The ideas presented in this research are the authors' and do not represent official positions of the Mercatus Center at George Mason University.
INTRODUCTION

Fannie Mae and Freddie Mac, two of the government-sponsored enterprises (GSEs), are in conservatorship, and taxpayers are on the hook for over $150 billion in losses. Currently, Fannie/Freddie and the FHA have captured the residential mortgage market with over a 90 percent market share in terms of purchasing mortgage loans and insuring mortgage losses. Given that Fannie and Freddie have essentially crowded the private sector out of the secondary mortgage market, can the private sector offer a less costly alternative to Fannie and Freddie that requires far less government involvement in the housing and mortgage market?

There is nothing, per se, unique about Fannie/Freddie that the private sector could not provide. Both Fannie/Freddie and the private sector have loan-underwriting models; both can purchase loans and create mortgage-backed securities (MBS); both the private and public sector can offer mortgage insurance. The one thing that Fannie and Freddie have that the private sector does not is an explicit guarantee from the federal government.

Is this federal-government guarantee necessary to entice investors into purchasing mortgage-backed securities? No. The original “gold standard” of Fannie and Freddie was the conforming loan with 20 percent or greater down payment and good credit quality. The default rates and loss per default on these mortgages have always been very low (typically less than 5 percent for the 30-year fixed-rate mortgages). The private sector can handle that segment of the market through private insurance markets and portfolio lending and will continue to attract interest from the global community. The “gold standard”-conforming mortgage market does not need a federal-government guarantee. If the private sector can replicate Fannie and Freddie’s only defining “virtue”—a federal-government guarantee—then there is no justification for keeping Fannie and Freddie around either in conservatorship or in their pre-conservatorship forms. Fannie and Freddie will not be missed nor will their absence make a difference to the housing market or the economy.¹

GOALS OF GSE REFORM—LESS GOVERNMENT, MORE PRIVATE SECTOR

The goal of GSE reform is to withdraw the government from the mortgage market and let the private sector take over mortgage lending and securitization. But if GSE reform is going to phase-out Fannie and Freddie, it needs to identify what the mortgage lending landscape would look like without their presences.

The Obama Administration has proposed gradually shrinking the housing GSEs (Fannie/Freddie/FHA) to a significantly smaller market share, reflecting the administration’s goal of transitioning away from federally backed mortgage financing. But the housing reform debate needs to begin with a sober assessment of where the funding of homes loans is today. Ninety percent or more of new residential loan originations go into either FHA, Fannie Mae, or Freddie Mac subsidized risk buckets. There is minimal portfolio lending, and private securitizations are non-existent. Even though the overall mortgage-loan market continues to shrink, the balance sheets of Fannie and Freddie are growing rapidly, especially with

¹ To be sure, affordable-housing groups and the housing industry would prefer having an explicit guarantee.
loans held for the portfolio. The largest banks are still selling almost all of their production; at the same time, the banks can purchase the same paper back in the residential mortgage-backed security (RMBS) market to hold in portfolios. Getting rid of favorable capital treatment for GSEs for banks would stop the capital arbitrage that exists, encouraging banks to hold RMBS.

So, the first task of housing finance reform is to find investors who, at some price, would be willing to take the first loss positions in mortgage loans, held either on balance sheet or in the private RMBSs that would replace Fannie and Freddie MBS. If the mortgage markets are able to attract new capital without any change in the funding of the mortgage markets, the size of the mortgage markets would remain the same. However, if some investors are hesitant to hold anything but Fannie and Freddie MBS (because of the guarantee), the mortgage markets would shrink in size. Smaller mortgage markets would be detrimental to the economy, but funding would not evaporate. It would simply be a matter of “at what price” the market charges to supply funds to the mortgage market.

It is clear that the GSEs (and FHA/Ginnie Mae) effectively crowded out the private sector from the residential-mortgage market, capturing over 90 percent of it. Of course, having the government control that large a segment of the mortgage market is inefficient, and the GSEs are entrenched. Trying to disentangle Fannie and Freddie from the economy will take some work (such as bank capital regulatory rules which preference the holding of Fannie/Freddie debt), but disentangling Fannie and Freddie is possible, and we strongly recommend it.

THE WORLD AFTER FANNIE AND FREDDIE: GOALS FOR HOUSING-MARKET REFORM

The United States is the only major country in the world with GSEs like Fannie Mae and Freddie Mac (Lea 2011). Government support of the mortgage market is quite limited in most countries. Only Canada and Japan have a government MBS guarantor. Only Canada and the Netherlands have a FHA equivalent. Yet, no other country had the same degree of mortgage market turmoil as the United States, and many have comparable or higher homeownership rates.

