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Don't let Fannie-Freddie reform fizzle



By Mark Zandi and Jim Parrott, April 25, 2014

Efforts to reform the two mortgage giants Fannie Mae and Freddie Mac have run into a new roadblock: the status quo. A mounting chorus of voices argue that while keeping Fannie and Freddie under government control isn't perfect, it is better than the alternatives.

This is simply incorrect. Today's mortgage market is far from healthy, and unless reformed it will deteriorate further, resulting in higher mortgage rates and less lending to creditworthy borrowers.

The government today makes nearly nine of every 10 U.S. mortgage loans, amounting to almost \$1 trillion annually. This leaves taxpayers on the hook for credit risk for an astounding \$6.5 trillion in mortgage debt.

Despite this unprecedented obligation, taxpayers are being served poorly by the current system. Home lending is all but closed off to borrowers without pristine credit histories, and tight mortgage conditions are acting as a drag on the housing market and on the broader economy.

This is not happening because policymakers have decided that conservative lending and less access make sense for taxpayers or the economy. It is happening because Fannie Mae and Freddie Mac are poor business partners for the lending industry.

Lenders are uncertain about Fannie and Freddie's commitment to back the loans they guarantee and are therefore willing to lend only to the best-quality borrowers. This uncertainty benefits Fannie and Freddie because it allows them to make lenders pay for the costs of any defaults. But it has terrible implications for the U.S. housing market, reducing access to credit and thus demand for housing.

Fannie Mae and Freddie Mac are doing this because they have neither competition nor a mandate to serve the taxpayers' interests. They are, in effect, a nationalized duopoly with no fiduciary responsibility to the nation. As such, not only do they have little incentive to address this problem, they have little incentive to improve the ways they serve the mortgage market generally. They have little incentive to innovate, little incentive to cut costs and little incentive to expand access.

Even if one finds the tight lending environment this leaves us acceptable, the situation is only going to get worse. Though Fannie Mae and Freddie Mac are the two largest financial institutions in the world, they operate today with no capital cushion, rendering their economic health — and thus the status quo — unsustainable.

Mortgage defaults will increase again in the next recession, and Fannie and Freddie will suffer losses. Without capital, they will have no choice but to borrow again from the Treasury to meet their obligations. This will trigger two events that will make it even tougher and more costly to get a mortgage.

First, their regulator, the Federal Housing Finance Agency, will require Fannie and Freddie to raise fees and tighten lending standards in order to put them back in the black. Indeed, Congress could force even more aggressive action, causing credit to contract even further.

Second, if Fannie and Freddie are forced to draw significant sums from the Treasury, investors will begin to question how long the government will stand

behind their guarantees. The government's line of credit is limited by law and decreases every time the enterprises draw on it. If investors see the government's support at risk, they will demand greater returns for their investments, pushing up the cost of mortgages and tightening credit even further.

This would set off a vicious cycle of rising mortgage costs, shrinking credit access and falling demand for housing, leading to a weaker and less stable market, still higher costs and still tighter credit.

This is bad for everyone and isn't necessary: Private investors are willing to take on much of the risk taxpayers hold today and within the right system are in a better position to do so.

The question, then, is not whether to maintain the status quo, which is neither acceptable nor sustainable. The question is whether to work with Congress to develop a housing finance system that protects taxpayers and provides broad access to mortgage loans over the long term, as the current system cannot.

The Senate banking committee has provided the right vehicle for this reform effort, in the draft legislation proposed by Chairman Tim Johnson (D-S.D.) and ranking minority member Mike Crapo (R-Idaho). While the bill needs some revision, it is close enough to the right course that those who care about the long-term health of the system, and the access to sustainable credit that depends on it, should engage to improve and advance the effort.

It would be a shame if those advocating for the status quo win the day, dooming this bipartisan effort to reform Fannie and Freddie. If they do, then we will fail to address the last important piece of reform coming out of the financial crisis, and all in the name of maintaining a dysfunctional system on the road to less access to credit, more taxpayer risk and greater market instability.

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