



# GSE Reform Is Dead – Long Live GSE Reform!

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# GSE Reform Is Dead – Long Live GSE Reform!

BY JIM PARROTT AND MARK ZANDI

**W**ith time running out for this Congress to pass legislation reforming Fannie Mae and Freddie Mac, focus will now turn to the executive branch. The Trump administration has made no secret of its interest in reforming these government-sponsored enterprises, or GSEs, if Congress proves unable to, so the question now is what they will do with the opportunity.

The most important player in the administrative reform of the GSEs will be their regulator and conservator, the Federal Housing Finance Agency. The term of the current director, Mel Watt, will expire in January, giving the Trump administration the opportunity to put in its own leadership to run an agency that has wide discretion over the course taken by Fannie and Freddie (see Box 1).

Given conservative ideology on these issues, we can expect the new director to take steps to reduce and re-price the GSEs' footprint in the housing finance system.<sup>1</sup> And given the public commitment by the administration to end their conservatorship, the new director is likely to work with the Treasury department on releasing the GSEs from their now decade-long economic limbo.<sup>2</sup>

In this paper we will discuss the options and challenges in each of these policy areas, concluding with our own recommendations for administrative reform.

## Reduce the GSEs' footprint

Since the early days of the recent Great Recession, conservatives have been highly critical of the role that the GSEs play in the housing finance system.<sup>3</sup> They attribute a significant portion of the blame for the crisis to Fannie and Freddie and bemoan the increased importance of the two institutions in the years since, arguing that they distort the mortgage market and create excessive risk for the taxpayer. To address these concerns, a conservative director of the FHFA will likely take steps to reduce the GSEs' role in the market.<sup>4</sup>

The most direct way to do this would be to gradually reduce the share of loans that qualify for the GSEs' support. Today the maximum size of a loan that can be purchased by Fannie and Freddie stands at \$453,100, or as much as \$679,650 in high-cost areas, where the local median home value is significantly higher than the standard loan limit. The FHFA could lower these limits, reducing the GSEs' footprint in those higher-income markets arguably best positioned to do without government support. For a sense of the scale involved, if the FHFA were to eliminate the high-cost area loan limit, GSE loan

volume could fall by as much as 5% and if it were to reduce the standard loan limit to, say, \$350,000, volume would fall by close to 25% (see Chart 1).

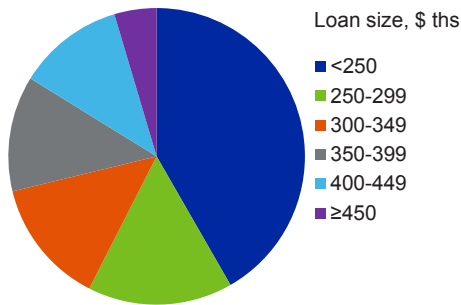
The move to lower loan limits would trigger protests that it is inconsistent with the Housing and Economic Recovery Act, which requires the FHFA to set the limits according to a formula that tracks house price appreciation, not falling prices. That is, it authorizes the FHFA to raise loan limits, not lower them. However, this provision in HERA applies to the FHFA as the regulator of the GSEs, which is only part of the agency's mandate under the statute. HERA also gives the FHFA a set of responsibilities as conservator, which in effect puts it into the shoes of the GSEs' boards of directors and management. And in that role, the FHFA could presumably decide that the GSEs could

## Box 1: Succession at FHFA

We assume in this paper that the Trump administration will put its chosen leadership into the FHFA as Director Watt's term expires in January. It is worth noting, however, that the transition may not be without some controversy. Under HERA, Watt can remain in his position until a successor is nominated and confirmed, putting a great deal of pressure on the confirmation of his successor. If Watt leaves before his successor is confirmed, HERA narrows the administration's choice for acting director to three specific deputies, who will have already been chosen by Watt. But the administration may claim that the Federal Vacancies Reform Act applies instead, allowing it to put anyone in as acting director who has been confirmed by the Senate for another position. How a similar dispute over succession at the Consumer Financial Protection Bureau plays out in the courts may well bear on how clear the picture of succession is here. For the relevant section of HERA, see [12 U.S. Code § 4512](#), and for the relevant section of the Vacancies Act, see [5 U.S. Code § 3345](#).

