Keeping Home Loans Cheap

By: Emily Holden - December 8, 2012

Four years after the government seized control of mortgage finance giants Fannie Mae and Freddie Mac to prevent the home loan crisis from getting any worse, Congress is showing early signs of a compromise path to the next step: renovating the nation's mortgage market.

The central question in this project, which may well take several years to resolve, is what role, if any, the government should play.

Republican doctrine holds that a new finance system must be built entirely with private capital. Party members look at the $137 billion cost of bailing out Fannie and Freddie in 2008 and vow that such a thing will never happen again. Even some Democrats concede that the government's outsize role in mortgage finance should be reduced.

Washington has been a major player in the mortgage market, though, since Fannie Mae was created under Franklin D. Roosevelt's New Deal to energize the housing industry by taking mortgages out of the hands of banks and other lenders. Democrats warn that any move to pare back Uncle Sam's role in the home loan industry, the bulk of which has for decades been propped up by Fannie and Freddie, might easily raise borrowing costs for everyone.

That specter of higher interest rates might be enough to persuade small-government Republicans to soften their stance on federal involvement in housing finance. In fact, it looks as if Republicans will blink first. Some top GOP lawmakers indicate a newfound openness on the question of government involvement as they position themselves for the long legislative slog toward an overhaul of the mortgage finance system.

Just last month, Sen. Michael D. Crapo of Idaho, who will be the senior Republican on the Banking, Housing and Urban Affairs Committee next year, suggested he would consider the possibility of a government backstop for mortgages, although he didn't offer specifics.

Rep. Jeb Hensarling of Texas, who will be the new chairman of the Financial Services Committee come January, has maintained a much harder line in public on thoroughly privatizing the mortgage business. But industry sources and lobbyists say Hensarling's views are more nuanced behind closed doors and that he might be open to a compromise if it becomes clear that conservative hopes for a private market cannot be realized.

The reason for this shift in sentiment owes more to economic reality than any other factor. Entirely wiping out Fannie and Freddie -- and, more importantly, ending the market's government guarantee -- might threaten the viability of the industry's most popular loan, the 30-year, fixed-rate "conventional" mortgage. The political fallout could be brutal, as lenders and borrowers would lose their cheapest and most stable loan product. Relentless lobbying by the industry has tried to drive home that point.

That isn't to say that Republicans are making a radical course adjustment or wholeheartedly embracing the idea of preserving the government guarantee. The party will push for the least amount of federal involvement it can get. And some conservative analysts insist that private capital on its own would be able to support a robust housing market, with only slightly elevated interest rates over what borrowers pay now.

Moreover, any substantial change in the Republican position is likely to play out over the long haul. For now, lawmakers can and will keep their cards close to the vest, given that there's little immediate pressure to overhaul the system. Home prices are rebounding, and the pace of foreclosures has slowed considerably as the real estate market recovers from the damage caused by the financial crisis.

But the collapse of the mortgage finance system in 2008, and the huge bailouts for Fannie and Freddie, have made it clear that the status quo isn't sustainable. Even the strongest advocates of a government backstop would be hard-pressed to endorse the current system, where the government underwrites 90 percent of new loans and taxpayers bear much of that risk.

"Republican and Democratic leadership in Congress have both talked about the likelihood of a long transition for whatever future state is required for Fannie and Freddie," says David H. Stevens, president of the Mortgage Bankers Association. "The real question will be whether there'll be a bipartisan effort to try to do something meaningful in the new Congress."

It's a good bet that most of the early action next year will focus on partisan positioning. The Obama administration, for example, is preparing a broad proposal that would establish a government-run "catastrophic reinsurance" program to backstop the industry in case of major losses.

And that's exactly the kind of proposal that will test the GOP's commitment to kicking the government out of housing finance.

A Glance Behind the Curtain

Crapo, a three-term House member before he was elected to the Senate in 1998, is one of the first influential Republicans to indicate that he has an open mind on the mortgage issue.

In brief comments to reporters last month, Crapo said he was open on the question of a government backstop in mortgages. "We'll see how it develops," he added when asked about the possibility of future federal involvement.

That's a far cry from the usual GOP maxim that the government needs to get out of the mortgage business, and it's all the more significant since Crapo will be a standard-bearer in the Senate as Banking chairman.

Notably, Crapo previously hasn't ruled out a guarantee, saying on his website that the main goals of overhaul legislation "should be to re-establish a housing finance market that has long-term stability in which private capital is the primary source of mortgage financing and the taxpayer is protected in the event of another housing collapse."

In the House, any policy shifts are happening outside the public spotlight. Hensarling, who would spearhead overhaul efforts as chairman of Financial Services, has long championed the importance of free markets and private capital in the housing market.

