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It is time for the government to reduce its role in the mortgage business


By Mark Zandi, July 12, 2013

It is time to fix Fannie Mae and Freddie Mac.

Since the government took over the behemoth mortgage companies during the financial collapse nearly five years ago, nothing has changed. The government is still making nearly nine of every 10 U.S. mortgage loans. This is bad for both taxpayers and home buyers.

Taxpayers are on the hook for potential losses on the mortgages, worth hundreds of billions, that Fannie and Freddie insure each year. This isn't necessary. Private investors are willing to take on much of this risk and, with some safeguards, are capable of doing it.

The longer Fannie and Freddie stay in government hands, the more lawmakers will be tempted to use them for purposes unrelated to housing. This has already happened. Last year's payroll tax holiday was partially paid for by raising the premiums Fannie and Freddie charge home buyers for providing insurance. Mortgage borrowers will be paying extra as a result over the next decade.

The housing market's revival has allowed Fannie and Freddie to again turn large profits, amounting to tens of billions of dollars each year. Policymakers may begin to rely on these profits to fund future government spending, making it especially hard to let Fannie and Freddie go.

Policymakers may also eventually be lured to make Fannie and Freddie lend to people who really cannot afford mortgages. This is partly how the two institutions got into financial trouble during the housing bubble — they took on more risk than they should have to meet their housing-affordability goals. Helping disadvantaged households become homeowners is laudable, but experience shows that politically driven help can be abused.

The bigger problem now is Fannie and Freddie's limbo status, which is fostering indecision at the two institutions and their regulator, the Federal Housing Finance Agency. Lenders who do business with Fannie and Freddie are unsure of the rules and are thus being extra cautious, keeping credit overly tight for potential home buyers. This can be seen in the average credit scores of borrowers through Fannie and Freddie, which today are in the top 25 percent of all of credit scores.

Corker-Warner bill

Some in Congress recognize the current situation's dangers. Sens. Bob Corker (R-Tenn.) and Mark R. Warner (D-Va.) recently introduced legislation to wind down Fannie and Freddie and restructure much of the system involved in making mortgage loans. Other lawmakers are working on similar legislation.

These are serious efforts that would significantly reduce the government's role in the housing market. The Corker-Warner bill would let the government continue to backstop housing, but only after a financial catastrophe much worse than the Great Recession. This backstop would be explicit, and paid for by mortgage borrowers, not taxpayers. Private financial institutions, large and small, would take the risk ahead of taxpayers.

With the government's role made clear, private mortgage lenders would be able to continue offering 30-year fixed rate mortgages to a broad range of creditworthy American households. These very popular loans would be available at reasonable rates in both good times and bad. Without the government backstop, 30-year fixed rate mortgages would essentially disappear, becoming as rare in the U.S. as they are in the rest of the world.

To make sure everyone plays by the rules and protect taxpayers, a new independent government agency would oversee the housing finance system. This agency would be set up much like the Federal Deposit Insurance Corp., which insures bank deposits. As the founding of the FDIC stopped cataclysmic bank runs after the 1930s, the new agency would stop similar runs on the mortgage market.

The current legislative efforts also deal constructively with other contentious issues in housing finance. Small lenders would be able to make mortgages with the government's backstop without going through big financial institutions that could use their size to their advantage. The reform proposals also establish a dedicated and sustainable funding source to help disadvantaged households find affordable housing.

Added cost is worth it

There is no free lunch, of course. Mortgage borrowers will have to pay higher mortgage rates in a reformed housing finance system. How much higher depends on many factors, but it probably would add no more than half a percentage point on the average mortgage rate, or about $75 a month in extra interest payments. This is meaningful but is worth the price, if it funds a rock-solid and accessible mortgage and housing market for generations.

The federal government has stepped back substantially from its extraordinary intervention in the economy prompted by the Great Recession. Fiscal stimulus has long since been replaced by fiscal austerity. The TARP bailout fund will soon be history. The Federal Reserve is beginning to plan for a normalized monetary policy.

That leaves Fannie and Freddie as the largest piece of unfinished business. With Congress on the housing finance reform train, it is time for the Obama administration to get on and perhaps even take a turn driving.

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