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Rethinking Homeownership:

A Framework for 21st Century Housing Finance Reform

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EXECUTIVE SUMMARY

The government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac were significant contributors to the build-up of the housing bubble. Yet, virtually no substantive action has been taken to reform them. This delay, continuing a model that has been proven to be both bad business and problematic for the broader housing sector, is distorting the market and preventing a real recovery in housing. The GSEs must be reformed as soon as possible, as a part of a sweeping overhaul of the housing finance system.

The main goal of reform should be remove the government from is role as financer and guarantor of the housing market. This will require a shift away from the mindset that promoting affordable housing is beneficial to individuals and families. With an economy and nation as dynamic as the United States, the government should not try to use policy to try and lower interest rates or encourage people to buy homes instead of doing other things with their money.

The role of government should be to support a sustainable regulatory structure for the private sector financing of mortgages. Federal involvement in housing finance ultimately distorts the market by placing unnatural upward pressure on home prices and downward pressure on mortgage yields. This isn't a stable system that benefits taxpayers in the long run. And a reformed housing finance regulatory structure should be used to align business and consumer interests more acutely, prevent fraud and ensure the market is a just field for competition.

INTRODUCTION

The most fundamental issue facing policymakers today in the housing finance reform process is what the role of government should be in supporting the housing market. Over the past decades, Washington has attempted to use fiscal policy (and more recently even monetary policy) to lower the price of mortgages, to expand the capital available for mortgage lending,

and to increase the homeownership rate in America. Unfortunately, these policies—mixed with a range of other regulatory failures, bad business models and imprudent individual borrowing—wound up shattering the housing market and leading to the financial crisis and economic lethargy plaguing the United States today.

There can be no stable, sustainable housing market as long as public policy distorts the real supply of and demand for housing by manipulating mortgage prices and over incentivizing investment resources toward the housing sector. A change will require a whole new way of thinking about housing in America, from the goals of Washington to mortgage banking strategies to how individuals and families perceive homeownership. After looking at the history of how we got here, it is clear that the path we need to take is towards a free housing market, with the only regulatory role of the government as guardian against fraud.

The foremost way policymakers have sought to impact the housing market has been the availability of credit for mortgage borrowers. Since the founding of the Federal National Mortgage Association (Fannie Mae) in 1938 and Federal Home Loan Mortgage Corporation (Freddie Mac) in 1970, the government has been in the business of buying mortgages from originators in order to increase the capital that can be lent, which in turn lowers mortgage prices and expands homeownership.

In an unencumbered market, banks protect themselves and control risk by aligning the price of a mortgage to its risk of default—the riskier the loan, the more it costs the homebuyer, keeping those liable to default on loans out of the homeownership market, but still with access to the rental market. Unfortunately, in the attempt to lower mortgage prices the government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac incentivized lower underwriting standards that increased the number of default-prone borrowers with access to credit markets.

Starting in the 1990s the Department of Housing and Urban Development (HUD) went on a campaign to increase homeownership and "affordable housing" by mandating Fannie and Freddie expand their purchases of higher risk subprime mortgages, which increased the market for private sector lending to less qualified borrowers. As mortgages became cheaper because of the increased willingness of originators to lend, demand for housing increased, driving up prices. By putting upward pressure on home prices, these government-sponsored enterprises artificially bloated the dollar size of mortgages across the housing market.

HOUSING 101: The price of a home is directly related to the cost of a mortgage. The cheaper mortgages are, the more demand for housing increases. And increased housing demand drives up prices.

This government action attracted a deluge of resources from the global economy to America's housing market, building a bubble. And with Fannie Mae and Freddie Mac able to purchase or guarantee billions of housing debt, the cost of mortgages was pushed to unnaturally low levels, spurring even higher demand for housing.

The debt that financial institutions and households took on during the growth of the housing bubble eventually became unsustainable and contributed to the market meltdown that spilled over into the entire financial system. Three years after the credit markets began to freeze up, Federal Reserve Chairman Ben Bernanke says that the lack of credit available in the system is a main reason why problems are persisting in the housing market.[1] Thus the unintended consequence of government making homebuying artificially cheap undermined the original goal of increasing affordable housing.

And yet government hasn't learned from this mistake: Fannie Mae and Freddie Mac continue to operate their broken business model today. Even in conservatorship the GSEs remain a significant source of distortion in the housing market, preventing a real recovery in housing from taking hold.