### Chart 1: GSE Single-Family Loan Buys

Distribution of loan size at origination, % of total, 2018



Sources: CoreLogic TrueStandings, Moody's Analytics

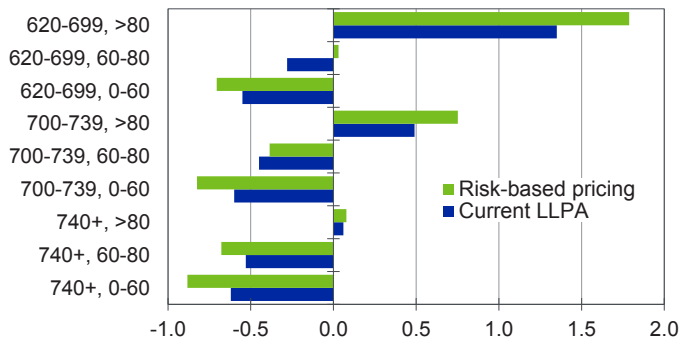
only support loans inside of whatever limit its regulator might set, precisely as its boards or management would be authorized to do.

A second way for the FHFA to reduce the number of loans that qualify for GSE support would be to tighten minimum credit requirements. Today Fannie and Freddie will guarantee loans up to 97% loan-to-value and 50% debt-to-income, and down to a 620 credit score. The FHFA could constrain the GSEs' lending along any of these dimensions (see Chart 2). The power of this lever was demonstrated when Fannie Mae recently increased its maximum DTI from 45% to 50%, which led to an immediate surge in this lending.<sup>5</sup>

Using either loan limits or underwriting standards aggressively enough to meaningfully reduce the GSEs' footprint would be disruptive, though in different ways. Lowering loan limits dramatically would leave entire neighborhoods with much less access to mortgage credit, potentially all at once. Portfolio lenders would provide an option for some of these borrowers, but many of those suddenly on the wrong side of the line would face considerably higher mortgage rates, particularly for long-term, fixed-rate lending. And a significantly tighter credit box would push a large number of borrowers into more heavily subsidized channels of government-supported lending, like the Federal Housing Administration, where adjustments would need to be made to avoid increasing rather than decreasing taxpayer risk.<sup>6</sup>

### Chart 3: GSE and FHA Rate Differences

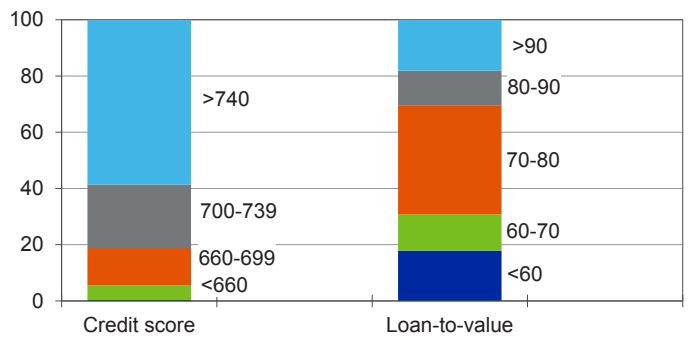
Across the credit distribution under LLPA and risk-based pricing, %



Source: Moody's Analytics

### Chart 2: GSE Loan Credit Characteristics

2017 loan vintage, %



Sources: Fannie Mae, Freddie Mac, Moody's Analytics

Another way to reduce the GSEs' footprint would be to gradually raise the fee that they charge for their guarantee. Fannie and Freddie currently charge a guarantee fee of about 60 basis points on all of the fixed-rate, 30-year loans they guarantee. They also charge a loan level price adjustment, or LLPA, of anywhere from 25 to 375 basis points on higher-risk loans, depending on the credit risk of the loans. The FHFA could require the GSEs' to raise either or both of these fees.

The effect of such an increase on the GSEs' footprint would depend on which fees they increase. If the GSEs raise their overall guarantee fee, many lower-risk borrowers would find it less costly to get a loan from portfolio lenders or the private label securities market, and many higher-risk borrowers would find it less costly to go to the FHA or other more heavily taxpayer-subsidized channels. If instead the LLPAs are increased, then the GSEs' footprint would shrink primarily at the bottom end of the credit spectrum, with higher-risk borrowers bearing the lion's share of the increase and finding it less costly to get an FHA loan (see Chart 3).

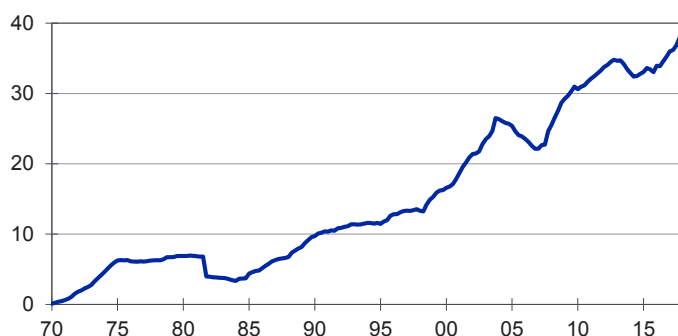
Finally, the GSEs could pull back on the type of loans they purchase. Conservatives and others have argued that there is no public-policy reason for the GSEs to do cash-out refinancings, loans to investors, and loans for second homes. Last year, cash-out refis accounted for more than 20% of all GSE loan volume, and investor and second homes accounted for close to 10% of volume.

