

What to do With Fannie Mae and Freddie Mac¹

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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. Fannie, Freddie, and the Federal Housing Administration (FHA) have a residential-mortgage market funding share of more than 90 percent through purchasing mortgage loans and insuring mortgage losses. In effect we have nationalized the mortgage market. Can the private sector offer an alternative to Fannie and Freddie that requires far less government involvement in the housing and mortgage markets?

Fannie and Freddie have essentially crowded the private sector out of the secondary mortgage market due to their government backing and huge scale economies. There is nothing unique per se about Fannie and Freddie that the private sector could not provide. Both the GSEs and the private sector have loan underwriting models, both can purchase loans and create mortgage-backed securities (MBS), and both can offer mortgage insurance. The one attribute 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 to purchase MBS? No. The original “gold standard” mortgage of Fannie and Freddie was the conforming loan with 20 percent or greater down payment and good borrower credit. The default rates on these mortgages have always been very low— typically less than 5 percent for 30-year fixed-rate mortgages—as has the loss per default. The private sector can handle that segment of the market through private insurance markets, private label securities and portfolio lending. Good quality assets will continue to attract interest from the global investment 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 unique “virtue”—a federal government guarantee—then what is the justification for keeping Fannie and Freddie around either in conservatorship or in their pre-conservatorship forms?

Proponents of the status quo argue that eliminating Fannie and Freddie would result in the disappearance of the 30 year fixed rate mortgage. This assertion is false. Jumbo long-term fixed rate mortgages existed prior to the crisis and have returned. Before the crisis such loans had mortgage rates approximately 25 basis points above Fannie and Freddie “conforming” loan yields. Today spreads are back to that level or lower. Of course the volume of such lending is still low and an increased volume may lead to wider spreads. What will borrowers do? They are likely to look at shorter term fixed rate mortgages such as the 5, 7 and 10-year hybrids. The days in which borrowers kept the same loan or house for 15 to 30 years are largely gone. So a 30 year fixed rate mortgage is neither a necessity nor a reason to keep the federal government funding the mortgage market.

GSE proponents believe that the market will be underserved without Fannie and Freddie. This is the rationale behind their housing goals, which still exist. But isn’t this in part how they got in trouble? And do we need multi-trillion dollar secondary market agencies to provide credit to low-moderate income and first-time borrowers when we have FHA performing that function?

Proponents also point to the supposed unpredictability of private capital (i.e., running for the exit if times get bad). Fannie Mae and Freddie Mac are not needed as a backstop for the mortgage market. The Federal Reserve can buy highly rated private label mortgage securities as well as those guaranteed by government (the European Central Bank has been doing this) and the government-guarantee of Ginnie Mae can be used to backstop the mortgage securities market in times of distress.

The economy and the mortgage market will be better off without Fannie Mae and Freddie Mac in their current form, particularly if taxpayers are no longer on the hook for further losses.

¹ For a more in-depth discussion see “The Future of Fannie Mae and Freddie Mac” in *House of Cards: Reforming America’s Housing Finance System*, Mercatus Center, George Mason University, March 2012

