



# Dollars and Sense

## 6 Proposals for GSE Reform

**Why a riddle as  
perplexing for some  
as the sphinx is a problem  
as old as democracy.**

By Ryan Schuette





## Four years after entering conservatorship, Fannie Mae and Freddie Mac remain on the taxpayer dime, baffling reformers working to reduce the housing market's dependency on the government.

**A**ncient cultures beheld sphinxes with the same fear and bewilderment as many saw their famously fickle gods. Beautiful monsters. Terrifying guardians. Riddles for which no answers exist.

In one Greek yarn, Oedipus—the namesake hero of Sophocles' classic tragedy—encounters a sphinx sent by the gods to guard the gates to the fabled city of Thebes. By correctly answering her riddle, an impossible feat for all but the Greek adventurer, he both frees the city and fulfills a prophecy that ultimately dooms it—and Oedipus himself.

The people trying to reform mortgage giants Fannie Mae and Freddie Mac may see a little of themselves in the ill-fated savior of Thebes. Four years into federal conservatorship and counting, the two companies sit astride more than \$11 trillion in government-backed mortgages and roughly \$180 billion in taxpayer funds from the Treasury.

Not that riddles dissuade champions of reform—especially new faces in Congress with axes to grind for what they see as a critical departure from limited government, circa 1776. Since the Tea Party cleaned house two years ago, calls for change only seem to continue amplifying, with House subcommittee chair Rep. Scott Garrett (R-New Jersey) spearheading the most widely praised piece of legislation last fall to defang government involvement in Fannie and Freddie.

His joined a motley group of proposals that overwhelmingly portrays a privately funded residential mortgage market as

the only answer to discomfiting questions of moral hazard and bailouts. (See sidebar “One Riddle, Six Answers” for a breakdown of the most talked-about proposals, including Garrett’s.)

The consensus seems straightforward enough. Slowly wind down the GSEs. Sign off on transfers of authority to other federal housing agencies. Streamline national servicing standards and repurpose the Federal Housing Finance Agency (FHFA) for other uses. Get government out of the way (along with taxpayers), open the gates to private capital, and let the city on a hill flourish anew.

Critics of the full-on privatization approach charge that a solution that seems too simple is just that—too simple—and fails an unpleasant test of reality.

Their main qualm: If policymakers take Fannie and Freddie off the taxpayer dime, how will the federal government preserve the crucial link between homeowners and overseas investors? The implicit guarantee for mortgages bought by the GSEs and sold as securities has helped funnel capital into the system needed to hold homeownership rates near 70 percent for the last 60 years.

There are other concerns, too. Lawmakers worry that interest rates could rise—and threaten a still-nascent housing recovery—if

investors see Uncle Sam pull guarantees for fixed-rate mortgages and securities. Others point out that GSE reform is as much about process as policy, with any substantive changes made less likely by election-year politics and a polarizing environment inside the Beltway.

### The Road to Thebes

**T**hings started out simply enough. Depression-era lawmakers legislated Fannie Mae into existence in order to buy mortgages insured by the Federal Housing Administration. Congress followed it by setting up Freddie Mac to compete with Fannie and Ginnie Mae to securitize the GSEs' mortgages. Cue the financial crisis, and the simple origins of Fannie and Freddie took a turn as tragic as anything conjured by the ancient Greeks.

The GSEs guaranteed 64 percent of single-family mortgage-backed securities in the first half of 2010, according to *Inside Mortgage Finance*. That reflects a residential mortgage market in which the GSEs back roughly nine out of 10 mortgages. Add more recent and continuing losses for Fannie Mae and Freddie Mac—\$2.4 billion in fourth-quarter net losses for the former and a measly \$619 million in net profits for the latter—and it's easy to see why experts want to unravel the riddle of reform before history repeats itself.

To date, six or more proposals, three of them bills, lay on the table of secondary mortgage market reform. Give or take a few years, all of them try to

address the tightrope act needed to deftly remove Fannie Mae and Freddie Mac from federal conservatorship without tipping the housing recovery. Some go after provisions in the Dodd-Frank Act, seeking to eliminate the risk-retention rule or regulations for broker compensation; others chime in with alternatives to the controversial Mortgage Electronic Systems, Inc.

Less certainty awaits two problem areas. The first involves the obvious question of what will replace Fannie and Freddie when lawmakers take them off Treasury's life support. The second is Uncle Sam's implicit guarantee for fixed-rate mortgages—and it is this part of the riddle that frustrates reformers largely in favor of a uniformly private-sector answer.

“Unless you have something backed by the U.S. government, foreign investors are not going to buy mortgage-backed securities,” says Peter Wallison, co-director of financial policy studies at the conservative-leaning American Enterprise Institute in Washington, D.C.

