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Comment on the Federal Housing Finance Agency’s Strategic Plan: Fiscal Years 2013-2017

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Executive Summary

This is a comment upon Performance Goal 4.3 from the Federal Housing Finance Agency’s Strategic Plan: Fiscal Years 2013-2017. Performance Goal 4.3 addresses the future of Fannie Mae and Freddie Mac as well as the future of the infrastructure of the housing finance market. This comment will address the future of Fannie and Freddie after they exit conservatorship. Once analyzed in the context of regulatory theory, Fannie and Freddie’s future seems clear. They should be privatized so that they can compete on an even playing field with other financial institutions, and their public functions should be assumed by pure government actors.

1 Professor of Law, Brooklyn Law School; The content of this comment is drawn from my previous works, including Fannie Mae and Freddie Mac the Future of Federal Housing Finance Policy: A Study of Regulatory Privilege, 61 ALA. L. REV. 907, 907-952 (2010); Reforming the Residential Mortgage-Backed Securities Market, Hamline Law Review (forthcoming); available at http://ssrn.com/abstract=203502. Thanks to Arthur Torkiver for excellent research assistance.
Performance Goal 4.3: Build a New Infrastructure for the Secondary Mortgage Market

The nation’s system of housing finance is undergoing a transition that will require both short and long-term reform strategies. There are significant public policy questions and choices ahead on how to achieve an appropriate balance between the role of the private sector and the role of government as housing finance conditions change.

During the deliberation process, FHFA will examine a variety of options across the housing delivery system with the objective of reducing the Enterprises’ role in the secondary mortgage market and attracting the private sector to a greater role.

FHFA will improve housing and mortgage market data and information systems. FHFA will participate in public policy deliberations on housing finance reform as requested and will serve as a resource to the executive and legislative branches.

FHFA also will begin working to build a new infrastructure for the secondary mortgage market. FHFA will explore options for involving personnel from both Fannie Mae and Freddie Mac to build a single securitization platform that will succeed their respective, proprietary systems. Another important aspect to building for the future will be to create a standardized pooling and servicing agreement.

Without the Enterprises, no secondary market for non-government insured mortgages exists. No private sector infrastructure exists today capable of securitizing the $100 billion per month in new mortgages being originated. Interest rates would increase and mortgage availability would be limited if the Enterprises were closed.

FHFA will work with the Enterprises to create the necessary infrastructure Congress and market participants may use to develop the mortgage market of the future, including a common platform and national standards for mortgage securitization.

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I. What Should Be Done with Fannie and Freddie?

Fannie and Freddie are not integral to a healthy market for residential mortgages and we now have an opportunity to fundamentally reshape housing finance policy so that it meets the needs of American homeowners and taxpayers. The next era of residential housing finance should have two components: a pure government actor and a fully-private, private sector. A government instrumentality that can act as a securitizer of last resort of plain vanilla mortgages will ensure that the mortgage market remains liquid in the worst panics. And a well-regulated private sector will ensure that the mortgage markets develop new, but appropriate, products for homeowners. Such regulation should also reduce the likelihood that taxpayers will need to finance a bailout of the mortgage industry down the line because it would keep homeowners from being placed in inappropriate and unsustainable mortgages.

A. Four Ways to Deal with Fannie and Freddie

There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. First, Fannie and Freddie are generally doing the job that they were designed to do, although their powers and that of their regulators should be tweaked. Second, Fannie and Freddie are generally doing their job, but they are retaining too much of the value of the government guarantee of their obligations for the benefit of shareholders and management at the expense of their affordable housing goals. Third, Fannie and Freddie should be nationalized because the federal government has taken on most of the risk associated with them already. And finally, Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and do not create net benefits for the American people.

This comment takes the fourth position. In particular, it argues that the government guarantee should be terminated and the two companies should be privatized. Until they entered conservatorship, this position has been considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Republican and Democratic parties. Due to recent events, it is now one of the options on the table for a post-conservatorship Fannie and Freddie.

1. Option One: Tweaking the Status Quo

One taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that “[t]he penetration of competitive markets by laws and regulations is a highly durable and robust intrusion in the U.S. economy . . . [which] is arguably as tightly regulated as the more socialistic economies of Western Europe.”

