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Mortgage Finance & Housing Reform: A Historical Context

Christopher Whalen

Abstract: Since the collapse of the U.S. financial markets in 2008, Congress and the policy community have been engaged in a broad-based discussion about the housing market reform, including making significant changes to the operations of government sponsored entities (GSEs) such as Fannie Mae, Freddie Mac and Ginnie Mae, which insure investors against the credit risk of most residential mortgages issued in the US. Over the past decade, the Senate and the House of Representatives have both put forward proposals to alter or eliminate one or more of the GSEs and expand the role of private capital in supporting the housing market, but no proposal has yet gained sufficient political support to pass Congress. Indeed, given the political gulf that exists between the two major political parties, it seems likely that there will be no meaningful housing legislation passed by Congress for years to come. This paper examines the debate over housing financial reform in historical context and then offers some suggestions on how to move the debate forward to a conclusion in terms of reforming the GSEs.

About the Author: Mr. Whalen is an author and investment banker with more than 30 years' experience in the banking and mortgage sectors. He previously served as head of the Financial Institutions Group at Kroll Bond Rating Agency in New York.

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“Everybody knows Santayana’s saying that those who fail to study the past are condemned to repeat it. In finance, those who do study the past are condemned to recognize the patterns they see developing, and then repeat them anyway!”

George Kaufman

Since the collapse of the U.S. financial markets in 2008, Congress and the policy community have been engaged in a broad-based discussion about the housing market reform, including making significant changes to the operations of government sponsored entities (GSEs) such as Fannie Mae, Freddie Mac and Ginnie Mae, which insure investors against the credit risk of most residential mortgages issued in the US. Over the past decade, the Senate and the House of Representatives have both put forward proposals to alter or eliminate one or more of the GSEs and expand the role of private capital in supporting the housing market, but no proposal has yet gained sufficient political support to pass Congress. Indeed, given the political gulf that exists between the two major political parties, it seems likely that there will be no meaningful housing legislation passed by Congress for years to come. This paper examines the debate over housing financial reform in historical context and then offers some suggestions on how to move the debate forward to a conclusion in terms of reforming the GSEs.

Christopher Whalen
Whalen Global Advisors LLC
New York, NY
www.rcwhalen.com

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Mr. Whalen is an author and investment banker with more than 30 years’ experience in the banking and mortgage sectors. He previously served as head of the Financial Institutions Group at Kroll Bond Rating Agency in New York.

Introduction

Ten years ago, the global financial markets were nearly crippled by a financial crisis that originated in the market for mortgage finance in the United States. The crisis began with the failure of a number of non-bank mortgage companies in 2007, then snowballed into a more general market collapse as liquidity disappeared from the financial markets. Eventually, a number of large financial institutions, commercial banks and government-sponsored enterprises (GSEs) failed. Today, two of these entities, Federal National Mortgage Corporation (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) remain in government conservatorship a decade after the financial crisis.

Since the 2008 financial crisis, successive governments in Washington have been unable to reach agreement as to how to bring the GSEs out of government conservatorship and, more broadly, reform the market for mortgage finance in the US, a market that is almost entirely regulated and underwritten by the US taxpayer. While the GSEs were in nominal terms at least “privatized” during the Vietnam War, in practical as well as credit terms, Fannie Mae and Freddie Mac remain for many purposes instruments of the United States and carry “AAA” credit ratings as a result of that sovereign support.¹

The lack of political consensus on housing policy is hardly surprising. Since the US government first ventured into the world of housing finance in the 1930s, the needs and priorities of the nation have changed dramatically. Indeed, one of the reasons why new legislation on the GSEs is unlikely to pass Congress in the near term is that the imperative for reform that was present in 2010, when Congress passed the massive Dodd-Frank Wall Street Reform Act, has subsided.² Just as in the 1930s, when an atmosphere of economic crisis resulted in radical legislation to address the Great Depression, the period following the 2008 market collapse provided an immediate impetus for reform that today no longer exists. But what constitutes “reform?”

As policy makers, investors and members of the public think about modifying current policy with respect to housing, it is useful to recall just how we arrived at the current juncture. The reckless financial speculation that was seen in the US in the years prior to the 2008 subprime financial crisis was the culmination of nearly eighty years of public policy aimed at supporting housing for a variety of reasons. If we take the turn of the last century as the starting point, we can define several periods of public policy (or lack thereof) focused on housing. Below is a somewhat arbitrary outline of the major periods.