He says the investors—many foreign central banks, among them—rightly appreciate the sense of “absolute certainty” that the federal government provides by backstopping mortgage-backed securities. “They are doing this because they [the mortgage-backed securities] are not yield-sensitive,” he adds.

To its credit, the National Association of Home Builders (NAHB) took a stab at the backstop issue by proposing a private account that would theoretically step in to preserve investor payments in the event



of another catastrophe. It modeled the mechanism after the Deposit Insurance Fund, which the FDIC maintains by collecting premiums from lenders who pay to insure their home loans.

Recent history may persuade lawmakers against private accounts. The bank failures resulting from the financial crisis depleted the FDIC's fund by billions, with one research firm estimating that it carried only \$648.1 million by the third quarter in 2009. The agency board responded to the crisis by requiring \$45 billion in prepayments from insured lenders—a decision that riled

conservative lawmakers, netting field hearings and even legislation last fall to uncover whether higher premiums had played a hand in exacerbating bank failures.

For Wallison and like-minded cohorts, the federal guarantee should not exist, period. In research he released last year, he and others recommended implementing tough new underwriting standards to give investors what they want—sound investments in the form of prime-quality mortgages.

“As long as we have mortgage-backed securities backed by the U.S. government, investors here will not buy them,” he adds,

referencing insurance companies and private pension funds, a market he says amounts to \$13 trillion. “We are substituting our own domestic buyers for others interested in complete certainty.”

In its own proposal, the FHFA—the federal regulator responsible for the GSEs—differed by acknowledging the benefits of a “securitization platform.” The plan called on lawmakers to devise a system to securitize mortgage debt in a world absent Fannie and Freddie, skirting specifics but reasserting the need to “preserve the relationship between homeowners

and investors” for the sake of a robust homeowner society.

But reformers like Wallison fire back that the federal backstop benefits from a reputation that far exceeds its usefulness in the housing market. Their main counterclaim centers on the homeownership rates of other countries, which lack the government-sponsored footprint historically peculiar to the U.S.

Nonpartisan sources seem to align with the affordability argument. Tallying up owner-occupied housing in 2009, *The Economist* found Spain leading nine modern industrialized countries at

# One Riddle, Six Answers

**The riddle is clear: How can policymakers devolve Fannie Mae and Freddie Mac without destabilizing the housing recovery or scaring investors? We explore six proposals in search of a new destiny for the secondary mortgage market.**

## 01 The Corker Bill

**THE GIST //** Sen. Bob Corker (R-Tennessee) introduced the Mortgage Market Privatization and Standardization Act in November last year.

**WHAT IT SOLVES //** The bill proposes winding down Fannie Mae and Freddie Mac over 10 years and replacing Mortgage Electronic Registration Systems, Inc. (MERS), with a federal alternative. It also seeks to axe the risk-retention rule under the Dodd-Frank Act.

**WHAT IT DOESN'T //** Corker's bill fails to deliver on the issue of foreign investment. It does away with the implicit guarantees for mortgage-backed securities without offering a replacement for the backstop in the to-be-announced market.

**UNIQUE ABOUT IT //** The legislation nationalizes a system for the electronic delivery of home loan data to servicers.

**MOST LIKELY TO KILL IT //** Senate Democrats and election-year politics.

## 02 The FHFA Plan

**THE GIST //** The Federal Housing Finance Agency (FHFA) provided lawmakers with a general outline for ways to end federal conservatorship without rattling a still-steady economic recovery.

**WHAT IT SOLVES //** The proposal sketches a rough look at the secondary mortgage market without Fannie and Freddie. It calls on lawmakers to shrink market share for the companies and create new “infrastructure,” including a private securitization platform.

**WHAT IT DOESN'T //** The slow-moving forces in politics responsible for the failure to move forward with reform.

**UNIQUE ABOUT IT //** The plan offers a comprehensive approach to reform without falling prey to a tyranny of partisan details. It also declares that the GSEs are unable to repay taxpayers under “any foreseeable scenario.”

**MOST LIKELY TO KILL IT //** The potential for Edward DeMarco's own ouster and election-year politics.

## 03 The Garrett Bill

**THE GIST //** Rep. Scott Garrett (R-New Jersey) shepherded the Private Mortgage Market Investment Act through the subcommittee he chairs in December last year.

**WHAT IT SOLVES //** Garrett's bill transitions existing responsibilities for Fannie Mae and Freddie Mac to the FHFA. It also does away with federal guarantees for mortgage-backed securities, tasks the FHFA with classifying new types of mortgages, and voids the risk-retention rule.

**WHAT IT DOESN'T //** Unlike Corker's bill, the Garrett version does not track a step-by-step course or list specific requirements in the devolution of Fannie Mae and Freddie Mac.

