THIRD WAY

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It's Time to Act on Housing Finance Reform

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Nine years ago, the federal government took over Fannie Mae and Freddie Mac. It was a dramatic step but a necessary one to prevent further damage to the U.S. housing market and capital markets around the world during the financial crisis.

Unfortunately, the job isn't done. There's still one important thing left for Congress to do: determine the future of Fannie and Freddie. Housing finance reform is the final piece of the puzzle when it comes to making our financial system stronger and more resilient.

Fannie and Freddie exist to make homeownership more accessible. They do that by packaging thousands of mortgage loans into bonds called Mortgage-Backed Securities (MBS) with a promise to protect the bonds' investors if the underlying loans go bad. Although Fannie and Freddie were created as government agencies, this service was so lucrative that they eventually became public companies owned by shareholders (Fannie in 1968 and Freddie in 1989), which is why they are known as Government-Sponsored Enterprises, or GSEs. The implicit guarantee that the government would back up the GSEs' bonds differentiated Fannie and Freddie's MBS from those created by private banks.

Without the GSEs acting as intermediaries in the housing market, the interest rate on a 30-year fixed-rate mortgage would be higher—anywhere from one-quarter of a percentage point to two percentage points. And anyone with a mortgage knows that repaying the accumulated interest is an even bigger financial burden than repaying the home's purchase price. GSE securities may also increase the availability of affordable rental housing because the owners of multifamily properties benefit from securitization as well.

Because of this role, the GSEs became hugely important to the economy. If they had been banks, they would have been the fourth and fifth largest in the country at the end of 2007, when the recession was officially underway. Their failure would have been devastating to the economy. When the housing bubble popped, they were so highly leveraged with debt that they didn't have enough of a safety cushion to handle the losses on all the bonds they created. The threat was so bad that it warranted the government takeover.

The U.S. Treasury provided a $187 billion bailout, with the condition that the GSEs would be put under the control of a new regulator, the Federal Housing Finance Agency (FHFA). This oversight is called conservatorship. Additionally, the GSEs had to issue preferred stock to Treasury giving it priority over shareholders on future dividends.

It worked: The GSEs are back in the black and have more than repaid their debt to the U.S. Treasury. In fact, Fannie and Freddie have given a combined $276 billion in dividends to the Treasury through the third quarter of this year.

Despite this progress, Fannie and Freddie remain in a state of limbo, and these dividend payments have become a new source of financial strain. Conservatorship was always supposed to be temporary. It was an attempt to stem the crisis in the housing market without overstepping Congress' ultimate authority over the GSEs. The goal was just to get Fannie and Freddie through the worst of the storm until the winds cleared and Congress could take its time to develop a safer and stronger housing finance system. That would give

Congress the opportunity to consider more fundamental changes in housing finance, like increasing the role of private capital in financing MBS while maintaining mortgage affordability.

It’s been nearly a decade since then, and, despite several attempts to take on this huge task, Congress still hasn’t come to an agreement on a path forward. With Congress sitting on the sidelines, the FHFA has done what it can to reform the GSEs by strengthening risk management and underwriting practices, as well as reducing the amount of loans they hold in their portfolios. But there’s a limit to how much the agency can do without Congressional approval. Furthermore, there’s a chance that all of that work could be overturned when Director Mel Watt’s term ends in 2019.

The time to act on a long-term solution to the housing finance system is now. Several groups of policymakers, industry stakeholders, and academics have come forward with ideas that could make a difference. Congress should come to the negotiating table in a bipartisan manner, put aside unworkable schemes coming from the extremes, and take a hard look at proposals that could lead to a compromise that is sustainable for the years to come.

Congress knows that the clock is ticking. It’s time to act before it’s too late.