Remodeling Fannie and Freddie

By Ben Weyl, CQ Staff

Talk to anyone in Congress about how to replace the mortgage giants Fannie Mae and Freddie Mac, and almost inevitably, the troublesome "sand states" come up. Arizona, California, Florida and Nevada don't just have beaches and deserts in common, they also have similar boom-and-bust housing cycles. When the housing market collapsed in the fall of 2008, these states were hit harder than most and their recoveries continue to be painfully slow.

As a result, their delegations are likely to be a major drag on House Republicans' campaign Pledge to America to "end government control of Fannie Mae and Freddie Mac" and on the long-held dream of conservative think tanks to remove government guarantees from the mortgage market.

Killing Fannie and Freddie could raise mortgage interest rates significantly in those states, which could further destabilize the housing market, a prospect that gives pause even to Republicans who favor eliminating the housing giants.

"The home market is too important a part of the American dream to leave it to the vicissitudes of the completely unfettered, unregulated market," says **John Campbell,** a California Republican who sits on the House Financial Services Committee.
"There has to be some degree of support. It has to be smart and it has to provide consistency, and we can't have socialized losses and privatized gains — but there are ways to fix all that."

Last July, as Congress enacted the biggest rewrite of the financial regulatory system since the Great Depression, Democrats deferred action on the government-sponsored mortgage giants, which had fallen back into government hands. GOP critics were withering about the omission, blaming Fannie and Freddie for the housing crisis and calling for their dissolution.

Under the 2010 law, the administration is required to offer a long-term plan for Fannie and Freddie by the end of January, although the administration's proposal is now expected in mid-February.

The administration is likely to argue for keeping a government support system to some extent, a position shared by most congressional Democrats. Even Senate Republicans are proceeding cautiously.

A spokesman for Richard C. Shelby of Alabama, the top Republican on the Senate Banking Committee, says, "While Sen. Shelby's natural preference is to reduce the role of government in private markets, it would be premature to prescribe particular policies absent a comprehensive review."

Bob Corker, a Tennessee Republican who was a lead negotiator on last year's bill and objected to deferring action on the mortgage giants, also vows to move carefully. While he warned against putting taxpayer money at risk, Corker adds, "We all know the current system is not tenable, and my staff and I will continue to do our homework so we can approach reform thoughtfully — mistakes could have serious consequences for the economy."

Suffice it to say, the new House majority already faced a heavy lift. Unplugging Fannie and Freddie from the housing market, and removing a cheap source of capital, would be plenty difficult in the rosiest economic times. With the real estate sector still on shaky footing, GOP unity on any overhaul effort is likely to fracture along regional lines.

Douglas J. Elliott, a fellow at the Brookings Institution and former investment banker, says middle-class voters care strongly about mortgage rates, and politicians are unlikely to take chances — particularly in high-priced areas such as the sand states and New York.

“They may be more concerned in places that have the larger housing problems or where housing is more expensive in the first place,” says Elliott. “If one of the ways that Fannie and Freddie are cut back is by reducing the upper limit on the size of the mortgages that they can handle, that’s going to affect high-cost areas more than lower-cost areas.”

How It Started

Congress created Fannie Mae in 1938 to help people buy houses when loans remained tight after the bank crash, and Freddie Mac was added in 1970 to provide additional liquidity and stability to the housing market.

The two companies provide capital for mortgage loans in two ways: They buy some home loans and hold them on their balance sheets; they also buy loans and repackage them for sale to investors in the form of mortgage-backed securities that are guaranteed against default. They were able to borrow money cheaply to pay for those mortgage purchases because their bonds enjoyed an implicit government guarantee — the widespread presumption that the government would step in to back them, as proved to be true in the recent financial crisis.

Even though the companies were eventually sold to private shareholders, they continued to operate under a federal mandate to expand homeownership, taking on the moniker government-sponsored enterprises (GSEs). Many, although not all, analysts believe that the two companies are essential for keeping 30-year mortgages affordable.

But many economists, along with Republican lawmakers, warned that the companies had grown dangerously large riding their implicit government guarantee. Their worst fears were realized when the collapse of the subprime loan market crippled the housing market, producing huge losses for the firms and forcing the George W. Bush administration to seize them in September 2008.

Since then, they have cost the public roughly $150 billion, largely to cover losses related to bad loans stemming from the housing boom; the Federal Housing Finance Agency recently projected that Fannie and Freddie may need as much as $215 billion more through 2013. Conservatives blame them for inflating the housing bubble, supporting the subprime boom and risking taxpayer money.

Having retaken the House, however, leading GOP voices for privatizing the mortgage market have seemed to waver in their zeal for abrupt action.

