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

<table>
<tr><th></th><th>“The Future of Fannie Mae and Freddie Mac”

Anthony Sanders and Michael Lea</th><th>“Two Approaches to GSE Reform”

Arnold Kling</th><th>“A New Housing Finance System for the United States”

Peter Wallison</th><th>“Reforming the U.S. Mortgage Market Through Private Market Incentives”

Dwight Jaffee</th><th>“The Way Forward: Residential Mortgage Finance in a Post-GSE World”

Larry White</th></tr>
<tr><td>Key Points</td><td>• 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</td><td>• Best approach to reform: phase out GSEs over a 3–5 year period

• Allow alternate channels of mortgage financing to evolve</td><td>• 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</td><td>• 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</td><td>• 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</td></tr>
<tr><td>Reforms</td><td>• 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</td><td><u>Option 1</u>

• Do away with affordable-housing goals

• Require 10–20% down payment, and restrict mortgages to long-term fixed rates for well-qualified borrowers</td><td>• 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</td><td>• 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</td><td><u>Option 1</u>

• 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</td></tr>
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	• 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 <u>Option 2</u> • 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 <u>Option 2</u> • 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	<u>Option1</u> • 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

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