The 30-Year Fixed-Rate Mortgage

The United States is the only major country in the world with almost 100 percent long-term, fixed-rate mortgages as the dominant mortgage product (see figure 1). Even traditionally fixed-rate countries such as Germany and Denmark have a broader distribution of mortgage products (long-term versus short-term, fixed- versus adjustable-rate mortgages).

As we have written (Lea and Sanders, 2011), the United States is unusual in banning or restricting prepayment penalties on fixed-rate mortgages. Most countries allow prepayment penalties to compensate lenders for loss, and rates in those countries don't include a significant premium for prepayments, which makes other financing techniques, such as covered bonds, more common. Even worse, all home buyers in the United States must pay for the option to refinance their 30-year fixed-rate mortgages penalty-free even if they don’t want to exercise the option; hence, the 30-year fixed-rate mortgage is socialized with everyone paying a premium in the mortgage rate for the option. In Europe, only borrowers who exercise the option for financial advantage pay the cost. We advocate having mortgage choice where consumers can choose fully refinancing, no refinancing, or restricted refinancing of the mortgages.

Finally, the 30-year fixed-rate mortgage exposes lenders and investors to interest-rate risk (along with default risk). Other countries have a greater mix of variable-rate, short-term fixed-, and medium-term fixed-rate mortgages, which exposes their economies (and taxpayers) to less interest-rate exposure and losses. If it has a greater variety of mortgage designs, the United States would have a more robust housing-finance system. Our recommendation then is to allow mortgage innovation and not simply ban mortgage designs that consumers or regulators find “unfriendly.”

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2 Approximately half the states have prohibitions on prepayment penalties on fixed-rate mortgages. Perhaps more importantly Fannie and Freddie have stated that they would not honor prepayment penalties on fixed-rate mortgages they purchase.

3 There is a danger that the Dodd-Frank definition of a Qualified Residential Mortgage will further ensconce the fixed rate mortgage as the dominant instrument. See Lea 2011.
Chasing Homeownership

Since 1998, Fannie and Freddie made concerted efforts, along with the Department of Housing and Urban Development (HUD), to increase homeownership rates in the United States. But after the government pumped trillions into the mortgage market through the GSEs (see figure 1), the homeownership rate is back to 1998 levels. In short, the government’s pursuit of an unsustainable homeownership goal created enormous pain and suffering in the United States all for the sake of increasing homeownership from 66 percent to 70 percent.

If Fannie and Freddie go away, will homeownership fall further than it already has? As can be seen in figure 2, homeownership rates bounced between 63 and 66 percent before the housing bubble and GSE funding began to accelerate in 1998.4 Hence, without Fannie and Freddie in the market, homeownership rates will likely return to the 63–64 percent range. However, if the housing market begins to recover and house prices start to rise again, homeownership rates could actually rise again to the 66 percent area.

Our national housing policies pushed too many households into homeownership. We want to encourage Congress and the administration to start unwinding the subsidies to homeownership, starting with Fannie Mae and Freddie Mac.

What Does the U.S. Mortgage Market Need to Reduce its Dependence on Government?

In order to get the private mortgage market back on its feet in a sustainable fashion, we recommend three approaches: 1) covered bonds, 2) rebirth of the private-label MBS market, and 3) greater lender holding of whole mortgage loans.

Covered Bonds

The Danish and German covered-bond systems have certain appeal for the U.S. mortgage market. In the German Pfandbrief model, covered bonds are securities issued by a bank and backed by a dedicated group of mortgage loans known as a “cover pool.” If the issuing bank becomes insolvent, the assets in the cover pool are separated from the issuer’s other assets solely for the benefit of the covered bondholders.5 In the Danish system, there is a one-to-one correspondence between a mortgage loan and a mortgage bond (the “balance principle”). Under both systems, the underwriting standards (and loan eligibility) are strict in an attempt to minimize loan defaults (just as the Fannie/Freddie conforming loan with 20 percent or greater down payment was intended). Asset eligibility for the cover pool and the process in the event of issuer insolvency are determined by laws specific to each country. As the credit risk remains on the balance sheet of the issuer, the covered-bond system properly aligns incentives.

