It's Time to Take Housing Finance Reform Through The 21st Century

Fannie Mae and Freddie Mac, the two mortgage giants under the control of the federal government, have more than 45 percent of the share of the $10 trillion of mortgage debt outstanding. Ginnie Mae, a government agency that securitizes Federal Housing Administration (FHA) and Veterans Affairs (VA) mortgages, has another 16 percent.

These three entities together have a 98 percent share of the market for new residential mortgage-backed securities. This government domination of the mortgage market is not tenable and is, in fact, dangerous to the long-term health of the housing market, not to mention the federal budget.

No one ever intended for the federal government to be the primary supplier of mortgage credit. This places a lot of credit risk in the government’s lap. If things go south, taxpayers will be on the hook for another big bailout.

It is time to implement a housing finance reform plan that will last through the 21st century, one that appropriately allocates risk away from taxpayers, ensures liquidity during crises, and provides access to the housing markets to those who can consistently make their monthly mortgage payments.

The stakes for housing finance reform today are as high as they were in the 1930s when the housing market was in its greatest distress. It seems, however, that there was a greater clarity of purpose back then as to how the housing markets should function. There was a broadly held view that the government should encourage sustainable homeownership for a broad swath of households and the FHA and other government entities did just that.

But the Obama Administration and Congress have not been able to find a path through their fundamental policy disputes about the appropriate role of Fannie and Freddie in the housing market. The center of gravity of that debate has shifted, however, since the election. While President-elect Donald Trump has not made his views on housing finance reform broadly known, it is likely that meaningful reform will have a chance in 2017.

Even if reform is more likely now, just about everything is contested when it comes to Fannie and Freddie. Coming to a compromise on responses to three types of market failures could, however, lead the way to a reform plan that could actually get enacted.

Even way before the financial crisis, housing policy analysts bemoaned the fact that Fannie and Freddie’s business model “privatizing gains and socialized losses.” The financial crisis confirmed that judgment. Some, including House Financial Services Committee Chairman Jeb Hensarling
(R-Texas), have concluded that the only way to address this failing is to completely remove the federal government from housing finance (allowing, however, a limited role for the FHA).

The virtue of Hensarling’s Protecting American Taxpayers and Homeowners Act (PATH) Act of 2013 is that it allocates credit risk to the private sector, where it belongs. Generally, government should not intervene in the mortgage markets unless there is a market failure, some inefficient allocation of credit.

But the PATH Act fails to grapple with the fact that the private sector does not appear to have the capacity to handle all of that risk, particularly on the terms that Americans have come to expect. This lack of capacity is a form of market failure. The ever-popular 30-year fixed-rate mortgage, for instance, would almost certainly become an expensive niche product without government involvement in the mortgage market.

The bipartisan Housing Finance Reform and Taxpayer Protection Act of 2014, or the Johnson-Crapo bill, reflects a more realistic view of how the secondary mortgage market functions. It would phase out Fannie and Freddie and replace it with a government-owned company that would provide the infrastructure for securitization. This alternative would also leave credit risk in the hands of the private sector, but just to the extent that it could be appropriately absorbed.

Whether we admit it or not, we all know that the federal government will step in if a crisis in the mortgage market gets bad enough. This makes sense because frozen credit markets are a type of market failure. It is best to set up the appropriate infrastructure now to deal with such a possibility, instead of relying on the gun-to-the-head approach that led to the Fannie and Freddie bailout legislation in 2008.

Republicans and Democrats alike have placed homeownership at the center of their housing policy platforms for a long time. Homeownership represents stability, independence and engagement with community. It is also a path to financial security and wealth accumulation for many.

In the past, housing policy has over emphasized the importance of access to credit. This has led to poor mortgage underwriting. When the private sector also engaged in loose underwriting, we got into really big trouble. Federal housing policy should emphasize access to sustainable credit.

A reform plan should ensure that those who are likely to make their mortgage payment month-in, month-out can access the mortgage markets. If such borrowers are not able to access the mortgage market, it is appropriate for the federal government to correct that market failure as well. The FHA is the natural candidate to take the lead on this.
Housing finance reform went nowhere over the last eight years, so we should not assume it will have an easy time of it in 2017. But if we develop a reform agenda that is designed to correct predictable market failures, we can build a housing finance system that supports a healthy housing market for the rest of the century, and perhaps beyond.

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