Thus, there is no need to extricate the federal government from its relationship with Fannie and Freddie because the government has similar relationships with many

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other private companies. Proponents of this view typically recommend limited reforms such as:

- Limiting the size of their mortgage portfolios;
- Limiting their debt issuance;
- Stripping (the two companies) of some of their unique privileges to signal to the market that the implied guarantee has been weakened;
- Freezing the conforming loan value to limit the size of mortgages they can buy, thereby limiting their overall size;
- Requiring them to obtain ratings from rating agencies for their debt issuances that discount the implied guarantee;
- Imposing user fees; and
- Strengthening their subordinated debt programs.

If any of these half-measures were adopted, however, Fannie and Freddie, formally known for their lobbying process and extensive “alumni network,” would be sure to undercut them as soon as Congress’ focus moved on to another pressing issue.

However, if such an approach were to be taken it should have the following characteristics:

- a commitment to identifying what went wrong with Fannie and Freddie in the subprime boom
- an identification of a tolerable level of losses from future bailouts
- the development of a workout plan that can be implemented for the inevitable bailout that will come at some point in the future.

2. Option Two: Increasing Fannie and Freddie’s Role in Developing Affordable Housing

Affordable housing providers and advocates have argued that over the long-term, Fannie and Freddie have pretty much done their job of making housing more affordable to Americans, but they are retaining too much of the value of the government guarantee for the benefit of the shareholders and management, at the expense of their affordable housing goals. Thus, these parties favor proposals that redirect some of the profits of Fannie and Freddie from their shareholders and management to affordable housing programs.

And, indeed, Congress had implemented an affordable housing fund in which the two firms would deposit upwards for $500 million of their income each year.\(^4\) This initiative was subsequently suspended because of the federal conservatorship of the two enterprises. These monies were to be invested in affordable housing projects throughout the country. Affordable housing advocates originally saw this as a painless way to

dramatically increase the supply of affordable housing. The ongoing bailout of the two companies demonstrates that the initiative was not painless, just pain deferred.

Fannie and Freddie had supported this proposal in exchange for expanding their market. This expansion was implemented by increasing the conforming loan limit in high-cost parts of the country, which allowed the two companies to expand into the bottom part of the jumbo market. It is of note, of course, that Fannie and Freddie’s support for such an extraordinarily costly initiative as the affordable housing fund came at a low point of their public prestige and was widely seen as a political compromise that brought together a broad set of special interests whose goals are aligned with those of Fannie and Freddie. These interests included affordable housing advocates, local governments and the construction industry.

The dynamics of this position are complex. Housing advocates are concerned with the sustained lack of attention that federal and state governments have paid to affordable housing policy and see any dedicated housing dollars as a long overdue priority. Implicit in this view is that the risk of a Fannie and/or Freddie bailout to the typical American taxpayer is worth the benefit of the affordable housing dollars that the affordable housing fund could direct to low- and moderate-income families. The real debate, from this perspective, is how much of the golden egg of the economic rents resulting from the implied subsidy (as revealed by Fannie and Freddie’s profits that consistently and greatly exceed their industry average) can be redirected to these affordable housing objectives without killing the Fannie and Freddie geese.

The key characteristics of this approach, if it were taken, should be the same as the first, along with these additional ones:

- a commitment to identifying how to extract funds for affordable housing from the Fannie/Freddie business model without undercutting their fundamental safety and soundness as financial institutions

- the development of a cost/benefit analysis of the affordable housing trust fund that will help to identify (and limit) the extent to which Fannie and Freddie would need additional regulatory privileges (such as the expansion of the conforming loan limit) to compensate them for the burdens of such a proposal.