A critical feature of the Pfandbrief and other European covered-bond systems is strict Asset and Liability (ALM) matching guidelines that allow funding of mortgages with standardized bonds govern them.6 There is no interest-rate risk in the Danish system due to the balance principle that requires strict loan-to-bond matching. One of the selling points of the German Pfandbrief market is that there has never been a default in over 200 years,7 and no Danish mortgage bank has defaulted on a covered bond.8

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5 The FDIC has concerns over covered bonds and over-collateralization (OC). The solution to the FDIC’s concern is to limit OC. Tight Asset-Liability Matching leads to the lowest OC requirements and aligns sovereign deposit guarantors with legislated covered bonds.

6 There have been covered bond issuer failures due to interest rate risk in Germany. The resolution has been a merger with a solvent bank and subsequent tightening of ALM requirements.

7 This is a little misleading since Germany has had several episodes of hyperinflation. So while there has not been a default per se, hyperinflation has caused the payment stream to become virtually worthless at times.

8 This is not to be confused with banks failing. Recently, Denmark has experienced several bank failures.
Reviving the Private-Label Mortgage-Backed Securities Market

The private-label mortgage-backed securities (PMBS) market should revive once Fannie and Freddie are not competing with the private sector. The “implied” guarantee for Fannie and Freddie gives them a funding advantage over the private sector.\(^9\) In effect, the GSEs are crowding out the private sector.\(^10\) A number of research papers find that, before Fannie and Freddie were placed in conservatorship, Fannie and Freddie could have borrowed at rates lower than comparably rated banks (see Ambrose and Warga, 1996; and Sanders, 2002).

Once the government removes the implied guarantee from Fannie and Freddie, the private-label MBS market should be able to compete with Fannie and Freddie by offering high down-payment, prime mortgages. Any proposal requiring government guarantees or credit wraps will end up with a system of continued government control and no resolution to the inefficiencies and misallocations caused by the government. The private-label MBS market should be allowed to purchase and securitize risky loans as long as it is understood that bailouts are not allowed.

Davidson and Sanders [2009] recommended that a securitization certificate travel with the loan when it is sold in the secondary MBS market. This certificate would contain all necessary information relevant to the loan including the chain of title. This type of improvement to the mortgage market would be extremely helpful in reviving interest in the private-label secondary-mortgage market.

Increasing Portfolio Lending for Banks

Banks will need to increase portfolio lending (where they originate the loan and keep it in their portfolio) in order to supplement covered bonds and securitization. An issue, however, with portfolio lending is the concentration of real estate assets on bank balance sheets and declining portion of deposits. Thus, a significant portion of mortgages will have to be funded in the capital markets with a mixture of (on balance sheet) covered bonds and securitization rather than relying on substantial growth in bank portfolio lending.

A Privatization Model for Fannie and Freddie

Even without government support, Fannie and Freddie have clear franchise value.\(^11\) Once privatized, through the revocation of their charters and the removal of their Treasury ties, Fannie Mae and Freddie Mac would operate more like non-depository banks or financial institutions. (An assumption behind this approach is that private firms operate more efficiently and expose the taxpayer to less risk.) The operative question is whether the private sector would fund such a model. Maintaining the conduit operations of Fannie and Freddie would facilitate a standardized MBS market that could serve small to mid-size lenders. With a clean privatization, the large banks may decide to issue their own securities. We recommend that the government breaks Fannie/Freddie up into pieces (underwriting platform, securitization operations, research, etc) and sells those piece over a five-year period. Keeping them in place under alternative forms of ownership leaves the door open to a resurgence of Fannie and Freddie in the future.

What About Affordable Housing?

Congress needs to have a serious discussion about how much affordable housing the United States wants for the economy and what the cost of affordable housing should be. Homeownership is risky and very expensive and is simply not for all

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\(^9\) Note that the private label commercial mortgage-backed securities (CMBS) market has revived itself without any government guarantee (implicit or explicit).

\(^10\) The continued uncertainty about the accounting and regulatory treatment of private-label securities is also a barrier to a revival of the market. Issues surrounding true sale, risk retention, and reporting need to be resolved before the market can expand.

\(^11\) Their franchise value lies in their business operations including systems and business relationships with lenders and investors, an incomparable database for analyzing risk and master servicing. While these can be replicated to a degree in the private market it would be a while before a private entity could achieve similar scale and economies. This does beg the question about market dominance that may need to be addressed by regulation.
households as seen by the many households that entered the homeownership market when they would have been better off renting. No matter what Congress decides, we recommend moving affordable housing mandates from Fannie and Freddie to HUD. HUD, along with FHA through its various programs in both homeownership and rental markets, already supports affordable-housing initiatives and could continue to do so.