House Financial Services Chairman Spencer Bachus, R-Ala., has likened government backing of mortgages to an addiction that can't be cured immediately.

New Jersey Republican Scott Garrett, the chairman of the House subcommittee that oversees the GSEs and a strong voice for eliminating government backing of the mortgage market, said recently that "some things can be done overnight and other things cannot be."

When industry observers got the sense that Garrett was softening his position, he quickly declared that he and his colleagues were "not backpedaling at all" on their drive to privatize Fannie and Freddie. But Garrett did acknowledge that some in his caucus, such as California Republican Gary G. Miller, were not intent on removing the government's role in the housing sector.

Barney Frank of Massachusetts, the top Democrat on the House Financial Services Committee, says Garrett's comments are "a pretty good indication that things are not going as smoothly for them as they would like," adding "I was surprised to hear that they would wait for the administration. Last year they were ready to go."

'Dial In' the Market

Some consensus is developing that dissolving Fannie and Freddie immediately would be not only difficult, but also unwise. The housing market remains sluggish, and analysts say the two companies are essential to bolstering a nascent real estate recovery. Today, the federal government, through the GSEs and other agencies such as the Federal Housing Administration, backs roughly 90 percent of new housing loans.

Texas Republican Randy Neugebauer, a leading advocate for canceling the government guarantee, recently acknowledged that federal support would have to be withdrawn gradually. At a housing conference last week, he called for incremental efforts to “dial in” the private market and “dial back” the government by reducing the upper limit for loans that Fannie and Freddie can purchase or guarantee and by increasing their guarantee fees.

Currently, the GSEs can buy home loans worth up to $729,750 through fiscal 2011 in certain high-cost markets.

Rep. Jeb Hensarling, R-Texas, has said he will introduce legislation to wind down Fannie and Freddie over the course of five years, with no government replacement. Neugebauer, a former real estate developer and bank executive, called that bill “a reasonable template to work off of,” but said the process could take as much as 10 years.

Since 2008, more than 40 percent of the nation’s foreclosures began in the sand states, according to the Mortgage Bankers Association, and the market has yet to pick up in those states.

In Florida, 19.5 percent of loans were seriously delinquent in the third quarter of 2010, meaning they were 90 days or more past due or in the process of foreclosure. Nevada had the second highest rate in the nation with 17.8 percent. The national average, on the other hand, is 8.7 percent, and North Dakota has a rate of only 1.9 percent.

“The situation is quite different in different places,” says Alex J. Pollack, a resident fellow at the American Enterprise Institute. “At least as measured by serious delinquencies, there’s quite a range.”

Pollack, who supports removing the government’s backing for mortgage loans, says he would not be surprised if lawmakers from states suffering high foreclosure rates object. “The more trouble there is, you might tend to be a bigger backer of maintaining the government guarantee,” he says.

High-Cost Regions

California's **Campbell** is not a big fan of big government. He previously led the conservative Republican Study Committee's budget and spending task force. He gives copies of Ayn Rand's "Atlas Shrugged" to his summer interns. But kicking the government out of the housing sector, he worries, would mean many of his constituents in Orange County would be unable to obtain an affordable mortgage.

"Even people buying a $1 million, $2 million, $3 million house, usually need to borrow some money to do it, and it's really hard to get some of those loans without a huge amount down," he says.
Campbell
notes that some lawmakers hail from districts where the most expensive homes fall far below the average housing price in his district. "
You have to make accommodations for those two different situations,"
he says.

Campbell could find an ally on the Financial Services panel in his California colleague Miller, who inserted a provision in the 2008 mortgage rescue law increasing the size of home loans that Fannie and Freddie could purchase and that the Federal Housing Administration could insure. Miller, through a spokesman, declined to comment.

Campbell wants to liquidate the existing GSEs immediately. In their place, he supports a public utility model, with as many as 15 or 20 private companies, perhaps organized regionally, that would be backed by an explicit government guarantee. Former Treasury Secretary Henry M. Paulson Jr., among others, has suggested something similar.

Whether lawmakers and the Obama administration can agree to overhaul this crucial, complex sector of the economy in such a highly politicized environment, including a looming presidential election, is far from certain and, perhaps, even doubtful.

But debate is likely to unify partisans far less than some of the other legislative showdowns over the last two years. **Campbell** and his allies will clash with their colleagues, and he, for one, is not prepared to back down.

“I understand there’s not unanimity of this feeling in the Republican caucus, but I feel very strongly,” he says. *“That position is not founded on the basis of ideology or belief. . . . I’ve seen these markets come and go.”*