Laissez Faire

The period between the turn of the 20th Century and the Great Crash of 1929 was characterized by an almost complete absence of government involvement in and regulation of housing and housing finance. Prior to the Great Depression, home finance was an entirely private sector of the economy and there was no legal structure to protect consumers. Indeed, one of the goals of European immigration to America seen in the 19th century was to acquire land, thus causing periodic boom and busts cycles in land prices roughly every two decades.

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¹ See “Housing Reform 2017: Can the GSEs be Privatized?,” *Kroll Bond Rating Agency*, January 6, 2017

² See “Housing Finance: What Happens if Nothing Happens on GSE Reform?,” *Kroll Bond Rating Agency*, August 12, 2014.

As the 20th Century began, investing in stocks and bonds became increasingly popular, adding another dimension to speculation in land and housing. In the mid-1920s, cities like Miami, Miami Beach, Coral Gables as well as Florida communities on the Gulf Coast became the focus of intense speculative activity. Robert Shiller (June 2007) notes that real estate booms in states such as California and Florida were frequent occurrences starting in the 19th and early 20th Centuries, but the more recent booms have taken on a national character.

John Kenneth Galbraith, writing in his 1954 classic “The Great Crash, 1929,” describes how parcels of land in Florida were divided into building lots and sold for a mere 10% down payment. In effect, Americans of the early 1920s were trading options on FL real estate. Charles Ponzi, the great American fraudster and namesake of the financial pyramid scheme, was actively involved in selling parcels of land in Florida to a steadily growing flow of investors until 1927, when the tide of new investors peaked and the FL property market began to crack.

The speculative nature of real estate in the 19th and early 20th Centuries came about partly because there was no mortgage market to promote stable home ownership. The primary sources of mortgage funding were title companies, commercial banks, and thrifts. The availability and pricing for mortgage loans varied widely across the country. Most mortgages were short-term loans with little liquidity.

Green and Wachter (2005) note that prior to the Great Depression, there was no formal housing finance market. “The U.S. mortgage before the 1930s would be nearly unrecognizable today: it featured variable interest rates, high down payments and short maturities,” they write. “Before the Great Depression, homeowners typically renegotiated their loans every year.”

More important, mortgage debt was barely measurable when compared with the size of the US economy. Whereas in the early 1900s, mortgage debt was less than 5% of GDP, by 2004 total mortgage debt had risen to almost 70% of annual economic output. Home mortgages, when they could be obtained, had loan-to-value (LTV) ratios of less than 50%, but even these conservative instruments did not protect lenders when real estate valuations fell by more than half in the 1930s. By the end of WWII, America’s housing stock was worth just \$6.6 billion or about 10 percent less than at the start of the Great Depression, even though the number of households had grown by 25%.

The Great Depression

The Great Crash of 1929 was actually the final crescendo of a period of financial boom and bust that began to end with the collapse of the FL real estate market in the mid-1920s. The collapse of the stock markets was not the final act, however, and would lead to the catastrophe of the banking crisis of 1933, when financial institutions from Detroit to New York were closed for months and scores of private businesses failed. When President Franklin Delano Roosevelt made his famous March 1933 inauguration day utterance about Americans having “nothing to fear but fear itself,” every bank from Detroit to New York was closed and millions of people were quite literally in the streets of major US cities.

In this time of deflation and widespread unemployment, the federal government became directly involved in the housing sector and the economy as a whole on a massive scale. The focus of US housing policy in the 1930s was to stabilize prices, which fell by roughly 50% nationally during

that terrible decade of deflation. An estimated 25% of all mortgages in the US defaulted during the 1930s. The New Deal marked the conversion of the housing market from a purely private sector endeavor to a quasi-public market with the government acting as the provider of long-term financing that was unavailable from private investors.

At the request of President Herbert Hoover, Congress passed the Federal Home Loan Bank Act in 1932. The Federal Home Owner's Loan Corporation and the Federal Housing Administration (FHA) were subsequently chartered to deal with defaulted mortgages and guarantee private mortgage loans, respectively. In both cases, these agencies not only helped to stabilize home prices and liquefy the assets of banks, but ultimately operated at a profit and fully repaid the US Treasury. The twin goals of buying time for borrowers and providing liquidity to the housing markets were validated in practice.

In 1937, the US Housing Authority was created to provide long-term financing via low interest loans to support low cost housing in the cities. The following year, Congress created Fannie Mae to make a market in new FHA guaranteed mortgages and help to restore a market for both existing and new homes. The FHA was a key part of the government's support for housing and brought about major changes in the structure of the home finance market. Whereas prior to the 1930s most mortgages were short-term, interest only loans with low loan-to-value (LTV) ratios and balloon principal payments required at termination, the creation of the FHA encouraged the creation of a long term market for home mortgages with maturities as long as 20 years, amortizing structures and higher LTV ratios.

