After Fannie and Freddie, A Role for Government In Mortgages?

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Abstract

In a contribution to the Christian Science Monitor, Donald Marron rethinks the government's participation in mortgage markets.

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The New Economy: After Fannie and Freddie, A Role for Government In Mortgages?

The United States needs a new system for financing American homeownership. The old system collapsed in 2008 when skyrocketing losses forced Fannie Mae and Freddie Mac, the two mortgage giants, into federal conservatorship. Since then, the government has backed 9 of 10 new mortgages.

That support kept mortgage credit flowing during the darkest days of the financial crisis. But the US needs to get back to a system where private investors, rather than government, evaluate mortgage risks and provide credit to home buyers. To get there, we need to rethink government's participation in mortgage markets.

Start with the hardest question: Should government participate at all?

It's tempting to say no. Many parts of the economy work just fine without direct government support. Fannie and Freddie's primary business was securitizing middle-class mortgages, which in normal times are stable, predictable investments easily handled by the private sector.

But times aren't always normal. Our government would support the mortgage market again if another crisis developed, so a fully private system seems beyond political reality. If government involvement is a given, what should it look like?

First, any government role should be clear. Fannie and Freddie were masters of exploiting the old system. When speaking to their investors, the firms touted the security of their implicit taxpayer backing. When faced with calls for tighter oversight, however, they portrayed themselves as regular private firms. That ambiguity helped them take on big risks while ducking needed oversight.

Second, taxpayers shouldn't backstop trillion-dollar hedge funds. Fannie and Freddie's most prominent business is buying mortgages, pooling them together, and selling those pools to investors with a sweetener: a promise that the firms will cover any default losses. But the two firms also boosted profits by issuing debt and using the proceeds to buy mortgages and mortgage securities. That hedge-fund-like portfolio exposed taxpayers to needless risk.

Third, the government should take a belt-and-suspenders approach to protecting taxpayers. The belt would be charging premiums that reflect the value of any government backing. The suspenders would be rigorous oversight of any private firms that get a guarantee, ensuring strong credit standards and ample capital.

Fourth, society should support affordable housing, but not through the successors to Fannie and Freddie. Homeownership is a great thing for many Americans, but not all. Congress and the White House should promote affordable housing, owned and rented, through dedicated agencies such as the Federal Housing Administration.

The Obama administration embraced many of these principles in its recent proposals to reform the housing finance market. That's a promising sign. However, it didn't settle the fundamental question of whether government should continue to guarantee middle-class mortgages.

Instead, it laid out three options. In one, the government would no longer offer any guarantees. In another, the government would sell a broad-based guarantee. In the third, the guarantee would cover only 5 to 10 percent of the marketplace, but could expand it at times of financial stress.

That third approach sounds most promising to me, although many devils lurk in the details. We want a system that can support mortgage markets in times of distress, but distorts the market as little as possible during normal times.

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Other Publications by the Authors

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