What levers a conservative FHFA uses to reduce the role of the GSEs will depend on which part of the GSEs' footprint it wants to shrink and what kinds of market disruptions it is willing to endure. What is relatively certain, though, is that it will use some mix of them to reduce the GSEs' role.

While we focus here on the role of the GSEs in supporting the market for single-family housing, the administration is also sure to consider ways to reduce the GSEs' footprint in multifamily lending, which has steadily increased over the decades and now accounts for nearly 40% of all multifamily loans outstanding (see Chart 4). Given that the GSEs' multifamily business avoided the excesses that ultimately undid their single-family businesses, there appears to be less pressure to shrink or wind down those businesses.

## Chart 4: Rising Share of Multifamily

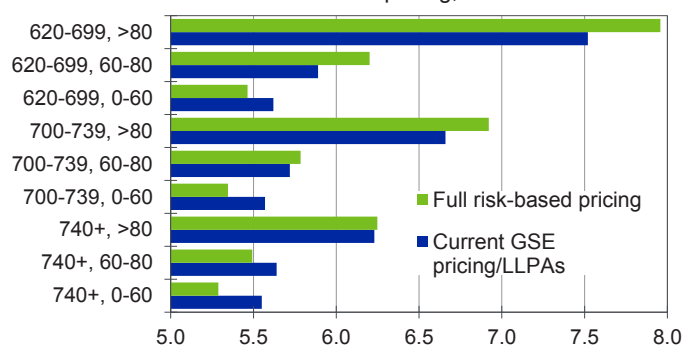
GSE share of multifamily mortgage debt outstanding, %



Sources: Federal Reserve Board, Moody's Analytics

## Chart 5: Rates Across Credit Distribution

Under current LLPAs and risk-based pricing, %



Source: Moody's Analytics

However, we expect at least some consideration to be given to reducing origination volume caps to more narrowly target such lending or even to spin the multifamily businesses out of government control altogether.

### Limit the cross-subsidy

In addition to being critical of the oversized role of the GSEs in today's system, many conservatives are skeptical of the cross-subsidy they provide. Fannie and Freddie charge lower-risk borrowers more than is needed to cover their risk and targeted return so that they can charge other higher-risk borrowers less than is needed, thereby putting a GSE-backed loan within reach of more borrowers. This cross-subsidy currently totals an estimated \$3.8 billion per annum.<sup>7</sup> The GSEs do this in part to meet their housing affordability goals, which require that a specified percentage of loans purchased by the GSEs go to low- and moderate-income borrowers, and in part to meet their mandated duty to serve manufactured housing and rural housing markets.

Critics argue that this cross-subsidy is unfair to lower-risk borrowers and pushes excessive risk into the system. Indeed, many assign a significant portion of the blame for the financial crisis to the affordability goals, arguing that they drove Fannie and Freddie to create enormous demand for subprime and other low-quality mortgage loans that ultimately took down the entire financial system. Others argue that the goals drive house prices higher by increasing demand, lowering housing affordability for the very households the goals are trying to help. While these views of the goals have been shown repeatedly to be incorrect, they remain central to conservatives' narrative of the crisis and their criticism of the market today.<sup>8</sup>

The next FHFA director is likely to change the status quo here as well. At the extreme, the director could require the GSEs to fully risk-based price their lending, leading them to increase significantly the LLPAs on high-risk borrowers and lower the guarantee fees on low-risk borrowers. This is comparable to what the FHFA and GSEs are currently requiring of the private mortgage insurers with the PMIERS capital standards. For a sense of what would happen to mortgage rates if the GSEs were to remove the cross-subsidy and fully risk-

based price, see Chart 5. This would mean that the GSEs would take some lower-risk borrowers from portfolio lenders and lose some higher-risk borrowers to the FHA and other more heavily subsidized channels of government support.

In taking this step, the next FHFA director would also likely roll back the affordability goals and duty to serve requirements far enough that the GSEs easily meet them without providing a cross-subsidy.<sup>9</sup> While the FHFA is mandated by HERA to set these requirements, the director has enough discretion to set them in a way that has little effect.