Vatter (1963) notes that much of the growth in housing from the 1930s onward was due to government spending and that the major emphasis of federal housing programs was to encourage new construction. "The credit policies and programs of Government played an indispensable part in the market demand for homes," Vatter writes. In addition to the creation of various federal agencies mentioned above to deal with the deflationary aspects of the Great Depression, the creation in 1944 of a mortgage guarantee program for veterans under the GI Bill of Rights served as a powerful stimulus for the housing sector. Instead of insuring the entire mortgage for a fee as with conventional FHA loans, the Veterans Administration guarantees part of the loan at no cost to the borrower, enabling veterans to borrow 100% of the cost of the home.

The increased participation of the US government in the housing sector from the 1930s onward must be seen in the context of the adoption of demand management in the economy as a whole. The Keynesian system of demand management that has been the dominant model of political economy in the US since the 1930s had its genesis in the interventionist arrangements of the 1930s and 1940s, when large public budgets with huge military and domestic welfare components became the norm. The evolution of American housing policy from the 1930s onward can only be understood properly by recognizing the strong support and subsidization by the federal government during this period to encourage increased employment, growth and industrial and agricultural output generally.

Post War Years

By the end of WWII, there was an enormous pent up demand for housing caused by the collapse of home finance during the great depression and the limitations placed upon many industries during the war years. Housing production soared after 1944, rising from 140,000 units to 1

million by 1946 and 2 million by 1950. A large portion of this increase came from private industries deploying private capital, but government policy clearly encouraged the growth in housing stock.

The 1950s represented not merely the satiation of pent-up demand from the war years, but the return of a speculative, gold rush mentality with respect to housing as an investment opportunity. Robert Shiller (September 2007) notes that the only time when construction activity in the U.S. was higher as a percent of GDP than it was in 2005 was the year 1950, when residential investment rose to 7.3% of GDP.

The Housing Act of 1949 set forth a National Housing Policy (NHP) with the explicit goal of providing “a decent home and suitable living environment for every American family.” The NHP also stated that the private sector should comprise “as large a part of the total market” for housing as possible and that “government assistance shall be utilized to where feasible to enable private enterprise to serve more of the total need” for housing.³

The next major piece of housing legislation in the US was the Housing Act of 1954, the first piece of housing legislation that was actually influenced by the Republicans in Congress after 20 years of Democratic control of housing policy. The Republicans essentially endorsed current housing and urban renewal policies and added the Charter Act, which set forth the framework under which Fannie Mae would operate as a mixed public/private corporation until 1968.

From 1959 through the late 1970s, five successive Republican and Democratic Presidents signed into law legislation expanding the role of government in mortgage finance and also created a network of programs to increase the supply of affordable rental housing. But by the late 1970s, rising federal deficits became a growing concern. The federal commitment to housing began to ebb and the overall rate of homeownership declined, especially among younger families. The S&L crisis of the 1980s and the tougher regulations for financial institutions further limited the opportunity to own as home as higher downpayment requirements, rising interest rates and home prices, and falling real incomes all combined to put the goal of home ownership beyond reach of many Americans.

The federal commitment to promoting affordable rental housing likewise began to suffer in the 1980s. “Starting in the 1960s, the federal government implemented a series of programs that gave private developers various incentives to develop and run low-income rental housing,” notes Alexander von Hoffman, Senior Research Fellow at the Harvard Joint Center for Housing Studies. “But these incentives – whether low-interest mortgages, rent supplements, or tax credits – all have time limits, and each year since the mid-1980s tens of thousands of them have expired, eliminating a large portion of the low-income housing stock. In addition, many of these properties have suffered the ravages of time, and required a large injection of capital to keep them habitable.”⁴

Just as the cost of home ownership has risen faster than incomes during the past several decades, the cost of rental properties have also risen, creating a squeeze on lower income Americans who

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³ See “A Decent Home,” The President’s Committee on Urban Housing, December 11, 1968

⁴ Von Hoffman, Alexander, “What is Affordable Housing & What Does it Mean to Preserve It? (Five New Case Studies),” Harvard Joint Center on Housing Studies, August 14, 2014

may not have any effective alternative to renting. The fact is that historically private investors have not been willing or able to provide a sufficient supply of affordable – that is, subsidized – housing, thus the decline of the federal commitment to housing in general has meant a decrease in the availability of affordable homes and an increase in cost overall.

