrange for not just first-loss private capital that is on the hook ahead of the government guarantee, but also private capital that takes losses alongside the guarantee. The Delaney approach would then use the market-determined price of this private capital to inform that of the government guarantee.

Over time, the amount of private capital ahead of the government guarantee gradually would be increased, both reducing the risk of another bailout and the extent of taxpayer exposure. Again, the idea is to make the guarantee explicit while switching it to MBS rather than to Fannie and Freddie as firms and gradually increasing the amount of private capital so that the guarantee narrows over time. A successful privatization would occur when there is no guarantee on most mortgages in normal times— government support in most circumstances would be limited to particular groups such as veterans, lowincome families, and first-time homebuyers. When credit markets are strained, however, the government guarantee could be expanded to a broader portion of the market to ensure the continued flow of mortgage credit. Mortgage-backed securities already issued without government backing would not receive a retroactive guarantee. In effect, this would create a system in which government backing is made available when it is most valuable during a crisis and recedes in normal times when it is least needed.

What is striking is that this model has been included in both Democratic and Republican reform proposals: this setup is found in the second proposal in the Obama administration's February 2011 housing finance white paper and in the PATH plan from Jeb Hensarling (R-Texas), chair of the House Financial Services Committee (in which the FHA guarantee is widely available during a crisis). The speed of the transition to this new system will depend on the market's willingness to take on mortgage risk and the pace at which additional guarantors enter to compete with Fannie and Freddie. While this process unfolds, the GSEs should continue to expand their efforts to off-load a large proportion of their credit risk through private mortgage insurance and the issuance of credit transfer securities. Both types of transactions protect taxpayers by increasing the exposure of private investors to housing risk.

4. Ensure the underlying quality of the loans.

Devising appropriate secondary market structures needs to be accompanied by changes in the primary mortgage market that emphasize prudence in origination. While the new administration seeks to eliminate some burdensome regulations, it should actually strengthen the requirement for mortgage participants to have greater "skin in the game." Specifically, the administration should reconsider current policy that effectively exempts loans sold to Fannie and Freddie from regulations designed to discourage the kinds of irresponsible lending that sparked the housing crisis. This could be done by eliminating the so-called Qualified Mortgage (QM) patch, which considers any loan sold to the two companies as inherently "safe" regardless of its characteristics. Applying the same set of standards that are used elsewhere by private parties evaluating mortgages would prevent lenders from gaming the system by selling their riskier loans to the GSEs while the two firms are supported by taxpayers. An additional way to improve incentives would be to reverse a 2014 decision by federal regulators that eviscerated a central provision of financial reform, namely, the requirement that lenders hold up to 5 percent capital against mortgages destined for sale unless the loans have significant down payments or other characteristics that mitigate their underlying risks. Greater skin in the game on the part of private market participants such as lenders is critical to ensuring a safer system and protecting taxpayers from future losses.

In the short run, we recognize that additional capital requirements – whether through a Delaney-style guarantee or greater skin in the game on the part of lenders or borrowers – will likely decrease affordability. However, we believe that a housing finance system that is both competitive and resilient is the best way to ensure sustainable homeownership.

5. View Fannie and Freddie reform in a broader context.

Finally, while the steps identified above will pave the way to reform, policy makers must also devise a workable way to support affordable housing. Thus far, discussions have been relatively narrow and largely tactical in nature, focusing on politically-charged issues such as the imposition of housing goals that echo those that operated before the crisis. The problem is that the goals were only modestly effective in expanding credit while requiring Fannie and Freddie to contort themselves into taking imprudent risk. Ultimately, a holistic approach would consider the appropriate targeting of taxpayer support for affordable housing, the respective roles of FHA, VA, and other government agencies, and the allocation of resources between owner-occupied and rental housing and between the housing sector and the economy at large.

Mr. Mnuchin's zeal to move forward with regard to Fannie and Freddie reform is laudable. A pragmatic approach to reform will ensure that privatization of the housing finance system leads to a better mortgage market for homeowners and a safer system for taxpayers. Fortunately, most of the basic building blocks to reform are already in play and have broad support. While policymakers may have different visions of the ultimate end state, a path to reform is clear.

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