Beginning of the End

Banks certainly made the bed they are sleeping in today. They were not forced to make the loans they issued, save for a few requirements from the Community Reinvestment Act. Nor were they forced to invest in the mortgage-backed securities (MBS) that they did. When the GSEs backed risky loans with taxpayer-

funded guarantees, they became powerful forces in the marketplace. Because mortgage issuers are often looking to sell their low- to moderate-income level mortgages to Fannie Mae and Freddie Mac, the underwriting standards that the GSEs set for mortgages they purchase simply become the de facto industry standard, flooding the market with riskier loans than wouldn't otherwise exist without the government's support.

Eventually, the housing goals and artificially low underwriting standards caught up to Fannie Mae and Freddie Mac. In 2007, both agencies began to experience serious delinquency problems, as many of the loans they had purchased or guaranteed began to fail. Banks across the industry holding mortgage debt also began to experience losses, as subprime mortgage defaults plagued the system. This instability caused credit markets to tighten on concerns that waves of losses at major financial firms from bad loans were just the tip of the iceberg.

Credit tightening, like the experience in 2007, is a natural reaction of a market attempting to "right the ship" of uncertainty and instability caused by the bad loans made from government guaranteeing billions of dollars' worth of low-cost, high-risk mortgage rates. With this tightening of credit, homeowners weren't able to refinance their overextended, unaffordable mortgages, and losses began to pile up. From 2007 to 2008 the confidence problem worsened, and financing for mortgages and other loans dried up.

Despite provision from the Federal Reserve of massive amounts of liquidity, banks have continued over the past two years to hold tightly to their capital. This means there is very little money available for mortgage borrowing. Today, the deeply troubled banks are continuing this practice, keeping the market at a standstill for three basic reasons.

First, market uncertainty has most long-term investors holding their cash and waiting for confidence to return. The Dodd-Frank Act provided a massive overhaul for banking practices, but left hundreds of rules yet to be written by regulators over the next two years. Until those rules are sorted out, banks do not know what their capital requirements will be, how they can legally trade, or what formerly acceptable operating practices will be condemned. Furthermore, the White House has continued to attack success in the marketplace and is pushing for increased taxes on earnings. All of this combined has created an uncertain marketplace that no one is sure how to navigate yet.

Second, in the meantime, banks can borrow at rates of near 0 percent from the government. They then turn around and buy Treasury bonds at marginally better rates and bank the small profit of the difference. They have no incentive to begin risky housing loans again in an unstable, uncertain housing market as long as this option is available to them.

Third, housing debt, particularly investments in mortgage-backed securities (MBS) full of nonperforming loans, remains a pervasive problem. This toxic debt weighs down the banks' balance sheets and ties up capital. Banks are also aware of a growing shadow inventory of homes—homes that have been temporarily prevented from going into foreclosure by a government refinancing program, foreclosure moratorium, or slow processing of delinquencies—that will eventually hit the market and put downward pressure on prices. This could in turn cause more homes to suffer negative equity problems, as mortgages become more than the value of the home they are paying for. Since that could create even more delinquency issues, banks are being cautious about what kind of additional debt they take on.

All of this is preventing banks from returning to their usual business of lending money into the general economy, which is a necessary step in a real recovery.

Taxpayer Bailout of GSEs

Mortgage default losses at Fannie Mae and Freddie Mac eventually became too difficult to manage and the Federal Housing Finance Authority (FHFA) brought them into federal conservatorship in September 2008. Understanding these and other distortions, as well as the accompanying regulatory failure, is important for reforming the housing finance system.

Under conservatorship, with the government directly managing Fannie Mae and Freddie Mac, the U.S. taxpayer has assumed responsibility for losses at the GSEs. As of September 2010, Fannie Mae and Freddie Mac have been given $148.3 billion from the Treasury to cover financial losses stemming from defaulting mortgages held in portfolio and guarantees

on MBS. Fannie Mae's most recent summary report showed 4.99 percent of its single-family portfolio and MBS ownership was in serious delinquency as of June 2010. Freddie Mac has reported its end of June 2010 serious delinquency rate at 3.98 percent. While these levels represent a slight dip in the delinquency rate for GSE mortgages over the past few months, defaults are still at a historic high (see Figure 1). The total losses stemming from these delinquencies and other investment failures by the GSEs are estimated by some to reach as much as $1 trillion.

For lawmakers wrestling with reforming the housing finance system, this problem of the banks is a central concern. But the role Fannie Mae and Freddie Mac played in contributing to this mess is also at the heart of questions surrounding how to move the housing finance system forward.