3. Option Three: Nationalization

The third position, nationalization, had only begun to be taken seriously as the Fannie and Freddie bailouts become more and more likely to occur. Indeed, as the subprime crisis unfolded, then-Treasury Secretary Paulson has raised the idea, one, which would seem to be anathema to a fiscal conservative like himself. Paulson proposed merging the two companies with the Federal Housing Administration (FHA), a pure government instrumentality, which already insures certain mortgages. He did note, however, that

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such a plan would place much of the underwriting in the hands of the government, which is unlikely to do that task well (not that the private sector has done so either in recent years!). Dwight Jaffee has developed one such proposal that advocates for the creation of a government agency along the lines of the FHA to serve the conforming market in lieu of Fannie and Freddie. In a slightly different vein, Hancock and Passmore have proposed the creation of a federal government bond insurer for mortgage related bonds created by Fannie, Freddie and other authorized issuers. This insurer would charge risk-based premiums in exchange for an explicit federal government guarantee against credit losses.

Since taking office, the Obama Administration has indeed looked to Fannie and Freddie as an extension of the federal government and as a tool for achieving its housing policies. Fannie Mae and Freddie Mac, as conduits of federal bailout money, have effectively propped up the U.S. housing market; Fannie and Freddie accounted for roughly seventy-five percent of all new mortgage originations since 2008, with the FHA accounting for almost all the rest. Fannie and Freddie are also centerpieces of the Administration’s foreclosure prevention efforts, refinancing and modifying mortgage loans they hold and guarantee, and further serving as the government’s administrator and compliance agent in managing other industry participants in the program. The Treasury has also employed Fannie and Freddie to support affordable housing programs, channeling money through Fannie and Freddie to purchase and securitize state and local housing agency bonds that were in demand by private investors in more flush economic times. This is not to suggest that nationalization of Fannie and Freddie is a fait accompli; in the months before Fannie and Freddie entered conservatorship, former Treasury Secretary Lawrence Summers suggested that under an emergency scenario, the government could “operate the GSEs as a public corporation for several years . . . to extend credit where appropriate to support resolution of the housing crisis” before dividing their functions into public and private components once the crisis had passed.

Because this approach would radically change the entire nature of the American housing finance system, the characteristics of this approach should be much more far-reaching. They should include:

- the enunciation of a broadly held philosophy of government intervention in homeownership policy that would guide any nationalization approach
- the selection of the appropriate mode of government intervention (e.g., MBS insurer; MBS securitizer; direct lender like in the student loan market)

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6 Dwight M. Jaffee, Reforming Fannie and Freddie, REGULATION, 31, 56-63 (Feb. 18, 2009).
• the determination of the political independence of the government instrumentality that implements such a nationalized housing finance policy (e.g., an arm of the executive as with post-conservatorship Fannie and Freddie or something more independent like the Federal Reserve Board)

4. Option Four: Privatization

As noted above, this comment advocates for the fourth view: Fannie and Freddie pose a systemic risk to the financial system, unfairly benefit from their regulatory privilege and no longer create meaningful net benefits for the American people. In speaking of regulatory reform, Cass Sunstein notes that a good first step “would be to adopt a presumption in favor of flexible, market-oriented, incentive-based, and decentralized regulatory strategies. Such strategies should be focused on ends . . . rather than on the means of achieving those ends.”¹⁰ Fannie and Freddie are holdovers from an earlier era of government action, one that has seen its day come and go. Indeed, if one were to create from scratch a new system of federally-supported residential mortgage finance, it is quite clear that the model would not be Fannie and Freddie, which are relatively inflexible and centralized solutions to the complex and fluid problems posed by the housing finance market. And while there is an argument to be made that Fannie and Freddie are market-oriented and incentive-based, it is a stronger argument to say that they are beneficiaries of various regulatory privileges that have benefited their shareholders and management disproportionately.

Privatization is needed to remedy this state of affairs. Because this comment advocates some form of privatization, I will address it at greater length below.

B. Privatization Options

Four concrete privatization plans have been proposed to fundamentally change Fannie and Freddie’s structure, each involving different degrees of government involvement. First, convert them into cooperatives owned by lenders. Second, break the companies up into a number of smaller companies (or charter a number of similar competitors). Third, leave them substantively intact, but regulate them like public utilities. Fourth, convert them into generic financial holding companies.

The first privatization option, converting Fannie and Freddie into cooperatives, has precedent. There are two other privately owned GSEs that are cooperative lenders: the Federal Home Loan Bank System (“FHLB System”) and the Farm Credit System. Some commentators have called for the FHLB System to take over Fannie and Freddie. This proposal has some initial attraction as it might attenuate the short-term profit-maximizing culture that characterizes publicly traded corporations like Fannie and Freddie. But history does not give comfort that such a GSE structure is superior to that of Fannie and Freddie’s. Indeed, Congress had to bail out the Farm Credit System in 1987.