The Age of Entitlement

By the 1980s, the federal government was generally withdrawing from the level of support for affordable housing seen in the previous decades, but that did not mean that the government's involvement in housing overall was decreasing. The focus of federal housing policy merely shifted from helping to provide affordable housing for returning soldiers and the poor to instead providing subsidies to middle and upper income Americans.

The Housing and Urban Development Act of 1968 reorganized Fannie Mae from a mixed ownership corporation to a for-profit, shareholder-owned company. This change removed Fannie Mae from the federal budget, a key objective of the Administration of President Lyndon Johnson because of growing concerns about federal budget deficits and the cost of the Vietnam War. Fannie Mae began funding its operations through the private stock and bond markets, although the taxpayer still ultimately bore the implicit risk in the GSE's balance sheet. It is important to note that since the 1968 privatization, the US taxpayer was not compensated for the implicit value of the federal guarantee on the debt of the GSEs.

The 1968 HUD Act also created the Government National Mortgage Association (Ginnie Mae), which was established as a government owned corporation within HUD. Unlike Fannie Mae and Freddie Mac, Ginnie Mae guarantees timely payment of principal and interest on privately issued mortgage-backed securities (MBS) collateralized by FHA, VA, or other government insured or guaranteed mortgages.

In 1970, Congress passed the Emergency Home Finance Act (EHFA), which established Freddie Mac to help thrifts manage the interest rate risk which would ultimately destroy the savings & loan industry. Unlike Fannie Mae, which purchased mortgages and kept them in portfolio, Freddie Mac purchased and securitized mortgage loans originated by thrifts. The EHFA also allowed Fannie Mae and Freddie Mac to purchase mortgages that were not guaranteed by the government. Freddie Mac issued its first conventional residential MBS in 1971.

The high interest rates and inflation seen during the 1970s had a devastating impact on both the thrift industry and Fannie Mae, but the response from Congress was to give the housing finance sector even greater latitude in terms of risk taking. By the recession of the early 1980s, much of the thrift industry was headed for insolvency. The Garn-St. Germain Depository Institutions Act of 1982 allowed thrifts to diversify into more risky investments, a disastrous turn in public policy that only hastened the demise of many S&L institutions.

The 1980s also saw both Fannie and Freddie move from being mere guarantors of mortgages to being issuers of mortgage-backed securities (MBS). Fannie Mae issued its first MBS in 1983, ostensibly to “compartmentalize prepayment risk and better addresses investment time frames and cash-flow needs” notes Kelman (2002), but this evolution also cemented the GSEs monopoly on the issuance of prime mortgage securities. Because of the implicit guarantee from

the US Treasury, no bank or non-bank issuer of MBS can compete with a GSE in terms of short-term funding cost or execution in the bond market.

By 1989, the federal deposit insurance fund for thrifts (as well as the remaining state run deposit schemes) was insolvent. In response to the growing crisis in the thrift industry, in 1989 Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). FIRREA created a new thrift insurance fund (which would eventually merge with the Federal Deposit Insurance Corporation) and created the Resolution Trust Corporation to resolve all troubled financial institutions placed into conservatorship or receivership.

FIRREA also reorganized Freddie Mac's corporate structure to one similar to Fannie Mae's, making it a for-profit corporation nominally owned by private shareholders rather than by the Federal Home Loan Banks. Significantly, FIRREA also restructured the regulatory framework for FHLBs and greatly expanded the membership of the system, which increased between 1989 and 2005 from 3,200 members to more than 8,000 member institutions. The total assets of the FHLBs grew from approximately \$175 billion in 1990 to \$1 trillion by 2005, making the FHLBs together the largest of the GSEs and an important source of liquidity for banks. The FHLBs contributed to the subprime crisis of 2008, but then provided an important funding backstop for banks in the immediate aftermath of the financial market collapse.

The savings and loan crisis cost taxpayers about \$125 billion and the thrift industry \$29 billion. More important, the S&L crisis sharply curtailed the supply of credit available to the housing sector, but Washington soon responded with another surge of public policy prescriptions to stimulate both home building and home ownership. The first step in the federal effort to boost the housing sector came with the evolution of the GSEs into direct issuers of MBS in the 1980s, effectively replacing the financing capacity lost with the implosion of the thrift industry. The second phase came in the 1990s, as many of the established rules for mortgage lending were gradually discarded.