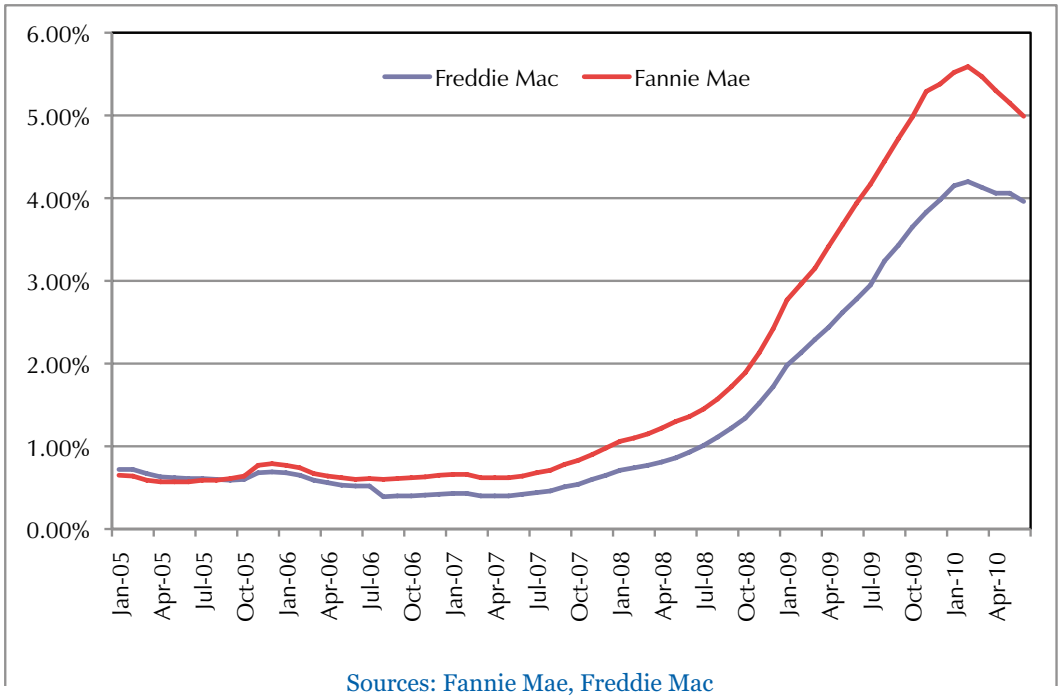
Government Housing Finance Today

Despite the losses, the government has directed Fannie Mae and Freddie Mac to continue buying and securitizing mortgages. And with credit markets still largely frozen today, the main source of liquidity in the housing finance system is coming from the GSEs. In fact, *Mortgage Service News* reported June 1, 2010 that Fannie Mae, Freddie Mac or Ginnie Mae (a similar agency operated out of HUD) purchased 98 percent of all mortgages originated this year, with the jumbo market virtually nonexistent.

This dominance of the housing market means that any recovery in price or sales volume is completely dependent on federal government financing backed by taxpayer dollars. Were the GSEs to cease buying mortgages or guaranteeing mortgage-backed securities, financing for buying homes today would be virtually nonexistent until the banks got back up on their feet. This would result in mortgage prices increasing, causing demand for housing to decrease, taking the value of homes even further down.

In essence, the government support for defunct Fannie Mae and Freddie Mac is unnaturally propping up the price of homes and with them, the housing market. This means that prices have not been allowed to reach their natural bottom, from which a sustainable recovery could begin. Washington has placed itself in a difficult position, desiring an increase in housing prices in order to ease pressures on bank and family balance sheets. However, this requires a continuous bailout of Fannie Mae and Freddie Mac, which is costing taxpayers—who are in financial straits themselves—billions of dollars, distorting the housing market and preventing a real recovery in housing.

Figure 1: Serious Delinquency Rate



Sources: Fannie Mae, Freddie Mac

In July 2010, Congress passed a financial services regulatory reform bill, the Dodd-Frank Act, which changed banking rules on a wide scale and stirred around the mix of regulatory authority between existing agencies. The bill was intended to correct

errors that resulted in the financial crisis. The legislation, however, was stunningly void of any substantive reform of Fannie Mae and Freddie Mac, two of the biggest financial institutions in the country.

Treasury Secretary Timothy Geithner proposes that it would be best to wait until after housing prices have recovered to deal with the mortgage giants, since major reforms could result in lower home values as mortgage costs go up. But the main problem with delaying GSE reform is that the continuation of their model, which has been proven to be both bad business and problematic for the broader housing sector, is distorting the market and preventing a real recovery in housing. This is the most important reason the GSEs must be reformed sooner than later, as a part of a sweeping overhaul of the housing finance system.