### Bring them out of conservatorship

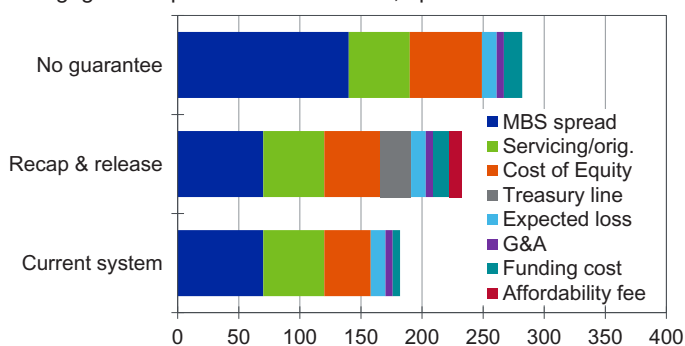
The new FHFA director may not stop at reducing and re-pricing the GSEs' role in the market. Given the administration's consistent commitment to ending the conservatorship, they could work with the FHFA to put the GSEs entirely back into private hands. While this is not a move that fits naturally within conservative ideology, it is worth some attention given the administration's interest.

To see how bringing the GSEs out of conservatorship might work, one must begin with the practical challenges involved, as the need to overcome them will affect the form that the GSEs' escape would have to take. The challenges arise primarily from the GSEs' obligations to taxpayers. Back in 2008, Treasury bailed-out the institutions from imminent collapse with an injection of substantial capital and a commitment to provide more as needed. In exchange, taxpayers received options to purchase 79.9% ownership interest in both companies, a dividend on their investment, and a fee to cover their commitment of additional capital should the need arise.

Under the funding agreements, the dividend was initially set to equal 10% of Treasury's investment, annually. But as Treasury grew concerned that one or both of the institutions would be unable to pay the dividend, forcing them to draw on their finite funding commitment from Treasury just to pay the dividends back to Treasury, the parties changed the dividends to equal a sweep of the institutions' annual positive net worth. The commitment fee was to be set at the market value of Treasury's remaining funding commitment, but Treasury suspended that immediately because of adverse conditions

## Chart 6: Rates Under Recap & Release

Mortgage rate spread over Treasuries, bps



Source: Moody's Analytics

in the mortgage market, and then suspended it indefinitely when the dividend was converted to a net worth sweep, leaving the institutions without the resources to cover the fee. If the dividend is ever modified in such a way that it no longer sweeps all of the positive net worth of the two institutions, they would be required to pay both the commitment fee and the dividend.

It would be extraordinarily difficult for Fannie and Freddie to escape conservatorship while weighed down by these obligations. Compounding the challenge, regulators would designate the institutions as systemically important, requiring them to hold a substantial amount of capital. Depending on how the dividend and commitment fee are determined, and where the capital requirements are set, the GSEs would have to raise guarantee fees so much that mortgage rates for the typical borrower would rise anywhere between half and a full percentage point on average through the business cycle, and much more for higher-risk borrowers in times of economic and financial stress (see Chart 6).<sup>10</sup> More fundamentally, though, the economics of their businesses are unlikely to work outside of conservatorship, so long as these obligations to the taxpayer remain in place.

A solution often suggested is to amend the terms of the relevant agreements to reduce the GSEs' obligations to the taxpayer. However, it is not at all clear that the law allows for such a move. Under [31 U.S. Code § 3711](#) and [31 CFR 902.2](#), the government can only "compromise a debt" owed the taxpayer when the debtor cannot pay, the cost of collection is prohibitive, or there is significant doubt as to the government's liability to prove that the debt is owed. It would not appear that any of these circumstances apply here.

This has in turn led some to the idea of putting the enterprises through receivership to unburden them from the weight of their obligations, much as companies commonly use bankruptcy. Under HERA, the FHFA can put each of the GSEs into receivership, where their existing obligations can be put into a "bad bank" that would go into run-off, freeing a "good-bank" to raise capital and be re-privatized. The legacy obligations of the bad banks, including the legacy mortgage-backed securities, the contractual obligations to the taxpayers, and the ownership interests of the shareholders, would be covered by the revenue stream from the legacy business, the sale of

the enterprises' assets, and the remaining capital commitment provided by the Treasury. The good banks, which would presumably purchase many of the assets and retain much of the personnel, would be formed as limited life regulated entities with up to five years to raise the capital needed to be released from receivership as privately owned companies.

Although this may sound like a return to the system we had prior to the crisis, in important respects it is not. Before the crisis, the market assumed, correctly, that the government would step in if Fannie and Freddie ever faltered. This meant that lenders would extend credit to the GSEs on terms that reflected an implicit government backstop and that mortgage-backed securities investors invested in agency MBS on terms consistent with an implicit government backstop. After all of the economic and political tumult that has followed their bailout, however, the market is highly unlikely to assume, universally, that the government will step in to backstop them again should they need it. This change in the market's assumptions about the risks posed by the GSEs will change their underlying economics, likely considerably.