In a prescient paper, Rosner (2001) noted that most of the traditional prudential requirements and safeguards regarding credit quality in mortgage lending were discarded in the 1990s. He wrote:

In 1989 only 7 percent of home mortgages were made with less than 10 percent down payment. By August 1994, low down payment mortgage loans had increased to 29 percent. This trend continued unabated throughout the 1990s so by 1999, over 50 % of mortgages had down payments of less than 10%. In 1976 the average down payment by first time homebuyers was 18%, by 1999 that down payment had fallen to 12.6%.⁷ In 1999, more than 5% of all residential mortgages had no equity or had negative home-equity. Eliminating down payment barriers has created a homeownership option for Americans who previously were forced to rent, due to savings or credit issues.

In the 2011 book "Reckless Endangerment," Morgenson and Rosner note that in 1993 the Clinton Administration embarked on a major initiative to increase homeownership. By no coincidence in that same year, the Census Bureau recommended lowering down payment requirements and increasing available down payment subsidies. In early 1994, HUD Secretary Henry Cisneros met with leaders of major national organizations from the housing industry to craft a national approach to the housing slump. By early fall, the Clinton Administration, along

with over 50 public and private organizations agreed on ‘working groups’, a basic framework and the core objectives of what they named the “National Homeownership Strategy” or NHS.

The primary goal of the NHS was “reaching all-time high national homeownership levels by the end of the century.” This was to be achieved by “making homeownership more affordable, expanding creative financing, simplifying the home buying process, reducing transaction costs, changing conventional methods of design and building less expensive houses, among other means”. Rosner notes that “it was almost unprecedented for regulators to partner this closely with those that they have been charged to regulate.”

And the NHS was successful. Homeownership began to rise in 1995 and continued to rise through the late 1990’s. Existing home sales grew from 27.5 million units in the 1970’s to 29.8 million units in the 1980’s and ended the 1990’s at 40 million units. New home sales grew from 6.5 million units in the 1970’s to 6.1 million units in the 1980’s and ended the 1990’s at 7.0 million. By 2000, US homeownership exceeded 67% and would continue to climb to almost 70% by the eve of the 2008 collapse of the US financial markets.

While some analysts have attributed the 2008 financial crisis to the excessive expansion of home ownership by lower income borrowers, in fact the housing boom of the 2000s also contained some important attributes of previous housing bubbles going back almost a century. Leibowitz (2010) notes:

[I]n an attempt to increase homeownership, particularly by minorities and the less affluent, an attack on underwriting standards was undertaken by virtually every branch of the government since the early 1990s. The decline in mortgage underwriting standards was universally praised as an ‘innovation’ in mortgage lending by regulators, academic specialists, GSEs, and housing activists. This weakening of underwriting standards succeeded in increasing home ownership and also the price of housing, helping to lead to a housing price bubble. The bubble increased the number of housing speculators with estimates indicating that one quarter of all home sales were speculative sales prior to the bubble bursting.

The key point about the housing boom of the 2000s is that it was driven by a deliberate change in government policy toward bank lending, regulation of the GSEs and the prudential standards applied to financial institutions – in some cases going back two decades before. In 2000, for example, the FDIC adopted a safe harbor for “true sales” by insured depository institutions that provided the largest banks with carte blanche to engage in unsafe and unsound mortgage securitization practices.⁵ These changes caused volumes of home sales, mortgage lending and MBS issuance to rise to record and clearly unsustainable levels.

In a stark illustration, from a peak of \$3.8 trillion in 2003 and \$3 trillion in 2006, residential mortgage lending volumes for 2014 barely reach \$1.2 trillion according to the Mortgage Bankers Association. Clearly the sharp decline in originations from the peak levels seen in 2004, three years prior to the crisis, represents a withdrawal of poorly conceived “affordability” products that drove home ownership rates to historical highs and are not expected to return. The average FICO score of loans currently being purchased by Fannie Mae and Freddie Mac is over 700,

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⁵ See “Capital Requirements for Non-Bank Mortgage Companies,” *Kroll Bond Rating Agency*, May 28, 2014

leaving the FHA as the only significant buyer of below-prime loan risk at present. This risk averse tendency on the part of the GSEs and investors may change over the medium term, but it seems pretty clear that we will not soon see a repeat of the policy and demographic factors which led to the housing boom of the 2000s.

The Credit Standing of the GSEs

When the financial crisis erupted in 2008, the GSEs were badly decapitalized and a number of FHLBs suffered significant portfolio losses that caused them to report net cumulative losses in 2009. Through 2008, the GSEs and FHLBs extended hundreds of billions of dollars in incremental credit to support subprime RMBS and with catastrophic results. In July 2008, when Treasury Secretary Hank Paulson asked Congress to explicitly guarantee \$25 billion in GSE debt, in retrospect a profoundly misguided request, markets reacted negatively, and investors and counterparties backed away from the GSEs. Both enterprises failed several months later.