House of Representatives Committee on Financial Services Chairman Barney Frank has repeatedly argued that the losses Fannie Mae and Freddie Mac are experiencing today are unrelated to their current activities. While this is true, it does not follow that the GSEs are not hurting the mortgage market today. During the build up of the housing bubble the GSEs were not experiencing losses, yet they were distorting the market and ultimately destabilized the housing sector. Today, Fannie Mae and Freddie Mac continue to distort the market, keeping housing prices from recovering from a natural decline, and skewing demand signals in the marketplace. This government involvement in the housing sector is well intentioned—no one wants to see homeowners lose the value of their homes or see foreclosures rise—but it is merely pushing the reckoning needed down the road. Today's housing pains are the result of yesterday's well-intentioned housing policy goals. Unless government removes itself from the housing finance market, it will just create more pain in the future.

In April 2010, the Treasury Department released a list of questions for public input on how the government should approach reforming the housing finance system. This brief is based on Reason's answers to those questions. The questions have been grouped into three categories and are addressed with broad principles to govern reform of the housing finance system.

WHAT IS THE ROLE OF GOVERNMENT IN HOUSING FINANCE?

A. Summary

Federal involvement and intervention distorts the market by placing unnatural upward pressure on home prices and downward pressure on mortgage yields. This distortion in the free market has led to a wide range of unintended consequences, most recently coalescing in the finance crisis, leading to taxpayer losses. The role for government in the housing finance system is to support a legal structure for private sector financing of mortgages, and to enforce laws and regulations that ensure the market is a fair field for competition. However, there should be no federal government (i.e., American taxpayer) dollars available to support housing finance on a market-wide basis. Furthermore, the government should not be collecting taxpayer dollars to bet in the financial markets, housing or otherwise. Using federal tax dollars to support housing finance puts Americans unfairly and unjustly at risk by encouraging banks to float high-risk loans guaranteed by taxpayer dollars.

TREASURY'S QUESTIONS

- What role should the federal government play in supporting a stable, well-functioning housing finance system?
- What risks should the federal government bear in meeting its housing finance objectives?
- How should the federal housing finance objectives be prioritized in the context of the broader objectives of housing policy?

REASON'S PRINCIPLES

- The regulatory role of the government should be to ensure fair competition and compliance with the law, not a financer itself.
- There should be no risk to taxpayers.
- If it is impossible to fully remove government, then the government's role as financer should be as limited as possible.

B. ANALYSIS

If we were starting from a blank slate, no one seeking a stable housing finance system would design what we have today. The government-sponsored enterprise system, and series of federal subsidies for mortgages, contributed heavily to the build up of toxic housing investments that reached unsustainable levels. Combined with poor banking practices and irresponsible borrowing, the problem of bad housing debt eventually spilled over catastrophically into the global economy when home prices imploded.

Understand the Damage of Distortion

The chartered mission of Fannie Mae and Freddie Mac is to increase the availability of mortgage financing for homebuyers. By its very nature this expansion of mortgage credit distorts the market and undermines the ability of banks to balance price against risk. Without the GSEs there would be less credit available for high-risk homebuyers, protecting the market from instability. Due to their high volume of bad loans, the GSEs have skewed the entire market of mortgage rates, effectively driving rates nationwide, as de facto federal agencies. The government, when considering the future of its role in housing finance, must keep in mind the distortions of its involvement and interventions.

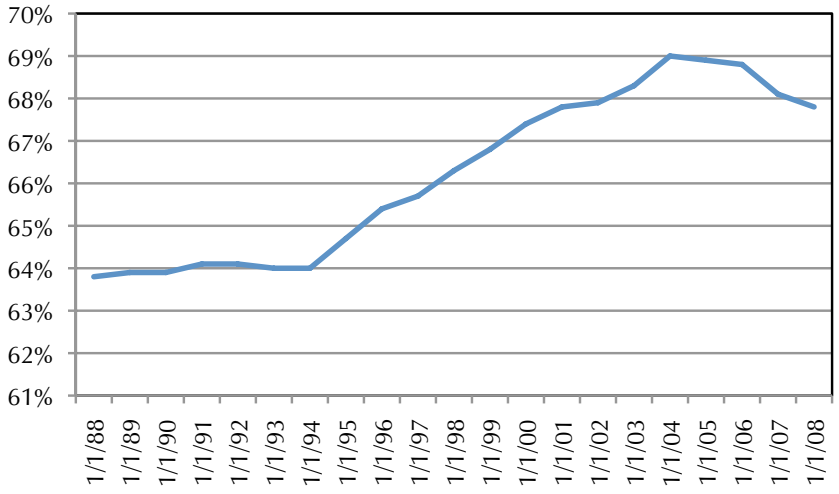
The intended consequence of government-backed housing finance distortions was to increase the percentage of homeownership in the U.S. by making mortgages more readily available. To some degree the GSEs have been successful in that regard, though studies have mixed findings when trying to quantify the exact benefit of Fannie Mae and Freddie Mac for homebuyers. Nevertheless, the GSEs played some role in encouraging the homeownership rate's rapid rise from 64 percent to 69 percent between 1995 and 2005 (see Figure 2).