A re-privatized Fannie and Freddie will be forced to raise capital and borrow at a higher cost that reflects the possibility that they would fail in some future financial crisis. Similarly, only MBS investors willing to take on counterparty and related credit risk will be willing to purchase Fannie and Freddie MBS. Many low-risk institutional investors, particularly sovereign investors, will be uncomfortable or

## Box 2: The Challenges of Moelis

The housing finance reform plan proposed by Moelis & Co., an advisor to some of the shareholders of Fannie and Freddie, is illustrative of how policymakers will bump up against these challenges in even the most well-thought-through efforts. Under this plan, Treasury would sell its interest in the enterprises, thus freeing them from the dividend obligation and allowing them to rebuild capital. And the enterprises would retain Treasury's purchase commitment under the Senior Preferred Stock Purchase Agreements, or PSPAs, allowing them to use the government's support of their solvency to keep their capital costs low and their credit risk-averse MBS investors interested. Even if this somehow elides the compromise of claim issue mentioned above, in spite of reducing the overall financial obligation to the taxpayer, it presents only a temporary solution to the problem of government support. The government's finite purchase commitment under the PSPAs will at some point fall to a level at which investors begin to factor in the resulting counterparty and credit risk, leading to the forbidding economic challenges mentioned. And even if Congress were to step in and solve the problem by extending the line, we would be left again entirely dependent upon a too-big-to-fail duopoly, with all of the incentive problems that brings with it. See "[Restoring Safety and Soundness to the GSEs](#)," Moelis & Co., June 2017.

simply unable to take this new risk and pull out of the market altogether. Those that are willing to take on the new risk will do so only at a premium. All of this will result in mortgage rates that are much higher and more cyclical, and likely mark the end of the TBA (to-be-announced) market vital to long-term fixed rate mortgages.

This is not to say that the administrative path out of conservatorship is impossible, only that there are variables that make it immensely challenging (see Box 2).

### Economic implications

If administrative reform results in scaling back the GSEs' footprint or privatizing them altogether, the housing and mortgage markets, and by extension the broader economy, could face significant disruption.

Today, the GSEs provide a taxpayer-funded subsidy to homeowners. Their mortgage securities and borrowing costs benefit from the federal government's support, for which they have historically not paid, creating a subsidy that the GSEs pass on to borrowers. Shrinking the share of the market they support will reduce the number of borrowers who receive this subsidized lending. Similarly, re-privatizing the GSEs will either force them to pay for their government support or forgo it altogether, either way eliminating the subsidy they provide and meaningfully raising the cost of a mortgage for most borrowers.

Under most scenarios, higher-risk borrowers will bear the brunt of the change. As they currently receive the lion's share of the GSEs' subsidy and cross-subsidy, they will see the lion's share of the increases in cost as the market shifts to full risk-based pricing. Moreover, in those segments of the market in which the government no longer stands behind the credit risk, we will see much less long-term, fixed-rate lending, as investors unwilling to take both credit and interest risk will focus on adjustable-rate mortgages. Higher-risk borrowers will also suffer if the administration limits FHA lending, which it will likely do when scaling back or privatizing the GSEs to avoid increasing rather than decreasing the overall risk to the taxpayer.

Even if one were of the view that smaller or privatized GSEs would provide a better housing finance system, all other things being equal, the transition from the system we have today would be disruptive. Consider the extreme scenario in which the GSEs are re-privatized as shareholder-owned institutions without a government backstop. Mortgage rates for the typical borrower would rise by an estimated 90 basis points on average through the business cycle, and much more for higher-risk borrowers and in stressed environments.<sup>11</sup> Based on simulations of a Moody's Analytics model of the U.S. economy, sales of new and existing homes would fall by approximately 450,000 units per annum, or 7.5% of sales; existing-home prices would fall by 6% compared with what they would have been otherwise; and the homeownership rate would be reduced by nearly three-quarters of a percentage point. The economy would ultimately adjust, but in the year after the change in mortgage rates, real GDP growth would fall 0.8 percentage point, driving up the unemployment rate by 0.4 percentage point.

### A more practical approach

A more practical approach to administrative reform would be to reduce Fannie and Freddie's centrality to the housing finance system without reducing their footprint or re-privatizing them. The FHFA could do this by developing their credit risk transfer process into a more durable means to off-load credit risk, expanding the common securitization platform into a market utility and increasing the GSEs' transparency. Together this would lessen the too-big-to-fail risk they pose and ultimately make it easier for Congress to pass legislation establishing the future system.

Credit risk transfer, or CRT, has come a long way in the nearly five years since its inception, and while the amount of risk the GSEs can transfer is bumping up against the bounds of what is economical, it should be expanded to include more institution-based sources of private capital.<sup>12</sup> The bulk of the current CRT program is going to capital market investors and has been highly successful in part because of the strong conditions that have prevailed in global capital markets (see Box 3).