Winston Sale notes that “while well intended, the GSEs affordable housing missions were a major contributing factor to their decline.”⁶ It is fair to say, however, that private lenders, financial institutions and investors also contributed to the crisis. Christopher Lewis Peterson concludes that “although the GSEs began to engage in unacceptably risky investment decisions, the two companies were only one part of a larger more complex commercial and regulatory pattern that also included monetary policy, regulatory dereliction, judicial passivity, ill-advised borrowing, and reckless (or dishonest) brokering, appraising, lending, servicing, and securitizing by private financial services companies.”⁷

The Housing and Economic Recovery Act (HERA) was enacted on July 30, 2008. HERA created the Federal Housing Finance Agency (FHFA) as the latest regulator of the GSEs. Less than six weeks later, as a result of spiraling losses and deteriorating market liquidity for GSE debt, the FHFA placed Fannie Mae and Freddie Mac into conservatorships, where they remain today. Since 2008, the U.S. Treasury has injected \$187 billion into the GSEs via preferred equity. Today, Fannie Mae and Freddie Mac are required to pay 100% of their earnings to the Treasury as dividends to compensate taxpayers for the continuing capital support, both in terms of the preferred equity invested and the explicit credit support of the United States.

While in theory the two GSEs became “private” companies after they sold common equity and preferred equity to private investors decades ago, in fact they were always treated as instrumentalities of the United States. Even after the initial public offerings of Fannie Mae and Freddie Mac, officials of the Federal Reserve System and U.S. Treasury routinely told officials of foreign central banks that the enterprises were implicitly supported by the full faith and credit of the United States. The fact of a credit line from the U.S. Treasury supporting the GSEs gave substance to these representations in the eyes of many foreign central banks.

Because of the fact that the U.S. government has never “loosed dominion” over the GSEs, to paraphrase the U.S. Supreme Court, the assumption that Fannie Mae and Freddie Mac are private

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⁶ 8 Sale, Winston. “Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing.” *Journal of Affordable Housing & Community Development Law*, vol. 18, no. 3, 2009, pp. 287–319

⁷ Peterson, Christopher Lewis, Fannie Mae, Freddie Mac, and the Home Mortgage Foreclosure Crisis (April 1, 2009). *Loyola University New Orleans Journal of Public Interest Law*, Vol. 10, pp. 149-170, 2009. Available at SSRN: <https://ssrn.com/abstract=1489110>

entities remains suspect. The U.S. government has never relinquished effective control over the GSEs, more so today under HERA than ever before. In the event that a financial transaction fails the test of a “true sale,” then the only other possible characterization for the transaction is secured debt. Seen from this perspective, the ersatz private shareholders of the GSEs are not equity holders at all, but rather creditors, and should seek redress from the courts on that basis.

More, historically the credit agencies assigned AAA credit ratings to Fannie Mae and Freddie Mac on the assumption that each enjoyed the sovereign support of the United States. In a November 15, 1982 letter from Treasury Assistant Secretary Roger Mehle, the Treasury confirmed the “special status” of the GSEs, a status which effectively qualifies their claim to be private companies. Based on this opinion, the credit rating agencies assigned AAA ratings to Fannie Mae, Freddie Mac and Sallie Mae, in one instance, “based on an individual analysis of the financial strength of each entity and its relationship with the U.S. government.”⁸

Many credit analysts take the view that Fannie Mae and Freddie Mac are, in fact, sovereign entities for the purpose of credit risk. That said, since 2008, many foreign central banks have refused to invest in the debt securities of Fannie Mae and Freddie Mac, although they do readily accept the obligations of the FHLBs and Ginnie Mae. Foreign central banks simply do not feel comfortable holding the obligations of these particular GSEs, even in conservatorship.

One of the more specious arguments advanced in the continuing debate over GSE reform is the idea that Fannie Mae and Freddie Mac need to accumulate private capital in order to protect taxpayers. In fact, taxpayers already have almost \$190 billion in capital invested in the GSEs. This capital infusion and the further credit support of the U.S. Treasury allows the GSEs to operate today. Keeping the two GSEs afloat cost taxpayers \$187 billion over time, making it the largest financial bailout in U.S. history. Indeed, in February of 2018 the Treasury was forced to once again advance capital support to Fannie Mae because the dividend payments to Treasury left the GSE undercapitalized.