However, the unintended consequence was to contribute to a housing bubble through the rapid expansion of mortgage credit. In 1993, as a part of the Affordable Housing Initiative, the Department of Housing and Urban Development began increasing the affordable housing mandates for Fannie Mae and Freddie Mac. By 2006, the percentage of "conforming" loans the GSEs were required to purchase, based on certain standards of quality and affordability, grew from 30 percent to 55 percent.

At the same time, the GSE definition of quality for conforming mortgage underwriting standards decreased. The average loan-to-value ratio of a subprime mortgage for instance, increased from 79 percent in 1999 to 86 percent in 2006. These actions had the effect of expanding the available credit to homebuyers from mortgage originators who knew they could sell their low-quality mortgages to the GSEs. The homeownership rate increased, but a bubble was formed as well, ultimately collapsing and hurting those very same citizens the government intended to help. The drive for increased homeownership has paradoxically now yielded a near doubling in the home vacancy rate in America.

Today, the GSEs continue to distort the market more than ever. As virtually the sole providers of capital, they are keeping mortgage prices below their natural level, and pushing housing prices higher than they otherwise would be. This is politically popular, as the government can use the GSEs as agencies to avoid populist anger at falling home prices. But this is having the unintended consequence of creating a false baseline for home values. The housing bubble inflated the price of homes above what their fair market value would have been without government interference.

Figure 2: Percentage of Population Owning a Home (1988 to 2008)



Source: U.S. Census Bureau

Now, the continued use of GSEs to prop up the housing finance sector is preventing the market from pushing those prices down to their natural level.

The government should not distort the housing market, or prevent American homeowners from losing value on their homes. Federal officials are not equipped to accurately price homes, or know through economic analysis, or any other means, an "acceptable" target range for homeownership in America. Market forces may be shifting more Americans to rental housing, and it is inappropriate to use the GSEs to artificially support the mortgage business. Furthermore, government-supported and directed distortion of the housing market under-prices the risks the market is seeing in the future of the housing sector, and this could lead to more problems down the road with a second (though smaller) bubble and burst.

Phase Out GSEs and Replace with Improved Regulatory Framework

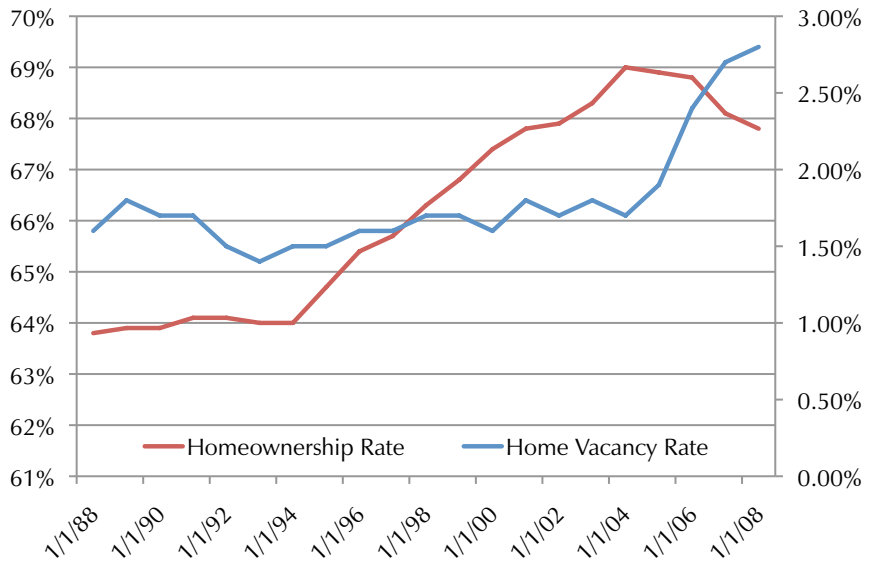
Congress and the executive branch should work to phase out Fannie Mae and Freddie Mac over a short period of time in order to remove the distorting impact of GSEs while prudently giving the market time to adjust. The taxpayers should not bear any financial risk for federal housing objectives, and the market should be allowed to naturally price homes to avoid destabilizing booms and busts in the housing sector.