The Necessary Steps to Weaning the Economy off Fannie and Freddie

The first step necessary to wean the economy off of Fannie and Freddie is to set a five-year “sunset” where they cease to exist as government-chartered institutions and transition to the private sector. During this period, there need to be defined transition steps.

1. Reduce the Conforming Loan Limits.

Fannie Mae’s conforming loan limit rose from $207,000 in 1996 to $417,000 in 2006 at the peak of the housing bubble. This represents a doubling of the conforming loan limit in a little over 10 years. By 2008, the conforming loan limit rose again to $729,750 for high-cost areas. Of course, raising the conforming loan limit (coupled with Fannie/Freddie’s guarantee) crowded out the private market, particularly when Fannie/Freddie were capturing the lower-risk mortgage loans leaving the private markets to insure and securitize the higher-risk mortgage loans.

In order to crowd out Fannie/Freddie in favor of private markets, the conforming loan limits should be lowered over time. Given a five-year sunset period for Fannie/Freddie, it would be tempting to simply reduce the conforming loan rates by 20 percent per year. While this approach has a certain appeal, it may also cause turbulence in the housing market if lending ceases. To avoid further rapid declines in house prices that could cause serious damage to the banking industry, we recommend an approach where the conforming loan limit is a function of house price changes. Furthermore, the loan limit should be regionalized to even out the effect.

We recommend that the first year be limited to a 10 percent decline in conforming loan limits. At the end of one year, housing prices and the recovery of the private market should be reviewed. If housing prices remain stable and the private sector has begun lending, then another 10 percent decline should be scheduled for the next year and so on. But it should be made clear that, even though the conforming loan rate will be back to 50 percent of its current level at the end of the fifth year, Fannie/Freddie are no longer purchasing or insuring mortgages.

2. Cease the Purchase of Non-Prime Affordable Housing Goal Mortgages

During the five-year sunset period, Fannie and Freddie should limit any loan purchases to prime mortgages with sufficient down payments. They should not be allowed to purchase non-prime and low down-payment mortgages (or any other mortgage related to affordable housing goals).

Eliminating affordable housing goals for Fannie and Freddie is vital to avoiding purchasing increasingly risky loans. As the HUD sponsors affordable housing programs, there’s no need to have Fannie and Freddie sponsor redundant affordable-housing programs.

3. Freeze and Unwind Retained Portfolios

The current retained portfolios of Fannie and Freddie should be frozen in terms of new additions and be allowed to unwind and sell-off. We would recommend transferring (selling) the retained portfolios to the Federal Reserve (the Fed) immediately. The Fed can finance this purchase by selling off some of its Treasury holdings and retaining the difference between agency debenture rates and Treasury borrowing costs. Under the Fed’s supervision, the portfolios can run off; the Fed may also decide to sell the more liquid loans to investors. This may take longer than the five-year sunset period because of liquidity reasons.

Making the phase-out of the conforming loan limits clear would force the private sector to brace for a world without Fannie and Freddie. Alternatively, taking the loan limits down to late 1980s levels, such as $175,000 and then selling them off in the private sector would prevent a too-rapid removal of the guarantee effects.
4. Eliminate Non-Mortgage Investments

During the five-year period, Fannie and Freddie should not be allowed to invest in non-mortgage investments; they should function as purchasers and securitizers only.

PREDICTED CHANGES FOR LENDERS AND CONSUMERS WITHOUT FANNIE AND FREDDIE

What would happen to the U.S. mortgage market with only FHA, covered bonds and private label MBS? Quantifying of the impact of eliminating Fannie/Freddie is difficult as the United States has not had a period without GSEs since the 1930s. But here is our educated guess of what the residential mortgage market would look like.

1. New mortgage rates would probably be higher, in the range of 50–100 basis points in the short term. As a result, home prices would fall slightly or take longer to recover. In the longer term, the rate would be 40–100 basis points higher than current rates.

2. More short-term mortgages and more variable-rate ones, to the extent that regulations allow them, would exist. In particular, more rollover mortgages like those in Canada where the borrower’s rate changes to the market after a fixed period would be in evidence.13

3. If mortgage rates increase, homeownership rates would be marginally lower, and overall consumption of housing would be lower.