Alex Pollock of the R Street Institute in Washington put the situation with the GSEs into sharp relief in a 2016 commentary for The Urban Institute:

“The giant American housing finance sector is as important politically as it is financially, which makes it hard to reform. From the 1980s on, it was unique in the world for its overreliance on the “government-sponsored enterprises” (“GSEs), Fannie Mae and Freddie Mac—privately owned but privileged and with “implicit” government guarantees. According to Fannie and Freddie, their lobbyists, and members of Congress reading scripts from Fannie in its former days of power and glory, this made American housing finance “the envy of the world.” In fact it didn’t, and the rest of the world did not experience such envy. But Fannie and Freddie did attract investment from the rest of the world, which correctly saw them as U.S. government credit with a higher yield: this channeled the savings of thrifty Chinese and others into helping inflate American house prices into their historic bubble. Fannie and Freddie were a highly concentrated point of systemic vulnerability.”

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⁸ November 15, 1982 letter from Roger W. Mehle, Assistant Secretary, U.S. Treasury to Robert Mebus of Standard & Poor’s. S&P subsequently assigned a “AAA” rating to the senior debt and mortgage backed securities issued by Fannie Mae and Freddie Mac based upon “an individual analysis of the financial strength of each entity and its relationship with the U.S. Government.”

Housing in the 21st Century

Since the Great Depression, the US government has played a primary role in the market for financial residential housing. The existence of GSEs focused on guaranteeing and providing liquidity for mortgage loans explains a great deal of the growth in the US housing market since the 1930s. Conversely, the private capital markets have played a relatively secondary role, providing risk-free capital to the GSEs and receiving supra-normal returns. Indeed, the only period in the past 80 plus years when private capital actually began to compete with the GSEs for market share in below prime loans came in the mid-2000s and was arguably driven by market arbitrage and gain-on-sale opportunities for private banks that are unlikely to be replicated.

As policy makers and investors consider the prospects for future housing reform, two conclusions seem to stand out from the historical experience. First, the market for providing mortgage credit to low and middle income borrowers requires substantial subsidies from higher income borrowers, either directly or via government programs. Without aggressive government policy to subsidize and encourage home ownership by lower income borrowers, the markets naturally tend to gravitate towards providing credit to prime borrowers with little probability of default. The notion that private investors are willing to take first loss credit as well as market risk on single family mortgages held by the most risky borrowers seems to be belied by eight decades of US financial history.

The second conclusion is that when government policy does turn toward encouraging home purchases, the markets seem to naturally take on a speculative character that puts financial institutions, investors and the taxpayer at considerable risk. The common thread seen in the housing booms of the 1920s, the 1950s, the 1980s and 2000s is that when government subsidies and credit are plentiful, Americans will take full advantage. The fact that a significant portion of the total home purchases of the 2000s were speculative investments in second homes illustrates the free rider, gold rush tendencies of the American population are still alive and well as the nation enters its third century. Crafting housing policies that avoid this reality will be a challenge and may well require that the role of government in the housing market in future be tightly defined and controlled.

With that said, Americans show no particular appetite for restraint when it comes to government spending, including the consumption of federal housing subsidies. The most recently passed tax cuts and spending measures seem to ensure that inflation as measured by prices for residential and commercial real estate will continue to be an important factor in housing finance, begging the question as to whether the degree of federal support can be reduced at all.

One of the most significant drivers of change in the world of housing finance over the past century is inflation. While the heavily qualified statistics published by the federal government tell us that “core” inflation is less than 3 percent, home prices have been rising at double digits in many markets for much of the past decade. Unceasing, endemic inflation – what former Federal Reserve Board Chairman William McChesney Martin called “a thief in the night” – is a key backdrop to the discussion of housing finance.

Because of steadily rising home prices, ever more aggressive and financially unsound means of financing home purchases have been required to keep pace with the true rate of inflation. The chart below shows annualized average changes in home prices from 1977 through the end of 2017 published by CoreLogic.

Note the upward surge in average home prices during 2012-2014, which was due to the work-out of distressed mortgages. Closing the gap between the deeply discounted value of foreclosed homes and normal sales accounted for a lot of the price gains reported during this period. The more subdued average home price action in many coastal markets since 2014, however, is still a multiple of the official inflation statistics coming from Washington.

