
GSE Reform: Not So Fast



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AUGUST 2014

Like so many issues in Washington these days, the debate over what to do with the nation's housing Government Sponsored Enterprises (GSE)—Fannie Mae and Freddie Mac—has been caught up in the Jihad against the role of government in any form.

That's a shame because last spring, with the announcement from Senate Banking Committee Chairman Tim Johnson (D-S.D.) and ranking member Mike Crapo (R-Idaho) of a bipartisan bill to reform the nation's housing finance system, it appeared that the question of what to do with Fannie Mae and Freddie Mac had finally been answered.

Instead, the Johnson-Crapo bill became another victim of ultra-right ideology, as strident opposition to anything short of the elimination of any government role in the mortgage backed securities marketplace remains unacceptable to House Republicans. Their approach—which was incorporated in the PATH Act (which passed the House last year), proposed virtually eliminating the Federal guarantee of mortgages in five years.

That's not to say the Johnson-Crapo bill was perfect by any means. Compromise isn't about creating the best solution, but rather a better solution than the status quo.

Ironically, House Republican opposition to Johnson-Crapo or any other solution, which includes the government serving as a limited backstop in the housing finance marketplace, has weakened the position of the Republican Right and has had the perverse effect of continuing the nationalization of housing finance. Conservatives, because of their blind adherence to their ideology, have, paradoxically, ensured that Fannie and Freddie will remain wards of the state for the foreseeable future.

In fact, shortly after taking over as head of the Federal Housing Finance Administration, Mel Watt stated at a conference at the Brookings Institution that "I don't think it's FHFA's role to contract the footprint of Fannie and Freddie," and that winding down the companies without clear proof that private investors are willing to step back in "would be irresponsible."

In May, Watt underscored that he does not see it as his role to end the Government's conservatorship of the GSEs. Said Watt: "I don't think about it in terms of taking steps to end the conservatorship. The statute would tell us to back out, and the statute doesn't tell us to back out. It tells us to continue to create a national resilient housing finance market in this country. That roll is there until Congress tells us that it is not there anymore. So I never think about it in terms of how am I going to end this."¹

Would keeping the status quo be so bad? A compromise that would settle the future of Fannie and Freddie once and for all along the lines of Johnson-Crapo would be a more optimal outcome, in large part because it would provide a permanent solution for the housing industry which has lived with uncertainty since the 2008 financial crisis erupted. But given the role of housing in the economy, the current situation is preferable to the vision of ideologues on the Right who believe that contrary to historical evidence, the private sector can and will fulfill the role of Fannie and Freddie.

The secondary market allows participants in our mortgage system to access capital from investors in the United States and around the world. Any decline in the size of the secondary market would reduce the amount of capital available for mortgage lending and, in turn, borrowers' options for financing the purchase of a home. This would further weaken an economy that is already tenuous.

While bank balance sheets are technically large enough to hold all the mortgages now outstanding—\$13.1 trillion—neither the bank nor its federal and state regulators would want to see such a concentration of risk.

Pension funds and insurance companies are also unlikely to step in and meet the demand should Fannie and Freddie disappear. At present, these financial entities only hold a fraction of their assets in mortgages, with life insurance companies being the biggest actor.

Then there is the question of money, or what Fannie and Freddie have and continue to pay the Federal government. While there is a debate as to whether or not the GSEs still owe the taxpayers (those on the right argue the government bailout has been repaid, others argue that calculation does not take into account repayment of the government's stock holdings as well as income forgone), the fact is that both entities have provided significant revenues in recent years that have helped mask the true cost of the deficit.

But despite some short-term benefits, it is not a good idea for the government to nationalize this function because it creates the potential for economic distortions and sets a troublesome precedent.

There are other reasons why it would be a mistake for the GSEs to remain under government conservatorship long term. First, the cost of recapitalizing both institutions could require taxpayer funding because the current revenue being generated by both entities would be hard to maintain and could take 20 years according to Treasury officials.² Second, both companies are required by laws to shrink their loan portfolios by 15 percent a year. This will reduce the amount of revenue transferred to the Treasury, as well as decrease the impact of the GSEs in the housing market. Finally, leaving the future of the GSEs unresolved will continue to hamper the housing recovery and the economy as a whole.

So while the pro-GSE forces have time on their side, the clock is ticking for the GSEs and the health of the housing sector. What is needed is a compromise solution. For that to happen the debate over ideology must be put aside and a couple of realities must be accepted by all parties:

1. The private sector is not capable of stepping in for Fannie and Freddie, so a role for them (albeit scaled-back to help ensure taxpayers are not on the hook again for another bailout), or something along the lines proposed in Johnson-Crapo is necessary.
2. The housing finance industry must be responsible for any future bailouts, not taxpayers.

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3. Affordable housing should continue to be a priority for the GSEs (or their replacement), but that goal must be balanced against safety and protection of taxpayers.
 4. The new housing finance system should be regulated and vigorously supervised. But the emphasis should not be on paperwork but rather safety and soundness.
 5. The housing sector is one of the most important contributors to economic growth and prosperity, and expanding homeownership should remain a goal of public policy.

In the end, a compromise actually would give both sides what they want. For Republicans, a deal along the lines suggested above could end the nationalization of housing finance. For Democrats, it would ensure working families would continue to have access to affordable housing. Best of all, it would show that Washington is not completely dysfunctional.

Endnotes

¹ Nick Timiraos, “Mel Watt: Here’s How I’ll Run Fannie and Freddie,” *Wall Street Journal*, May 16, 2014: <http://blogs.wsj.com/economics/2014/05/16/mel-watt-heres-how-ill-run-fannie-and-freddie/>.

² “UPDATE 2-Recapitalizing Fannie, Freddie not viable -Treasury official,” *Reuters*, June 13, 2014: <http://www.reuters.com/article/2014/06/13/usa-housing-idUSL2NoOUoJY20140613>.

About the Author

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