Many business interests and affordable housing proponents have proposed assorted schemes to have the government involved in the housing and mortgage markets, but there is no justification for this. Investors must fully bear the risks and consequences of the investments that they choose to make, as this is a quintessential component of a free and robust economy. Even a more moderate proposal, such as establishing a government shared-risk program with securities holders paying fees for a federal guarantee, will only subsidize unwarranted risk-taking because investors will be able to shift losses onto the taxpayers' checkbook. Furthermore, it would artificially increase the capital available for mortgage lending by using the taxpayers as a backstop.

While they exist, the GSEs should be formally put on the federal budget. They are in effect run by the federal government and meet the Congressional Budget Office standard for being included on the budget. Currently, the White House Office of Management and Budget does not include them. Adding them to the budget would not only be more honest, it would add more transparency to the true drain the GSEs are on the fiscal stability of the federal government. If the GSEs were put on budget, then all cash flows from maturing mortgages or servicing fees on pools of loans would go into the Treasury to mitigate losses the taxpayers have taken on the GSEs. Also, adding the GSEs to the federal budget should be accompanied by putting GSE employees on the federal payroll, thereby forcing it to conform to federal pay scales.

But even Secretary Geithner and Rep. Barney Frank recognize that Fannie Mae and Freddie Mac must go. Keeping them in conservatorship or on the federal budget is not a long-term solution. There are a number of possible ways to dissolve the GSEs. And while there is room to discuss details, the most important pillars of any plan are: first, that they are not replaced by another housing market distorting agency; and second, that the phase out take a clear, prudent path.

Figure 3: Home Vacancy and Ownership Rates (1988 to 2008)



Source: St. Louis Federal Reserve Bank

Here is a five-step proposal for dissolving the GSEs:

Step 1: Lower Conforming Loan Standards

The 2010 conforming loan limit for single-family houses is $417,000 and the "high-cost" limit is $729,750. First, eliminate the high-cost limit and put a ban on purchasing or securitizing second liens by December 31, 2011. Second, lower the conforming loan standard to the median home value on a state-by-state case and require that all new mortgages purchased or securitized after December 31, 2011 have a loan-to-value (LTV) ratio no higher than 80 percent.

These standards would not ban the private sector from issuing second mortgages or originating loans with higher LTV ratios. Fannie and Freddie would just not be allowed to buy or package them, thus taxpayer dollars would not be put at risk. None of these steps would hurt responsible low-income borrowers and they would create opportunities in the secondary mortgage market for private market participants to gradually and responsibly enter the market to pick up the slack. This will effectively phase out most of the need for GSEs.

An alternative idea for reforming the GSEs would be to further lower the conforming loan standard to state-defined pricing for affordable housing standards (oftentimes a mortgage payment costing no more than 30 percent of a family's income) below some federal limit.

Step 2: Restrict New Portfolio Holdings

First, ban the GSEs from retaining new, raw mortgages on their balance sheets for more than two quarters. All mortgages purchased, in conformity with the new standards, would have to be packaged into securities and pushed off the balance sheet within six months of the date of purchase.

By only allowing the GSEs to operate in securitizing mortgages, you eliminate the problem of maturity mismatching with short-term liabilities (debt) and long-term asset holdings (waiting for mortgages to fully payout) that contributed to the illiquidity of the two firms. The mismanagement of the maturity gap exposed the GSEs to significant risks with interest rate changes. When interest rates rose on longer-term assets, their prices dropped significantly and the decreased cash flow was not enough to cover the GSEs' short-term liabilities. This wiped out the equity Fannie Mae and Freddie Mac had and led to their take over by FHFA and Treasury.

Second, require that the GSEs cease all new mortgage purchase activities by June 30, 2013. The GSEs would have the remainder of 2013 to securitize those and any remaining mortgages, and shift them off their balance sheet.

This will open the secondary mortgage market to investment from the private sector. Only the private sector could buy whole mortgages from their originator and hold them for cash flow. This gradual wind down will mitigate any severe shocks to the mortgage market.