Despite policies from the Federal Housing Administration and Federal Open Market Committee meant to boost house finance, regulation and extremely tight secondary market terms are hurting profitability and employment in the mortgage industry. Total mortgage originations have been falling since 2016 and are likely to reach just \$1.5 trillion in 2018. Most of the credit flowing from Washington is going to consumers buying larger homes rather than first time home buyers. Meanwhile, prices for mortgage servicing rights (MSRs) are still trading at a discount to the underlying collateral, illustrating one of the most important deficiencies in the world of housing finance, namely the high cost of private capital in what is a heavily subsidized marketplace.

At the start of 2018, mortgage industry observer Rob Chrisman wrote of colleagues working “in a business where many are experiencing contracting volumes and contracting margins. Bank of the Ozarks of Little Rock will stop originating home loans for resale on the secondary market, a line of business that had ‘operated at essentially break-even’... Every company is taking a hard look at the continued high cost of originating loans, regardless of channel, and evaluating profitability. Watch for plenty of changes in 2018.”

The chart below shows net lending production profits published by the Mortgage Bankers Association from 2012 through Q3 2017. The chart shows that mortgage industry profits are at the lowest levels since 2014.

With Mel Watt, head of the Federal Housing Finance Administration, leaving office in less than a year, speculation about the chances for reform of the housing enterprises, particularly Fannie Mae and Freddie Mac, has grown over the past several months. In a letter from Watt to members of the Senate Banking Committee regarding his views of GSE reform, the former congressman suggested that the two GSEs be turned into utilities.

“Watt said that once they are returned to the private sector, Fannie and Freddie would be the first two ‘secondary market entities’ able to issue government-guaranteed mortgaged backed securities as a common security that has a mandated rate of return set by a regulator,” *American Banker* reports.

If, as Watt suggests, the idea is to have two “private” utilities with a government backstop for catastrophic risks, then that is what we have today. The two enterprises have government ownership with private capital standing in front of the taxpayer in the form of risk sharing transactions. The key flaw in both Watt’s plan and other proposal for recapitalizing and reprivatizing the GSEs is the role assigned for private equity capital in the “privatized” Fannie Mae and Freddie Mac.

If Congress wants to privatize the GSEs and bring private capital into the mortgage industry, then they should note that today mortgage companies trade well below book value in the global equity markets. There is no apparent utility in providing two more large, independent mortgage banks to an industry that is already struggling with profitability issues. If true privatization is the object of GSE reform, then the last thing the mortgage sector needs right now is Fannie Mae and Freddie Mac in drag, pretending to be private finance companies. All ties between the federal government and the GSEs must be severed to make “privatization” a reality.

Instead of continuing the strange pretense of the “private” GSEs, it would be better to simply liquidate the two enterprises and focus the distribution of all government housing subsidies on

the FHA and Ginnie Mae, as suggested in several alternative plans proposed by the House of Representatives. The US government through the FHA would offer insurance on eligible loans held by any issuer without providing a backstop for the corporation. The private bank or non-bank would then sell the mortgage backed securities to investors, with either GNMA cover, private insurance or no insurance at all.

As today, higher quality mortgages such as prime jumbos would not require any government insurance cover whatsoever, but the real opportunity facing us today is to privatize the 60% of the market now served by the GSEs. If you think of the mortgage market today, 25% of all mortgage loans are held by banks in portfolio with no government insurance cover, about 50% (mostly prime loans) are guaranteed by Fannie Mae and Freddie Mac, and the rest of the market (including below prime loans) are covered by the US government via the FHA and GNMA.

Private investors could easily accept uninsured prime mortgage securities now covered by the GSEs and do so at a lower cost to consumers. Some three quarters of all GSE-insured loans today have FICO scores above 720, quality loans that private investors would readily accept. The pricing for Fannie Mae's risk transfer deals calculated by Well Fargo suggests that virtually all of the default risk from GSE mortgage exposures could be underwritten by the private sector and at a cost that is a fraction of the guarantee fees charged today by the GSEs. Whereas in the 1930s the GSEs were needed to create a market in residential mortgages, today it seems pretty clear that private banks and investors would be willing to support at least half of total mortgage issuance at prices that are competitive to GSE-insured mortgages.

The missing ingredient is a proposal from the White House and the Treasury to move the reform process forward. House Financial Services Committee Chairman Jeb Hensarling (R-TX) has expressed a preference for eliminating Fannie Mae and Freddie Mac, and moving all of the government's housing subsidies to a revamped Ginnie Mae. "To be clear, Fannie Mae and Freddie Mac must be wound down and their charters repealed," argues Hensarling, who is retiring from Congress this year. "I fear any plan to recap and release the GSEs may very well constitute déjà vu all over again."

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