4 Ideas on Reforming Fannie and Freddie

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With the White House report on how to reform government sponsored enterprises Fannie Mae and Freddie Mac due this week, Congress decided to get a head start. Today, the House held a hearing on the GSEs, featuring several think tank scholars who provided a variety of ideas for fixing the housing finance system. While there were a number of interesting ideas provided, there were four that stood out.

Before getting into those highlights, it's worth noting the difference between this hearing and those held over the past couple years. This year, Republicans are in charge of the House committees since they took the majority. As a result, hearings are already looking much different. In this case, four witnesses were invited to testify. Three were from free market-leaning think tanks including the Cato Institute, the Reason Foundation, and the American Enterprise Institute. One was from the left-leaning Center for American Progress. So as you might guess, much of the testimony involved ways in which to remove the government's influence from the mortgage market and to protect taxpayers.

Push Future Losses to Investors

It's pretty likely that the GSEs have endured the majority of their mortgage-related losses. That could make now a reasonable time for the government to step back from guaranteeing additional losses to investors. Mark Calabria from Cato suggests putting the GSEs into a receivership so that future losses hit bondholders. He argues that panic is behind us so these losses would be minimal:

> If Fannie and Freddie were to experience losses of another $100 billion, then it is likely that MBS holders would experience little loss and holders of

> unsecured debt would receive about 94 cents on the dollar. Subordinated debt would likely be wiped out. As insured depositories hold mainly MBS, additional resulting bank and thrift failures would be few. Money Market Mutual Funds would likely incur significant losses, with several funds "breaking the buck". Foreign holders, particularly central banks, would experience losses, although these losses would be likely less than that already experienced due to exchange rate movements.

Alex Pollock of AEI suggested a variation on this proposal, which would just eliminate the government guarantee for subordinated debt. Another witness, Anthony Randazzo of Reason, recommends wiping out shareholders as well. Although GSE stock is on life support, it hasn't been eliminated entirely yet.

Gradually Increase Guarantee Fee

One objective to allowing the private market to play a bigger role in mortgage financing would be to level the playing field. One step in doing so could be for Fannie and Freddie to raise the fees that they charge for their mortgage guarantees. This idea was suggested by Reason's Randazzo, but Calabria from Cato provides a way for higher fees to explicitly benefit taxpayers as well. He says the fee should be used directly to reduce the deficit and recoup some of the $150+ billion loss that taxpayers have already endured. This is a nice way to provide two benefits with one change: private financing will be more competitive and the taxpayer loss will be reduced.

Remove Preferential Capital Standards Provided to GSE Debt

Fannie and Freddie's debt was extremely attractive to banks in part because they were required to hold a small amount of capital to back up their agency bonds. That gave banks an additional incentive to buy GSE bonds over others. Of course, this resulted in a lower cost of capital for Fannie and Freddie than private firms that might try to own or guarantee mortgages.

This competitive advantage was bad for two reasons. First, it stifled competition. Second, it created a sort of double-leveraging on the part of banks. The GSEs were already had ultra-low requirements for the amount of capital they had to hold to back up their assets. Banks getting a break on the amount of capital they were required hold to back up GSE debt made matters worse. Both Calabria and Pollock proposed this change.

Exercise Patience

As frustrated as people might be with Fannie and Freddie, patience is important here. Sarah Rosen Wartell from the Center for American Progress explains:

> Another proposal to rapidly liquidate the GSEs' portfolios could also have the unintended effect of reducing recoveries for taxpayers. The basic laws of supply and demand tell us that when entities the size of the GSEs put a large number of assets on the market at once, particularly in a soft market, prices will fall. Holding these assets for the markets to recover and selling them gradually into the markets over time is far more likely to maximize recoveries. Patience is likely to be rewarded in this case.

This is an important practical point. The housing market is still in bad shape. While a freer mortgage market is a reasonable long-term objective, moving too quickly could harm the U.S. economy. While some measures can be put into place in the short-term, you can't simply remove the government's influence from the housing market altogether immediately. That would cause the market to collapse.