But Jerry Howard, chief executive of the National Association of Home Builders, says lawmakers now are thinking more pragmatically about the government's role in the housing industry. "The holdup has been that everyone has had an emotional reaction to the housing meltdown," Howard said. "It's taken time for wounds to heal."

That means it will take time to reconcile House leaders' public positions on Fannie and Freddie with the realistic politics that will be required to strike a deal.

Hensarling has sponsored legislation that would end the government's conservatorship of the companies in two years and fully privatize them in another three.

Another influential Financial Services conservative, Scott Garrett of New Jersey, has called the current housing finance system "crony capitalism." As the Republican point man on Fannie and Freddie, Garrett wants them completely eliminated, along with any hint of a government guarantee.

Getting Garrett to compromise would be almost impossible, given his devotion to free-market principles. Hensarling might have to be more flexible, particularly now that he's been elevated to chairman and will have to shepherd any overhaul of housing law. If Hensarling isn't willing to compromise, it's hard to see how he could strike a deal with Senate Democrats or the White House, who remain committed to some kind of federal fail-safe.

At the least, Hensarling is willing to listen. "Although Mr. Hensarling has very strong philosophical views on the issue," Howard says, "it would make sense to me that he would recognize the need to engage in an open dialogue with not only the Democrats on his committee and on the Hill but also with the stakeholders."

But he's not going to give up hope for a fully privatized system without a fight. The House is likely to vote on, and possibly pass, Hensarling's preferred bill to privatize Fannie and Freddie in five years. If it becomes clear that Democrats won't accept the kind of free-market solution he'd like, Hensarling will have to consider a more measured approach.

Republicans also will feel tremendous pressure from outside interest groups, many of whom benefit from government's deep involvement in the real estate market.

"In the long run," says Mark Calabria, director of financial regulation studies at the libertarian Cato Institute, "I'm quite skeptical about these subsidies going away because I think that there are entrenched interests that benefit tremendously from these subsidies."

Since the early 1950s, almost all U.S. mortgages have had a government-backed source, says Robert Van Order, a finance professor at George Washington University's School of Business and former chief economist at Freddie Mac.

"The issue has been which institutions do it and how far back in the queue the government stands," he says. "What is likely to happen next is an attempt to keep the backstop while keeping a lot of private capital in front of it."

The Cost of Buying a Home

There have always been a handful of maverick Republicans in both chambers, largely from areas with high-cost real estate markets, who have embraced various levels of government backing for home loans.

In the House, John Campbell and Gary G. Miller of California have called for federal involvement to keep home loans affordable. Georgia Republican Johnny Isakson, a former real estate executive from Atlanta, proposed a measure last winter that would replace Fannie and Freddie with an independent government agency that would collect fees to guarantee mortgage-backed securities. But his plan drew no support from top Republicans on the Senate Banking Committee.

So what would drive the rest of the party closer to their position? At the most basic level, the answer is that members of Congress from both parties are worried that any move to cut federal support for housing will make it more expensive to buy a home.

To get at the root of that question, you have to look at how housing finance works in this country and how Fannie and Freddie provide capital for home loans.

Gone are the days when a bank made a home loan and pocketed the interest for profit. For decades now, banks have made loans and then immediately sold the notes to another financial institution, most often Fannie or Freddie. The two companies then package the loans into mortgage-backed bonds, which they guarantee and sell or keep on their own books.

Banks prefer this system because they don't have to worry about whether a borrower pays them back. The bondholders, and Fannie and Freddie, bear that risk. Banks also don't have to worry about how much interest they are charging because they no longer own the mortgage.

Of course, a private financial company could provide all the same services for banks. The key difference is that Fannie and Freddie, because their purchases are guaranteed by the government, are able to buy more loans from banks and with much lower interest rates than any private company could.

When Fannie and Freddie need to raise cash for buying loans, they borrow cheaply.

Investors will accept below-market interest rates because they know the government will make sure they get their money back.

With that cash in hand, Fannie and Freddie can buy home loans with relatively low interest rates because they need only small margins to cover their borrowing costs.

The guarantee works in other ways, too.

When it comes time for Fannie and Freddie to issue mortgage bonds, they package thousands of home loans into a single security and guarantee that bond. And even if the underlying loans default, investors know Fannie and Freddie can tap taxpayer money to make bondholders whole.

All things being equal, that means investors are happy with lower interest rates from the mortgage bonds and the underlying mortgages because they know the securities carry little risk.

But if Congress eliminated that guarantee, investors would demand higher interest rates, the cost of which would be passed back to consumers. Many conservatives say that's what should happen -- that Fannie and Freddie have artificially depressed the cost of buying a home.

In the past, there was a lot of debate about whether the government actually stood behind Fannie and Freddie. They were founded by Congress after the Great Depression and sold to private investors in the 1960s. Throughout their history, officials debated whether the shareholder-owned companies had a guarantee.