Step 3: Divest Fannie and Freddie's Securitized Mortgage Pools and End Guarantees

Mortgage-backed securities (MBS) exist in two places on the GSEs' books. First, their balance sheets contain recently securitized mortgages that have yet to be sold. This amounts to about 15 percent of the total GSE-issued MBS (as of June 2010). Second, the GSEs maintain off-balance sheet "Agency- and GSE-Backed Mortgage Pools" that serve as special purpose vehicles accounting for the majority of the GSEs' MBS. When Fannie and Freddie receive mortgage payments, those balances flow into the pools in order to pay off the investors of Fannie and Freddie's MBS.

The GSEs should be required to divest as many of the mortgage-backed security pool assets as possible by December 31, 2015, selling off the securities in such a way as to not shock the prices in the market. The outcome of Step 2 of this plan is a shift of all mortgage debt off GSE balance sheets and into the pools by the end of 2013. Fannie's and Freddie's only purpose from that date would be to service the mortgages in the pools, which would likely be holding somewhere between $4 trillion and $6 trillion in mortgage debt, and to attempt to sell them all back to the private sector.

There are a few approaches to divesting the MBS by the end of 2015. First, the GSEs could target a certain percentage of their securities to be sold in a specific time frame, such as 12.5 percent per quarter of the 2013 balance. This could prove difficult, however, as many of the securities held by the GSEs contain undesirable assets. Second, in order to avoid a shock in prices, the MBS could be sold off within specific limits based on the effect their sale has on interest rates. These limits could be anchored to a benchmark such as the federal funds rate. If mortgage interest rates begin to rise over a certain specified limit, the volume of MBS divestment activities could decrease so as not to place additional upward pressure on interest rates.

Step 4: Establish a "Bad Bank" for Remaining GSE Assets

Given the likely possibility that the GSEs will be unable to divest all of their assets by December 31, 2015, it is necessary to develop a contingency plan. By January 1, 2016, all remaining, likely toxic, mortgage debt owned by the GSEs should be moved into a new entity on the federal balance sheet that would serve as a "bad bank." Any securities that were not divested from the MBS pools would be transferred to this bad bank holding entity.

A private sector asset manager should be hired to service this pool for the government, instead of being operated by Fannie Mae and Freddie Mac. A private sector asset manager would be able to leverage the operational quality and efficiency advantages of the private sector. Across all sectors of the government, competitive sourcing has a strong history of providing federal, state and local services cheaper and with more efficiency. This contractor would be selected through a competitive sourcing bid to service the holdings remaining from the mortgage pools. Hiring an asset manager would not be selling the servicing business, but keeping it on the books of the government and bringing in the private sector to manage the bad bank.

The exact details of the contract would depend on the bids received. The contract could be structured to have the private manager pay the government up front for the right to the servicing fees, thus transferring risk of losses away from the taxpayer, or the asset manager could simply take a portion of the servicing fees. In any case, any servicing agreements with investors in the pool of MBS would have to be honored. This asset manager would service the mortgages in the pool for the government until maturity. The asset manager would also be required to divest what holdings it could.

Step 5: Dissolve the GSEs by the End of 2015

The GSEs should cease to operate as of December 31, 2015. By this time the private sector will have fully supplanted the secondary and securitization markets. All remaining mortgage holdings would be shifted into the bad bank holding vehicle to be managed by a private sector company. Under this plan, there would be no federal guarantee for any privately originated or securitized mortgages. All affordable housing functions and operations would be transferred to the Federal Housing Administration. There would be no more reason for the operating existence of the GSEs. All remaining assets of the GSEs would be liquidated.

HOUSING 101: Loan-to-value ratios measure the percentage of a mortgage that has been borrowed compared to the price in a home. If a home is bought with a 20 percent down payment and 80 percent loan, then the loan-to-value ratio is 80 percent.

This five-step process for dissolving the GSEs meets the goals of eliminating the price distortion effect of Fannie Mae and Freddie Mac while prudentially avoiding shocks to the market, but still allows the government to continue its affordable housing policies.

Immediately dissolving Fannie Mae and Freddie Mac would damage the U.S. economy. But rather than replacing them with a new government entity, the government should establish a new regulatory framework that allows the private sector to efficiently allocate capital for housing finance as the GSEs are phased out. The new regulatory framework will need to respond quickly to new ideas for housing finance. It should also focus on continuing to enforce regulations restricting fraud.

