Insight

The White House Proposes Mortgage Finance Reform

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Executive Summary

- Many see mortgage finance reform as the most significant regulatory omission since the 2007-2008 financial crisis—an omission made all the more astonishing given the primary role of the collapse of subprime mortgages in triggering the crisis.
- The White House has issued a wide-ranging reform plan that briefly considers mortgage finance reform via the privatization of Fannie Mae and Freddie Mac, although details are scarce and legislative action is not likely this year.
- A healthy and free secondary mortgage market requires that Fannie Mae and Freddie Mac be stripped of the systemic privileges that have allowed them to dominate the industry artificially.

Background

Widespread defaults on home mortgages as a result of the Great Depression led to the creation in 1938 of the Federal National Mortgage Association, known as Fannie Mae. In 1970 the same impetus drove the creation of the Federal Home Loan Mortgage Corp, known as Freddie Mac. By securitizing mortgages as mortgage-backed securities (MBS) Fannie Mae resulted in the creation of a secondary mortgage market, greatly improving the ability of banks to issue home mortgages. The 2007-2008 financial crisis required the U.S. government to rescue Fannie Mae and Freddie Mac, putting them into conservatorship in September 2008, and the two government-sponsored enterprises (GSEs) remain in conservatorship under the Federal Housing Finance Agency (FHFA) to this day.

As GSEs, structurally Fannie Mae and Freddie Mac, although privately owned, are publicly chartered with an implied line of credit to Treasury. Despite the fact that the GSEs are in conservatorship, the Office of Management and Budget (OMB) estimates that loans backed by the GSEs comprised 70 percent of mortgages originating in 2017, and the value of their assets exceeds the value of those held by Bank of America and JPMorgan Chase.

The White House's proposal

On June 21st, 2018, the Trump Administration issued a wide-ranging reform and reorganization plan for the federal government. The White House proposes privatizing the GSEs, and therefore ending both their federal charter and conservatorship. The administration also seeks to "reduce [the GSEs'] role in the housing market" by decreasing federal support for the GSEs and opening up the secondary mortgage market to additional competition from new entrants. In the event of catastrophe, guarantors would still have access to an explicit federal guarantee for MBS, paid for by the guarantors. A new federal entity would regulate the secondary mortgage market, and responsibility for affordable housing would be largely transferred to the Department of Housing and Urban Development (HUD).

Implications

This proposal would have enormous consequences for the GSEs themselves. Profitability would be seriously undermined by privatization, as the GSEs would be required to hold significantly more capital; their day-to-day activities would also be subject to a range of operating fees. More broadly, the explicit goal of reducing the GSEs' role in the housing market would end their duopoly and therefore their artificially inflated market share.

The actual mechanism of privatization is unclear. FHFA could either recapitalize the GSEs or put them into receivership, penalizing the 20.1 percent private shareholders in the GSEs. It is not clear from where the estimated $200 billion required for recapitalization would arise. The proposal does not consider the impacts of reform on the cost of a mortgage.

Privatization would also likely have significant regulatory implications for the GSEs. The Financial Stability Oversight Council (FSOC) would likely deem a privatized Fannie Mae or Freddie Mac to be a global systemically important financial institution (GSIFI), which would subject the GSEs to, among other things, significant capital requirements and enhanced oversight. The White House proposal also requires the creation of a new federal entity with oversight over the secondary mortgage market, yet the plan does not outline any structure or accountability of that entity.

Does the White House's proposal go far enough?

Some critics wonder if privatization with an explicit federal guarantee for MBS is in fact privatization at all; it may be difficult to distinguish this new structure from the current implied federal backstop of a congressional charter. The White House proposal seeks to remove only "some of the benefits that have led [the GSEs] to dominate the market," but concerns remain. Those nervous about the GSEs' ability to contribute to another recession are rightly worried about the explicit federal MBS guarantee. Such a guarantee could allow the GSEs to resume riskier operational behavior, leading them back to the toxic loan packaging that many see as having caused the financial crisis in the first place. In the event of another crisis and another GSE collapse, can the taxpayer be expected to fund yet another bailout?

Although this proposal is a step in the right direction, the GSEs must be stripped of all unfair systemic advantages, which must mean more than opening the market up to serious private contenders. The barriers here are significant: It will be difficult enough to move towards a truly free market, as GSE systemic bias ranges from the obvious (the GSEs are allowed to borrow on more favorable terms than competitors) to the more insidious (the extensive technology platforms driving the GSEs, funded by the American taxpayer).

Conclusion

The U.S. housing finance system is in dire need of reform. Although the White House's proposal is a welcome step toward that end, details remain scarce and the full extent of change will require an act of Congress. It is not clear that Congress has the appetite for this change—or, at this point, the time. Reform cannot be expected until 2019 or 2020 at best, but proponents of this long-overdue reform should not waste the momentum generated by the White House's proposal.