**UNIQUE ABOUT IT //** The legislation enjoys wide acclaim among policymakers. FHFA Acting Director Edward DeMarco praised it during a hearing last fall. Even Rep. Barney Frank (D-Massachusetts) gave lip-service to it.

**MOST LIKELY TO KILL IT //** The more moderate and Democratic Senate and election-year politics.



more than 80 percent, alongside 71 percent in household mortgage debt. The U.S. came in at sixth on the list—behind Spain, Australia, Britain, Canada, and Ireland—with a homeownership rate just below 70 percent and mortgage debt by household towering at 101 percent.

“It’s clear you don’t need this kind of heavy central government involvement in order to get homeownership rates in the mid-60 percent to low 70 percent of household outcomes,” Lawrence J. White, professor of economics at New York University’s Stern School of Business, told us.

### Finding Oedipus

**W**hite applauds recent proposals to reform the secondary mortgage market but laments that “everybody gives lip-service to the idea” of an era absent Fannie and Freddie.

“We need to deal with the Fannie and Freddie problem,” he said. “But there are significantly divergent views about what ought to follow.”

Of the six proposals profiled, three are bills—two in the House, one in the Senate—currently awaiting action by their respective chambers. Experts tell

us that none will navigate its way through Congress in an era of razor-thin partisanship, especially before a general election.

For her part, Michele Dickerson, a professor of bankruptcy law at the University of Texas Law School, says housing finance reform is even less likely this election because it reads like Greek for the average voter.

“I don’t think the general public has a clue about the intricacies of mortgage finance,” she tells us, adding that she thinks the lack of political will only fuels ambivalence for meaningful GSE reform on the campaign trail.

Recent surveys seem to support her conclusions, revealing anything but consensus when it comes to the tricky issue of federal aid for housing. An NAHB poll from January found three out of four voters in swing states in agreement that it is “appropriate and reasonable” for the federal government to back homeownership with tax incentives. Tellingly, 67 percent of voters identifying with the fiscally conservative Tea Party vowed to oppose any member of Congress who tries to axe the mortgage interest tax rate deduction—despite assertions from

### 04 The Hensarling Bill

**THE GIST //** Rep. Jeb Hensarling (R-Texas) introduced the GSE Bailout Elimination and Taxpayer Protection Act just after the companies went into conservatorship in 2008. He reintroduced the bill last fall.

**WHAT IT SOLVES //** Hensarling’s bill calls for the devolution of Fannie and Freddie exactly two years after enactment and their return to the private sector in three. It caps and shrinks their portfolios, returns conforming loan limits to precrisis levels, and increases so-called g-fees for lenders.

**WHAT IT DOESN’T //** The legislation seeks to end payouts to Fannie and Freddie without sketching out an alternate future for the secondary mortgage market.

**UNIQUE ABOUT IT //** The bill is the only one from the height of the financial crisis.

**MOST LIKELY TO KILL IT //** The more moderate and Democratic Senate, plus competition from the many other bills and proposals.

### 05 The NAHB Plan

**THE GIST //** The National Association of Home Builders (NAHB), a prominent trade group, outlined policy recommendations in its proposal for a new secondary mortgage market in March.

**WHAT IT SOLVES //** The proposal replaces Fannie and Freddie with a patchwork of responsibilities shared between state and federal housing agencies. It notably replaces the federal guarantee with a private account ala the FDIC’s Deposit Insurance Fund.

**WHAT IT DOESN’T //** The NAHB plan bypasses qualms about the Dodd-Frank Act.

**UNIQUE ABOUT IT //** This is the only proposal to come from a private industry group.

**MOST LIKELY TO KILL IT //** The fact that it isn’t a proposal from lawmakers or administration officials.

### 06 The Treasury Plan

**THE GIST //** The Obama administration unveiled a tiered proposal to wind down Fannie and Freddie last year, giving Congress three choices that remain in disuse.

**WHAT IT SOLVES //** The three-part proposal offers to solve the problem of process as much as policy by giving lawmakers choices for complete privatization, higher g-fees, and “backup” funds separate from traditional sources of liquidity for use in another catastrophe.

**WHAT IT DOESN’T //** It scrimps on a timeline to wind down Fannie and Freddie.

**UNIQUE ABOUT IT //** It presents lawmakers from both parties with three options and to date remains the only proposal on the table from Treasury.

**MOST LIKELY TO KILL IT //** House Republicans who identify with the Tea Party as well as election-year politics.



Federal Reserve economists that the policy helps few low-income homeowners and may balloon the federal deficit by tens of billions of dollars.