The second type of privatization option, chartering additional housing finance competitors, has some attraction. The Center for American Progress (CAP),11 the Mortgage Bankers Association (MBA)12 and the National Association of Home Builders (NAHB) each have one such proposal.13 CAP proposes the creation of privately owned, monoline chartered mortgage issuers that could issue mortgage-backed securities (MBS) guaranteed by the federal government. The MBA proposal anticipates creating “mortgage credit-guarantor entities” that would have a federal government guarantee of MBS issued by them. The NAHB advocates the creation of conforming mortgage conduits that play a similar role. Under these options, insurance premiums levied on the MBS would be paid to the federal government in exchange for the guarantee. Such premiums would be designed to protect taxpayers from future bailouts.

One might consider the federal deposit insurance system to be a model of this type of proposal: numerous recipients of regulatory privilege (access to federally guaranteed insurance) who must compete amongst themselves. If the Fannie/Freddie duopoly could be diluted with enough similar competitors, the amount of economic rent that Fannie and Freddie retain from their government guarantee subsidy should reduce significantly. In addition, one might think that a more competitive market would spread risk among more firms. And, indeed, credit guarantees have played a central role in American housing policy since the 1930s. The guarantee protects against credit risk but leaves investors with interest rate risk and prepayment risk. Investors have various tools to hedge against those risks.

Upon further reflection, however, this option also reveals significant flaws. The benefit of GSE competition is less compelling now that we have experienced a bubble where so many financial institutions demonstrated herd-like behavior in their business models. And, as with the first option, the American taxpayer is still left with the contingent liability of the government guarantee.

The third privatization option, regulating them like utilities, appears to be favored by former Treasury Secretary Paulson and taken seriously by the likes of former Federal Housing Finance Agency Director Lockhart. The Housing Policy Council of the Financial Services Roundtable, for instance, proposes the creation of one MBS issuing facility that works with a small number of heavily regulated mortgage securities insurance companies which would originate a limited set of plain vanilla mortgages that

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can only be securitized in simple MBS structures by the MBS Issuing Facility.\textsuperscript{14} A Credit Suisse plan also has some of these utility-like characteristics: a reformed Fannie and Freddie that only issue federally guaranteed MBS containing plain vanilla mortgages.\textsuperscript{15}

In theory, appropriate regulation could help set proper pricing and control risk taking under this utility model. One worries however, how the common regulatory problem of capture would be avoided here where the two companies to be regulated are so clearly skilled in the art of politics. Fannie and Freddie are also poster children for “soft capture,” in which lobbyists will hire former politicians and legislators to push current lawmakers into a particular direction when there are competing, and contradictory, sources of information available to decision-makers.

One also worries that useful innovation will be stunted with such highly regulated players. In \textit{The Regulation of Monopoly}, Roger Sherman argues that government-created monopolies face very little competition and, because of this, have no great need nor urge to innovate.\textsuperscript{16} However, Richard Posner argues that it is an empirical question of whether monopolies do or do not retard innovation; he believes the question has not yet been answered.\textsuperscript{17} Therefore, there is no definitive answer as to what turning Fannie and Freddie into utility-like monopolies would do to innovation.

The fourth privatization option, converting Fannie and Freddie into generic financial services holding companies along the lines of institutions like Citigroup, J.P. Morgan Chase and Bank of America, has the attraction of simplicity. It also terminates the contingent liability of the government guarantee and allows the conforming mortgage market to function like other sectors of the overall credit market. And there is a precedent for this approach: Sallie Mae was successfully converted from a GSE to a private company. This approach would send the message that the American mortgage markets have grown up and are now to be integrated with the rest of the financial sector.