When the George W. Bush administration seized them in 2008, after huge losses on their mortgage portfolios, that argument was settled.

Vast Reach and Buying Power

With lawmakers contemplating life after Fannie and Freddie, lenders, builders and realtors are worried that an overhaul of the mortgage market will go too far and drive investors away. Specifically, investors might not want to buy bonds, including 30-year mortgages, in a strictly privatized system that carries the full weight of market shifts.

For investors, it's hard to predict where interest rates will be in a few years, let alone in 30. When rates fall, some borrowers refinance and pay back their loans early, reducing profitable interest payments. But when rates are rising, existing mortgages are much less valuable than new loans.

Fannie and Freddie can shrug off most of the risks, in part because taxpayers will make sure the companies remain afloat even if an interest rate shock blows a hole in the value of their mortgage portfolio.

Stevens, the head of the Mortgage Bankers Association, says Fannie and Freddie provide several unique services that private industry wouldn't be able to replicate -- at least not easily.

With their vast reach and buying power, the two companies standardize bundles of loans so investors around the world know what they are getting. And there's a question of whether some investors could legally purchase securities from private firms unaffiliated with the U.S. government.

Fannie and Freddie bonds are owned by all types of investors, from retirement funds to foreign governments. Stevens says many of those entities have charters stipulating that they can only invest in companies that are very secure.

"There are many who remain skeptical as to whether you can get enough private capital into the U.S. housing finance system without having some level of guarantee," Stevens says.

Not everyone agrees, of course.

Calabria, the CATO scholar, says 30-year, fixed-rate mortgages may be less prevalent and slightly more expensive in a privatized system but they would remain viable.

Calabria says homebuyers might have to pay 1 percent more in interest or face higher penalties for refinancing. And he notes that the Federal Housing Administration would still offer cheap mortgage insurance for lower-cost loans.

For more expensive loans, like the ones that Fannie and Freddie buy now, Calabria suggests a loan product that begins as a fixed-rate loan for several years before turning into an adjustable-rate note. That would help insulate bondholders from interest rate shocks.

The market could support fixed-rate loans, says Van Order, as long as regulators don't make it hard for lenders to hedge risks. He thinks in a private system, homebuyers might pay 0.25 percent to 0.5 percent higher interest rates.

Van Order says it would be "tough but not impossible" for savings and loan banks to finance long-term mortgages with short-term deposits. He says the mortgages would still be subsidized because most deposits at those banks are insured by the federal government.

Gone With the Wind

One thing is certain about the coming debate: Fannie Mae and Freddie Mac, or at least those names, will be no more. No lawmaker wants to carry that political lodestone around anymore.

But the opening bids from the White House and industry would force Republicans to make tough choices about keeping a federal backstop.

The administration currently favors a plan that calls for a private finance system underpinned by a government-run catastrophic-reinsurance fund, all the details of which have yet to be revealed.

The plan, which quickly won plaudits from the financial industry, would allow private entities to package mortgage securities for investors. The reinsurance fund would kick in only if all of the shareholders of those entities were wiped out.

Republicans, as expected, have expressed worries that such a system would make it difficult to price premiums because the insurance fund would still carry an implied guarantee from the government. And there's some question about whether the fund would have enough money to weather a sharp housing downturn.

Industry envisions similar backup systems. For example, the Financial Services Roundtable has circulated a plan for the government to serve only as an emergency fail-safe for mortgage investments after other firewalls have failed.

Even a conservative such as Garrett sees some future role for government. He wants the Federal Housing Finance Administration to facilitate a new system by setting standards and processes for packaging home loans into securities to be sold to investors.

Garrett says the 30-year mortgage would be viable under his proposal because the federal government is subsidizing the market in so many other ways, such as Federal Reserve actions to keep interest rates low.

"It should be a pretty strong assurance to the market that Washington politicians will always want to step in and protect them," Garrett said.

Any real showdown is still months, if not years, away.

"It'll be a big fight," says Dean Baker, co-founder of the liberal Center for Economic and Policy Research. "It's not a fight I think anyone's really anxious to have right now."

Stevens, the head of the Mortgage Bankers Association, says the timeline for an overhaul comes down to political will. And the general economic outlook has to be steady before lawmakers move forward on housing finance.

After that, we can expect to see "more thoughtful consideration," Stevens says.

Part of that deliberation might mean working through plans for privatization to try to understand exactly what they would mean for the market, including the costs of long-term mortgages, he adds.

But like any other high-stakes deal, top leaders will meet outside the glare of the spotlight to produce a bill that forces painful compromises from both parties, as well as from industry.

"At the end of the day, it'll really be a deal that'll be largely behind the scenes, with the leadership of the Republican Party coming to an agreement with the Obama administration," Baker says. "When push comes to shove, they're probably not very far apart."