But conditions will worsen at some point, and in times of stress capital markets investors will demand a much higher return to cover the risk, forcing the GSEs to either absorb the cost, pass it on to borrowers, or pull back on their risk-sharing when the risk is most critical to share. To ensure that the CRT process is durable through the cycle, which is critical if this is to help ease the system off of its overreliance on Fannie and Freddie, a significant portion of the GSEs' risk must be shared through transactions that rely on so-called institution-based capital, such as reinsurance, lender recourse, or deep cover mortgage insurance.

To that end, the next FHFA director should continue to develop a set of structures that will allow institutional equity to compete effectively for the GSEs' credit risk, much as the Connecticut Avenue Securities and Structured Agency Credit Risk structures have allowed capital market investors to compete for the risk. This will help stabilize the CRT effort over the longer term and give policymakers a much better handle on what kind of mix of structures is needed for the long-term health of the housing finance system. And while this approach means introducing some counterparty risk to the transactions, this risk is manageable and well worth taking given the benefits to the system.

To further reduce the centrality of the GSEs and lay the groundwork for an easier transition to a new housing finance system, the next FHFA director should also expand the current effort to build out the common securitization platform. Today the CSP is being developed to support a single security issued by Fannie and Freddie. If the scope of the effort stops there, it will further entrench their dominance by extending their advantage over the rest of the market. The next FHFA director should expand the objective to a platform that is open to other issuers, thereby making it easier, not harder, to reduce the dominance of Fannie and Freddie.<sup>13</sup>

Opening up the CSP to other users would in effect turn it into a market utility. This would reduce barriers to entry for new issuers and other intermediaries between the primary and secondary market, easing the way for Congress to either charter new guarantors



### Box 3: The Credit Risk Transfer Process

The GSEs have made significant progress reducing their footprint in the mortgage market through the credit risk transfer process. Risk transfers began five years ago through capital market transactions with an array of investors, including asset managers, hedge funds, and sovereign wealth funds. These investors agree to buy securities backed by the agencies' loans that are subject to write-downs if homebuyers default. The risk transfers have since expanded to include transactions with other financial institutions, including reinsurers, private mortgage insurers, and mortgage lenders.

There is some concern over just how much risk is being transferred in these transactions, given their complexity. Our analysis indicates that they are transferring a meaningful amount. If the nation suffered another financial crisis and Great Recession like the one that put Fannie and Freddie into conservatorship, approximately two-thirds of the losses suffered by the enterprises would be borne by private investors.

Another concern is that the enterprises are overpaying investors—that is, paying them more than the enterprises' own costs of shouldering the risk. That concern is also misplaced. Fannie and Freddie are paying out just over one-fourth of what they collect

for bearing the credit risk in mortgage loans to private investors through risk transfers—about the same amount of risk the agencies are transferring to investors.

That is not to say that there is no room for the program to improve. Financial markets are volatile and there will be times when the capital market investors that dominate the program today are unwilling to provide capital at a reasonable price. Left unchanged, the program would leave the GSEs in position to assume almost the entirety of the credit risk in their channel during times of stress, making them just as critical to the system as they have been historically. To ensure that the risk transfer process actually reduces the risk—and thus the centrality of Fannie and Freddie—through the entire cycle, it must be less reliant on such investors.

Institutions that invest equity capital in credit risk as a core part of their business—reinsurers, mortgage insurers, banks and RE-ITS—will be willing to price the credit risk they assume more evenly through the economic cycle, making them a more stable source of capital in times of stress. For the credit risk transfer process to provide a durable means of de-risking the GSEs, the FHFA will need to take steps to integrate more of these investors into the process.

to compete with Fannie and Freddie or merge them into the utility to spread market power and risk more evenly throughout in the system. The former is the path envisioned recently in the Senate Banking Committee<sup>14</sup> and the latter is the path we have proposed elsewhere,<sup>15</sup> either of which would be made much easier if the CSP is expanded from a proprietary platform for Fannie and Freddie to a market utility.

To maximize its use as a market utility, the CSP should be expanded to handle those GSE functions that would otherwise pose prohibitive barriers to entry in a reformed system. A good example of this is Fannie and Freddie's use of automated underwriting systems, or AUS, to evaluate the credit risk of a loan and determine if the GSEs' will purchase and insure the loan. Lenders have integrated Fannie and Freddie's different systems into their lending processes to such a degree that many would be highly unlikely to adopt a competing model unless they had little to no choice.