This option has its own limitations, which must be addressed if it were to be implemented. First, because Fannie and Freddie can offer at least a short term stabilizing role in the residential mortgage markets, the federal government would need to implement other policies to ensure that other entities take on that role. Possible policy responses to market disruptions could include providing targeted federal mortgage guarantees; authorizing the Treasury to make mortgage-backed securities purchases; and allowing mortgage lenders to access the Federal Reserve’s discount window. Policies like these can ensure that the residential mortgage market function during a panic. Donald

\textsuperscript{15} \textsc{Qumber Hassan and Mahesh Swaminathan}, \textit{GSEs – Still the Best Answer for Housing Finance (Credit Suisse Mortgage Market Comment)} (Oct. 6, 2009), \textit{available at} http://www.zigasassociates.com/images/uploads/GSEs_-_Still_the_best_answer_for_housing_finance.pdf.
\textsuperscript{16} \textsc{Roger Sherman}, \textit{The Regulation of Monopoly} 64 (1989).
\textsuperscript{17} \textsc{Richard A. Posner}, \textit{Antitrust Law} 20 (2d ed. 2001).
Marron and Phillip Swagel have proposed something along these lines, where a fully privatized, but regulated, Fannie and Freddie and their potential competitors would be able to purchase MBS guarantees from the federal government. Under such a scenario, the MBS would benefit from the federal guarantee but the firms and their debt would not. As always, the devil is in the details: ensuring that the cost of the federal guarantee matched the government’s actuarial risk is no small task and the failure to do that correctly could lead to future federal bailouts.

Second, homeowners will pay slightly higher interest for conforming mortgages if the two companies are privatized. If Congress determines that this increase is too much, particularly given the current condition of the economy, it could reduce the burden by modifying the deduction for residential mortgage interest or by providing a tax credit relating to residential mortgage interest. While such a strategy will decrease federal revenues it will be offset by the liability that Fannie and Freddie impose on the federal government, a liability that is already on its way to costing taxpayers hundreds of billions of dollars as part of the current bailout.

Third, if the federal government wanted to increase funding for affordable housing as contemplated in the Act, it would need to do so through direct expenditures. Again, this direct cost would be offset by terminating the contingent liability of the government guarantee.

Fourth, Fannie and Freddie have imposed pro-consumer terms on the prime conforming mortgage market. These must be maintained and built upon through new consumer protection regulation in order to avoid the historically nasty and brutish environment of the subprime mortgage market. And, indeed, it is hard to imagine that privatization would be politically feasible if such protections were not built into the privatization option.

Finally, Fannie and Freddie’s role as a gateway to the secondary market will end or be materially changed. This path presents great risks for small retail financial institutions because they would face some increased competitive disadvantages from the conversion of Fannie and Freddie to large, fully private competitors. Without Fannie and Freddie, small retail financial institutions would have a harder time offering long-term fixed-rate mortgages and that would put them at a competitive disadvantage to the very large financial institutions with whom they compete. Thus, small retail financial institutions will certainly want to see that GSE gateway function transferred to a new set of entities to ensure their ongoing access to the secondary markets. This is of key importance to such financial institutions but it is also important to the “Too Big To Fail” agenda – if a privatized Fannie and Freddie continue in anything like the size they are in now, they will continue to pose a systemic risk. Thus, smaller financial institutions should continue to be active participants in the secondary market in order to spread credit risk over a larger number of institutions.

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Notwithstanding these limitations, the “full-privatization” privatization option has the most going for it. It avoids the problem of the government guarantee that remains with the other three proposals. It leaves to the private sector what the private sector is supposed to do best: evaluate risk; and it leaves to the government what it is supposed to do best: protect against systemic risk, protect consumers; and provide affordable housing to those who could not otherwise afford it.

The federal government should terminate the Fannie and Freddie hybrids and spin their existing functions off to a pure government entity and to a truly private, private sector.

II. The Future of the Thirty-Year Fixed-Rate Mortgage

What is the future of the thirty-year fixed-rate mortgage? My best bet is that it will survive one way or the other. But I certainly question the knee-jerk support of that mortgage product. The average American household only lives in its home for seven years. That implies that most Americans, or a very large swath of Americans, could do better with a shorter-term fixed interest rate, which would result in lower monthly interest payments. This is not to say that ARMs are the answer to everybody’s housing situation, but it calls for innovation in the context of the thirty-year mortgage.