4. Higher down payments would produce safer mortgages in the economy.

For the lenders, we see two possible outcomes. One, the mortgage markets shrink because they are unable to attract new capital because investors are unwilling to fund mortgages. We think this outcome is unlikely. Two, banks and other entities expand to fill the gap left by Fannie/Freddie’s exit. This is the most likely outcome.

Without the government guarantee, mortgage rates will rise in order to attract new capital. Today there are huge accumulations of capital waiting to re-enter the market. The primary obstacle to capital entry is a lack of clarity in the role of the government (guarantees and regulation). Once government clarifies its roles, private capital will be forthcoming. Over time, alternate capital (such as sovereign wealth funds, foreign central bank holdings, mutual funds) will enter the market to augment large U.S. funds. Banks are likely to hold more mortgages on balance sheet funded by a combination of deposits and covered bonds. Correctly structured, private-label MBS with large down payments and good credit scores would alleviate some of the concerns of investors, but there is a chance that mortgage rates would still have to increase to cover the expected guarantee benefits.

Current mortgage rates for conforming loans are influenced by the economics of the GSEs.14 The GSEs charged 15–20 basis points for their credit guarantee. This was a result of a capital requirement of only 45 basis points for sold mortgages and expected losses and operating costs in the neighborhood of single digit basis points (it is clear from Fannie/Freddie losses that they greatly underpriced their guarantee leading to massive taxpayer losses). Private guarantors are likely to require significantly more capital. Equity capital is likely to be more in the range of 4–10 percent. This capital might require somewhat lower returns than the 25 percent ROE the GSEs were able to obtain, but is not likely to be much below 15 percent on the first 5 percent of capital. This creates a minimum capital charge of 75 basis points, plus any amounts required to cover expected losses and operating costs. These “advantages” of the GSEs relative to private funding must be weighed against the fact that they operated at non-competitive and extremely low levels of capital which are not sustainable.

13 The Canadian rollover mortgage is similar to the 30 year fixed-rate mortgage, but only for a limited time, such as five years. At the end of every five years, the loan rate is renegotiated.

14 See Davidson and Belbase (2011) for further discussion.
SUMMARY

Fannie Mae and Freddie Mac should be phased out over a five-year period. Covered bonds (like in Denmark and Germany) and an improved private label MBS market are needed to take their places, along with increase lender portfolio lending. Without Fannie and Freddie, we expect to see a small drop in homeownership rates as well as a small increase in mortgage interest rates (100 basis points in the short run, less in the long run). In other words, not much will change in a world without Fannie Mae and Freddie Mac, other than saving taxpayers hundreds of billions of dollars in the future.
REFERENCES


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TABLE 1: INTERNATIONAL MORTGAGE PRODUCTS

<table>
<thead>
<tr>
<th>Country</th>
<th>Variable rate</th>
<th>Short-term fixed</th>
<th>Medium-term fixed</th>
<th>Long-term fixed</th>
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<td>Australia</td>
<td>92%</td>
<td>8%</td>
<td></td>
<td>10%</td>
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<tr>
<td>Canada</td>
<td>35%</td>
<td></td>
<td>55%</td>
<td>43%</td>
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<tr>
<td>Denmark</td>
<td>17%</td>
<td>40%</td>
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<td>67%</td>
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<td>France</td>
<td>33%</td>
<td>17%</td>
<td>38%</td>
<td>29%</td>
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<tr>
<td>Germany</td>
<td>16%</td>
<td>9%</td>
<td></td>
<td>9%</td>
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<tr>
<td>Ireland</td>
<td>91%</td>
<td></td>
<td>20%</td>
<td>22%</td>
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<tr>
<td>Japan</td>
<td>38%</td>
<td>6%</td>
<td></td>
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<tr>
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</tr>
<tr>
<td>Switzerland</td>
<td>2%</td>
<td></td>
<td>98%</td>
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<td></td>
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</tr>
<tr>
<td>US</td>
<td>5%</td>
<td></td>
<td></td>
<td>95%</td>
</tr>
</tbody>
</table>

FIGURE 1: GSE/FHLB DEBT SINCE 1990

Case Shiller Index vs. GSE/FHLB Debt
Trillions $, Quarterly Data, 1990.Q1-2009.Q4 for Debt

Source: Federal Reserve System, Flow of Funds, S&P

GSE/Agency Debt

Case Shiller 10 City Index

1999.03


Source: Federal Reserve System, Flow of Funds, S&P
FIGURE 2: HOMEOWNERSHIP RATE IN THE UNITED STATES

Source: US Census