Policymakers should thus consider harmonizing the two automated underwriting systems into a single system for the CSP, allowing new entrants to use it as a baseline from which to develop their own automated underwriting systems over time. This would make it much easier for lenders to move from Fannie and Freddie, while allowing the market to continue to develop, differentiate and compete across underwriting systems.

Another function that policymakers should consider migrating to the CSP to promote competition is master-servicing. Having the CSP set the rules for servicing loans in a pool on behalf of the securities investors would increase standardization and make it easier to

improve outcomes for both investors and homeowners. It would remove a complex and costly function from among the issuers' responsibilities, reducing what would otherwise be a significant barrier to entry. And it would remove the ability of issuers to use their master-servicing roles in ways that benefit larger customers, as will sometimes be in their interest.

Converting the CSP to a market utility would also enable policymakers to explore opening it to the private label securities market. One of the impediments to the resurgence of the PLS market has been the inability of investors and issuers to develop a set of standard terms upon which to base future deals, forcing each new deal through a prohibitive gauntlet of negotiations between parties still skeptical of one another after their experience in the crisis. Introducing a standard set of terms for issuance on the CSP may help establish a baseline off of which parties can negotiate a more manageable set of open issues.<sup>16</sup>

The next FHFA director could also ease the path to reform by requiring the GSEs to be more transparent. The FHFA has already done this to some degree, most importantly by having the GSEs provide data on the credit characteristics and performance of their borrowers. This allows others to do the analysis needed to take more credit risk in the system, which will continue to be critical as the GSEs move their risk out into the private market.

The next step would be to increase transparency around the GSEs' capital framework and pricing. The GSEs set their guarantee fees as if they are holding a certain level of capital, yet it is unclear both how much implicit capital they are holding and what the implicit return they require on this capital is. This makes it difficult to judge whether

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their implied capitalization is consistent with other sources of capital in the housing finance system or broader financial system, how effective the risk transfer process is in reducing the capital burden of the GSEs, and whether and how much they are subsidizing and cross-subsidizing mortgage borrowers. The GSEs' opaqueness over capital and pricing solidifies their control over the system, since it is all but impossible to assess the appropriateness of the rules and standards they effectively set for all the stakeholders in the system.<sup>17</sup> Transparency around their capital framework and pricing would ensure a more level playing field for all the actors in the system and reduce the centrality of the GSEs.

### Conclusion

With a new director at the FHFA next year, we are likely to see a meaningful shift in the role of Fannie Mae and Freddie Mac.

This likely means a reduction of both the GSEs' footprint and the cross-subsidy they provide, and it may also mean an attempt to get the GSEs out from under the government's wing altogether. If it is any of these, it will mean higher mortgage rates, less access to credit, and disruption to the housing and mortgage markets and broader economy.

The next FHFA director should instead expand the GSEs' current credit risk transfer process to more sources of private capital, expand the common securitization platform into a more robust market utility, and make the GSEs more transparent. If the next FHFA director were to accomplish these key steps, it would put the nation into position to transition to a housing finance system in which mortgage credit is as available as it is today but in a way that poses less risk to taxpayers and the economy.