It would be beneficial to see innovation along a variety of axes, such as: (1) longer (ten or fifteen year) fixed periods for interest rates for ARMs as they might cover most households, given how long they typically stay in their homes; (2) interest rates that are based on rolling averages that slow the rate of change of the interest rate; (3) longer adjustment periods so the interest rate does not change every year, and instead maybe every three or five years; and (4) lower caps on annual interest rate increases, perhaps limiting them to one percent instead of the more typical two percent. All of these variants could reduce “payment shock,” when a household is used to making a monthly mortgage payment of a certain size and suddenly has a much bigger bill. Payment shock is really, I think, what people are afraid of, and there are tools other than the thirty-year fixed-rate mortgage to respond to that very legitimate concern. The good thing about all of these suggestions is that they would also allow lenders to move away from the thirty-year fixed-rate mortgage. Thirty-year fixed-rate mortgages also expose lenders to severe interest rate risk because their business model is based on borrowing short (from depositors and in the commercial paper market) and lending long (to residential borrowers).

III. The Future of the Lock-In

Fannie Mae and Freddie have created a unique “to be announced” (TBA) market that allows originating lenders to hedge the interest rate risk that could arise from a gap between the interest rate at the time a mortgage commitment is issued and the interest rate at the time at which the mortgage is closed. Many worry that a fully private market cannot replicate this system if Fannie and Freddie were to be privatized and borrowers
would no longer be able to lock in an interest rate at the time of the loan commitment. While maintaining the TBA market appears to benefit lenders and borrowers by allowing them to hedge interest rate risk, it does not appear to be too difficult to create a private version of this market—it is just a kind of forward contract. There is no reason that the private market could not create an alternative market that provides a similar type of hedge. But it is possible that such a market would need some type of enabling legislation from Congress.

IV. Future of the Low-Down-Payment Mortgage

We must also look at the fate of the low-down-payment mortgage. From an underwriting perspective, the hallowed 20% down payment is clearly desirable as defaults for such mortgages are exceedingly low. From an opportunity perspective of increasing homeownership, especially with first time homeowners, it is an overwhelming burden. This is why the federal government has implemented a variety of low (for example 3%) down payment mortgage programs, particularly through the FHA. Many of these programs have had very high default rates, which have led to calls to abolish them. The problem with such an approach, of course, is that returning to a high down payment requirement would keep a large swath of financially responsible, potential first-time homeowners from taking the plunge. There is evidence, however, that there is a down payment sweet spot of around five percent at which default rates are within an acceptable range.¹⁹

V. Conclusion

The main problem with government-sponsored enterprises (GSEs) like Fannie and Freddie is well documented: they take on a life of their own and can survive well after they have achieved the purposes for which they are created. The typical result of poor GSE design is that the GSE ends up driving much of the legislative and regulatory agenda regarding its own fate.

Fannie and Freddie reflect what is worst in GSE design. After fulfilling their purpose of creating a national mortgage market, they have taken on monstrously large lives of their own. As the FHFA plans to restructure the infrastructure of the housing finance market, it should take the opportunity to convert Fannie and Freddie to fully private status. Congress should also enact appropriate financial regulation, consumer protection legislation and affordable housing programs.

And, as the FHFA, along with Fannie and Freddie, works to create the necessary infrastructure for the development of the mortgage market of the future, it must take the future of the thirty-year fixed-rate mortgage, the lock-in and the low-down-payment mortgage into consideration. It would be best to reduce our reliance on the thirty-year

fixed-rate mortgage and move the market to shorter fixed periods of ten or fifteen years for interest rates, which are more reflective of the actual living situations for most Americans. A private version of Fannie and Freddie’s TBA market should also be created in order to provide a similar type of hedge to what exists now. Finally, while the low-down-payment mortgage can have high default rates, abolishing them leaves out too many potential homeowners. Therefore, low-down-payment mortgages should be kept but down payments should generally have a floor of five percent to balance fiscal responsibility with opportunity.

The residential mortgage market we create today will likely be the one our grandchildren use. We have one chance to get it right. The FHFA should carefully work out the contradictions inherent in the current system to ensure that the next era is fiscally sound and reflects the American value of opportunity.