MERCATUS CENTER AT GEORGE MASON UNIVERSITY
GOVERNMENT-SPONSORED ENTERPRISES (GSE) SYMPOSIUM: REFORMING FANNIE & FREDDIE

	"The Future of Fannie Mae and Freddie Mac" Anthony Sanders and Michael Lea	"Two Approaches to GSE Reform" Arnold Kling	"A New Housing Finance System for the United States" Peter Wallison	"Reforming the U.S. Mortgage Market Through Private Market Incentives" Dwight Jaffee	"The Way Forward: Residential Mortgage Finance in a Post-GSE World" Lawrence J. White
Key Points	• Government guarantee not necessary to entice private investors to purchase mortgage-backed securities • GSEs have crowded out private-sector secondary-mortgage market • There is nothing unique about the GSEs that the private sector could not also provide under the right conditions	• Best approach to reform: phase out GSEs over a 3–5 year period • Allow alternate channels of mortgage financing to evolve	• Government involvement in U.S. housing market inevitably involves losses to taxpayers but produces few benefits • U.S. housing market will function well without GSEs; government backing not needed for 30-year mortgages • Benefits of the GSE structure have already been realized • Success of Jumbo market points to crowding-out effect of the conforming market • High-quality mortgages will ensure a liquid and robust market in absence of government guarantee	• GSEs create costs to taxpayers that far exceed expected benefits • Private incentives and institutions are sufficient to create a functional and efficient mortgage market • Western European countries provide model of housing markets with comparable home ownership but with minimal government intervention	• Don't use financial system to address social externalities, low-income housing goals, or maintenance of residential-property housing values • Don't use system to support employment in home building, real estate, or mortgage lending
Reforms	• Reduce conforming loan limit by 10% in first year; after a review, and if house prices remain stable, continue 10% decrease until new limit reaches 50% of original • By the end of the fifth year, no more purchasing or insuring mortgages	Option 1 • Do away with affordable-housing goals • Require 10–20% down payment, and restrict mortgages to long-term fixed rates for well-qualified borrowers	• Reduce GSEs' conforming loan limit by 20% per year • After three years, a formal review would take place, and unless Congress votes otherwise, reductions would continue until terminated after year five • Prevent GSEs from buying anymore mortgage-backed securities as they are winding down	• Gradually reduce conforming loan limit by $100,000 per year over seven years • Existing GSE balance sheet would run off over same time • Retain FHA & HUD programs to support low-income and first-time homebuyers	Option 1 • Rely on increased financing through depository institutions and private-label securitization • Reduce conforming loan limits by 10% per year • Increase GSEs guarantee fees by 5 basis points/year until it is 25 basis points higher

	• Immediately cease affordable-housing goals; at no time during the five-year sunset will GSEs be allowed to purchase non-prime, low down payment mortgages • The current portfolios should be immediately frozen to new additions; transfer (or sell) the portfolio to the Fed, who would finance this purchase through sales of some existing Treasury holdings • Under Fed supervision, the portfolios will be unwound (sold or allowed to run off) over five years or more • Prohibit any non-mortgage investments during sunset period • Continue FHA/HUD affordable-housing programs	• Re-offer GSE equity through IPO; old shareholders would be wiped out permanently. • Create separate "bad bank" to hold low-quality/ nonperforming mortgage portfolio • Oversight by Treasury Option 2 • Phase out GSEs over 3–5 years • Allow private sector to develop alternative to GSEs • Return of traditional local bank funding and holding of mortgages • Require additional monitoring of interest rate risk among banks; constant verification of safety and soundness of institutions	• Create liquidating trust w/ Treasury securities to guaranty remaining liabilities; when last mortgage is refinanced or sold, all remaining net worth shortfall would be borne by taxpayers • May only invest in short-term Treasury bills • GSE "nonfinancial capital" would be auctioned off with proceeds going to Treasury to offset final net losses • FHA continues to insure low-income borrowers, but commitments will be on budget and transparent • Congress would set prudent standards for FHA mortgages: minimum FICO and down payments, maximum home price • Ensure liquidity of MBS market and discourage bubbles by regulating securitized mortgages to require (1) 10–20 percent down payment, (2) debt-to-income ratio of no more than 38 percent, and (3) FICO score of at least 660	• Expand regulatory oversight of depository institutions with regard to all their mortgage funding/investing activities • "Covered Bonds" • If not a private market, allow government to guarantee conforming mortgages	• Stricter prudential regulation including higher capital standards • Limited role for Ginnie Mae as securitizer of FHA/VA loans Option 2 • The government would offer side-by-side insurance alongside private mortgage guarantors. • Initial ratio would be 25% private, 75% government; government pricing would be entirely passive, simply matching the corresponding private insurance rate • Insurance would only be applied to suitable prime mortgages and would not be mandatory • As capital returns to the market, government would reduce its share until it is zeroed out
Outcomes/ Predictions	• Higher mortgage rates: 50–100 basis points in the short-run, 40–100 points in the long run • Home prices would fall slightly • More short-term and variable-rate mortgages	Option1 • Maintains ability to channel global capital for U.S. home ownership • Reduce ability of consumers to repeatedly refinance at lower rates	• Private securitization will take over as GSEs wind-down • Prime mortgages will increase share of market again and find large demand for such assets	• More choice in mortgage products (type of rates, prepayment penalties, recourse, etc.) • Private sector will provide stability and access to mortgage credit • Contract standards would be set by private market	• Government crowd out would be reduced and a well functioning mortgage financing system would remain • 30-year fixed-rate mortgage would remain the staple of the market

	• Marginally lower homeownership rates—lower consumption of housing • Safer mortgages would be a higher share of the market due to higher down payments • Alternative capital will enter the market as rates rise on higher quality mortgages • Banks will hold more mortgage on their own balance sheet	• Availability of government provision of emergency funding would still be necessary <u>Option 2</u> • Reduction in number of 30-year fixed-rate mortgages • Shift toward variable rate and five-year rollover mortgages • Increase in average down payment		• Expanded private mortgage insurance market	• Risks reduced through more transparent tranching, expanded private mortgage insurance, and/or CDS hedging • 25 basis point increase in rates