Not that presidential candidates help. The only talk that voters likely heard about either of the GSEs this primary season centered on former House Speaker Newt Gingrich's \$1.6 million contract with Freddie Mac in 2006, an issue that former Massachusetts Gov. Mitt Romney's Super-PACs gleefully supersized in Florida.

Adds Dickerson: "The debate we're discussing—what Fannie and Freddie will do if there are no federal guarantees—is important, but I don't think that'll be part of any candidate's platform on either side of the aisle in this election."

So where's an enterprising reformer to find America's Oedipus? Insiders say the more moderate and Democratic Senate is unlikely to take a serious look at any of the legislation on the table.

White says it will take a "mandate" from the electorate for the next administration to disentangle the taxpayer from Fannie Mae and Freddie Mac. He nods at the example set by the savings and loan crisis—the oft-cited precursor to the Great Recession—when he served as one of then-President Ronald Reagan's Democratic appointees on the now-defunct Federal Home Loan Bank Board.

By his own account, the Reagan administration ignored systematic reform for the system that begot the collapse of nearly one-fourth of the nation's thrifts, so much so that the opportunity to make history fell on Richard Breeden, chairman of the Securities and Exchange Commission under the first Bush administration.

White says GSE reform will likely happen once the election ends and an "independent political appointee" like Breeden—one either with the Obama

administration or the eventual GOP presidential nominee's team—steps forward with the grits for serious change.

For some, FHFA Acting Director Edward DeMarco emerges as an answerer of riddles in the age of federal conservatism. Right-leaning Beltway insiders admire the regulator—a registered Republican—for his dedication to the FHFA's "preserve and conserve" mandate, a reputation that he bolstered in

that called on the president to sack DeMarco and recess-appoint a new director, criticizing the agency for "consistently and erroneously interpret[ing] its mandate far too narrowly." And in signs that a general election is well under way, MoveOn.org—the progressive group famous for lampooning Gen. David Petraeus for the Iraq surge strategy in a 2007 *New York Times* ad—followed suit by fronting a "Dump DeMarco" campaign in March.

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— Lawrence J. White, New York University

February by releasing the agency's strategic plan and renewing calls for GSE reform.

The regulator continues to hold off on principal reductions for more than 3 million underwater first-lien mortgages, arguing that any substantial write-down could lead to roughly \$100 billion in losses for the GSEs—and taxpayers. Last fall he gained notoriety (and infamy) by reportedly resisting moves from the Obama administration to overhaul the Home Affordable Refinance Program, a tug-of-war that lasted until October (and paid off for the nation's four largest servicers, which welcome the changes).

But it's that kind of heroics that may ultimately cost the FHFA acting director his job.

Twenty-eight Democratic lawmakers signed a letter in January

## The Fate of the GSEs

In Sophocles' tale, Oedipus' father abandons his newborn son outside Thebes to prevent the prophecy of his own death, only to set in motion the return of his son, who fulfills it by meeting the sphinx's challenge. Experts fear that GSE reform may walk the same thread of fate thanks to variables other than partisanship.

Of chief concern: interest rates for mortgage loans, which rise and fall on interest from investors in U.S. Treasury debt.

"There are serious impediments [to reform] because there is a widespread belief in Congress that Fannie Mae and Freddie Mac reduce mortgage interest rates," adds Wallison.

"There is also a widespread belief that they are essential to the 30-year fixed-rate mortgage. Both of those ideas are wrong."

David John, a senior research fellow with the right-leaning Heritage Foundation, takes the economy issue a step further by tying it to the wallets—and lobbying power—of players who fear a secondary mortgage market without Fannie and Freddie.

"There are those of us who clearly want to get rid of Fannie Mae and Freddie Mac," he said. "There are others—like homebuilders and Realtors—for whom that would be an utter disaster."

Point in fact, just after the FHFA unveiled its guarantee-free proposal, the NAHB submitted a statement that reiterated the need for "a strong federal backstop for both single-family and multifamily mortgage markets," cautioning against any sudden move toward "privatization" of the latter. The National Association of Realtors, another prominent housing trade group, somewhat tellingly passed on releasing a similar statement.

Others point to the considerable political influence that Fannie Mae and Freddie Mac curry with policymakers. White warned of their lobbying muscle in *Guaranteed to Fail*, an unapologetically critical book he co-authored with several fellow academics last year that draws comparisons to another monster—Frankenstein—and accuses the companies of turning on their creator.

Whatever the fates decide, experts agree that the road to a housing market sans Fannie and Freddie remains riddled with the one feature as old for American democracy as the Greek one—politics. And the body politic is more distracted than decided, if anything, ahead of Decision 2012.

"It's easy to say Fannie and Freddie are mistakes and let's get rid of them—that's campaign material and there's broad consensus there," White says. "The difficulty is: What replaces them?"

Maybe it's time the sphinx got a new act.