### Endnotes

- 1 It is not entirely clear how conservative the administration is on these issues, given the lack of specificity in their few public comments on them and the apparently wide range of views among senior officials in Treasury and the White House. But we assume that their actions, including their choice to lead the FHFA, will at least be broadly consistent with conservative ideology.
- 2 For example, see "[Senate Banking, Housing and Urban Affairs Committee Holds Hearing on Domestic and International Policy](#)," posted by the National Multifamily Housing Coalition.
- 3 For example, see Peter J. Wallison and Edward J. Pinto, "The Taxpayer Protection Housing Finance Plan Gradually Winding Down Fannie Mae and Freddie Mac and Improving the FHA," American Enterprise Institute, January 23, 2018. <https://www.aei.org/wp-content/uploads/2018/02/Taxpayer-and-Home-Buyer-Protection-Housing-Finance-Plan-1.26.18.pdf>
- 4 The GSEs' current share of the single-family residential mortgage market is approximately 45%, close to its historical average. However, considering that almost half of the credit risk in these GSE loans is being sold to private investors, the amount of risk that the GSEs are shouldering is actually about as low as it has ever been.
- 5 Private mortgage insurers responded to this surge in high DTI loans by tightening their own underwriting standards.
- 6 The GSEs are currently off-loading almost half of the credit risk they are taking on through their risk transfers to private capital market investors, reinsurers, and private mortgage insurers. In contrast, taxpayers hold on to all of the risk in an FHA loan. So if the GSEs' lose market share to the FHA, then taxpayers' risk exposure increases.
- 7 For an analysis of the cross-subsidy in the current GSE system, see Jim Parrott, Michael Stegman, Phillip Swagel, Mark Zandi, "[Access and Affordability in the New Housing Finance System](#)," Urban Institute, Moody's Analytics and Milken Institute, February 2018.
- 8 Research from the Federal Reserve System shows that the affordable housing goals have had [little or no impact](#) on mortgage credit availability and thus did not meaningfully contribute to the financial crisis. This was also the conclusion of the [Financial Inquiry Commission](#), a bipartisan group tasked by Congress to determine the causes of the crisis.
- 9 Funds currently going to the Housing Trust Fund and Capital Magnet fund to expand access to affordable housing, estimated at close to \$300 million a year, could also be curtailed. As with the loan limits, a muscular FHFA director could justify such actions based on her role as Fannie and Freddie's conservator.
- 10 The mortgage rate spreads shown in Chart 6 are for the typical borrower in a full-employment economy with inflation at the Federal Reserve's 2% target. The assumptions underlying the analysis for recap and release are available in "[Privatizing Fannie and Freddie: Be Careful What You Ask For](#)," Jim Parrott and Mark Zandi, Urban Institute and Moody's Analytics, May 15, 2015.
- 11 For the basis of this estimate see Mark Zandi and Cris deRitis, "[Evaluating PATH](#)," Moody's Analytics, July 2013.
- 12 First loss capital market CRTs are not economical at this time.
- 13 For more on this issue, see Jim Parrott, "[The Common Securitization Platform: A Cornerstone for Reform](#)," Urban Institute, July 2017.
- 14 See: Laurie Goodman, Jim Parrott, Eric Kaplan, Michael Stegman and Ted Tozer, "[A Conversation About Housing Finance Reform](#)," Urban Institute and Milken Institute, March 2018.
- 15 Jim Parrott, Lewis Ranieri, Gene Sperling, Mark Zandi, Barry Zigas, "[A More Promising Road](#)," Parrott, Ranieri, Sperling, Zandi and Zigas, March 2016.
- 16 For more on how this might work, see Jim Parrott, "[How to Wake the Private Securities Market From Its Slumber](#)," Urban Institute, December 2016. For why it would be challenging, see Jim Parrott, "[The Common Securitization Platform: A Cornerstone for Reform](#)," Urban Institute, July 2017.
- 17 This is evident in the PMIERS capital standards for the private mortgage insurers. It is unclear how those standards are set the GSEs and the FHFA, and how they compare with the implicit capital standards to which the GSEs are held.

# GSE Reform Is Dead – Long Live GSE Reform!

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## About the Authors

**Jim Parrott** is a nonresident fellow at the Urban Institute and owner of Falling Creek Advisors, which provides strategic advice on housing finance issues to national bank and nonbank lenders, a mortgage finance technology start-up that helps smaller lenders sell loans into the secondary market, and a consumer finance technology start-up that uses advanced data science to lend to households not well served by the rest of the market. Jim spent several years in the White House as a senior advisor on the National Economic Council, where he led the team of advisors charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions; articulating and defending those positions with Congress, the press and public; and counseling White House leadership on related communications and legislative strategy. Prior to his time in the White House, Jim was counsel to Secretary Shaun Donovan at the Department of Housing and Urban Development.

Prior to his life in public policy, Jim was a litigator, first in New York with Sullivan and Cromwell, and later in North Carolina with Smith Anderson. He has a JD from Columbia University School of Law, an MA from the University of Washington, and a BA from the University of North Carolina. Jim also served in Sri Lanka with the Peace Corps.

**Mark Zandi** is chief economist of Moody's Analytics, where he directs economic research. Moody's Analytics, a subsidiary of Moody's Corp., is a leading provider of economic research, data and analytical tools. Dr. Zandi is a cofounder of Economy.com, which Moody's purchased in 2005. Dr. Zandi conducts regular briefings on the economy for corporate boards, trade associations and policymakers at all levels. He is on the board of directors of MGIC, the nation's largest private mortgage insurance company, and The Reinvestment Fund, a large CDFI that makes investments in disadvantaged neighborhoods. He is often quoted in national and global publications and interviewed by major news media outlets, and is a frequent guest on CNBC, NPR, *Meet the Press*, CNN, and various other national networks and news programs. Dr. Zandi is the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century*, which provides an assessment of the monetary and fiscal policy response to the Great Recession. His other book, *Financial Shock: A 360° Look at the Subprime Mortgage Implosion, and How to Avoid the Next Financial Crisis*, is described by the New York Times as the "clearest guide" to the financial crisis. Dr. Zandi earned his BS from the Wharton School at the University of Pennsylvania and his PhD at the University of Pennsylvania. He lives with his wife and three children in the suburbs of Philadelphia.