Embrace the New Market for Housing Finance

The new housing finance market will look much different with the elimination of Fannie's and Freddie's government-subsidized mortgage prices. The value of homes may not return to the heights Americans became used to for some time, if ever. This will mean more affordability in the short-run, but potentially higher losses for current homeowners, particularly those who bought at the height of the boom. There will not be as much credit available in the system, and it is likely that more individuals and families will rely on rental housing, at least in the near term, as the market sorts out how much capital it wants to risk investing in housing.

This kind of change will likely also adjust the way lenders and individuals think about America's standard 30-year, fixed-rate mortgages. The cost of these mortgages could increase as private sector sources of mortgage credit reassess how they want to lend in a market without a government guarantee. But other products would rise in their place if the typical fixed-rate mortgage became unpopular. These products

could be modeled on global mortgage models where long-term fixed-rate mortgages are relatively rare.

Higher standards for large loans will likely focus American homebuyers on building wealth and sounder financial practices. This would mean a shift in thinking about the economic and social value of homeownership. Whatever the changes, government officials and citizens alike will need to embrace a market without distortions and not fall into the trap of comparing it too much to the prior, flawed system.

The U.S. needs a shift in thinking about the economic and social value of homeownership.

HOW SHOULD WE ORGANIZE THE FUTURE SYSTEM?

A. SUMMARY

The future housing finance system should be free of government distortions in the market. Fannie Mae and Freddie Mac should be eliminated, and all mortgage distortions and fiscal policies favoring homeownership removed along with them. A preferable housing finance system would focus on protecting consumers by prosecuting fraud, providing the necessary legal approval for creative methods of mortgage lending, and changing the tax code to favor savings (rather than consumption) and investment, letting the market allocate capital to housing as is appropriate.

TREASURY'S QUESTIONS

- How should the current organization of the housing finance system be improved?
- Should the government approach differ across segments of the market, and if so, how?

REASON'S PRINCIPLES

- Repeal all policies and regulations that distort the housing market and overtly favor increasing homeownership.
- The government approach should not favor any particular segment of the housing market over another.

B. ANALYSIS

The core problem of the current housing finance system is that government interventions are creating distortions in the marketplace. These distortions fueled an unsustainable housing bubble, encouraged banks to reduce underwriting standards, and have ultimately stuck a multi-hundred billion-dollar bill at the feet of the U.S. taxpayer to cover losses at Fannie Mae and Freddie Mac. Therefore, the future housing finance system should be organized without these distortions.

End the Distortions

The simple fact of the matter is that the government cannot know what is actually best for the market when it comes to determining how much financing should be available for mortgage lending. Officials in Washington have used the political priority of helping Americans achieve the nebulously defined American Dream of homeownership. But this ignores the broader, negative implications of picking this industry to support. The government does not have a positive track record of picking winners and losers in the marketplace, and housing is no exception.

The goal of making homes more "affordable" is essentially subsidizing homeownership, creating a dangerous cycle. The more affordable homes become with government-supported downward pressure on mortgage prices, the more expensive homes become, due to increased demand. This means each percentage point increase in the homeownership rate requires exponential subsidization. And the cycle simply spirals up until the artificially boosted prices reach an unsustainable height and come crashing down. Ending distortion, and creating a stable regulatory framework for housing finance, means ending the subsidies. There are two types of distortions the government uses to pursue its homeownership goals:

1. Mortgage Distortions:

Mortgage price distortion generally comes from activities by the government-sponsored enterprises, including mortgage purchases and guarantees. Since mortgage prices directly influence the price of a home, this is a chief area of focus for government officials seeking to influence the homeownership rate.

The Federal Housing Finance Authority and the Federal Housing Administration (FHA) also influence mortgage prices by offering mortgage insurance at rates not always consistent with market prices. The FHA furthermore influences mortgage rates through direct subsidization of loans through qualified lending organizations. The Community Reinvestment Act also sets specific terms and limits for private sector investments in housing that encourage certain levels of mortgage financing for the low- and middle-income segment of the market.

These combined distortions put downward pressure on the interest rates for mortgages, thereby increasing the pool of potential homebuyers by lowering prices. This in turn triggers the exponential cycle of subsidization, destabilizing the market to meet government goals of "affordable" housing.

2. Housing Distortions:

Housing distortions stem from a range of fiscal policies including tax credits for homeownership, mortgage interest deductibility and selective capital gains taxes that favor residential investment. First, the tax code incentivizes owning a home by making mortgage interest payments deductable. Interest on loans backed by up to $100,000 of home equity, no matter what the loan is used for, is also deductable from income tax returns. Collectively, this is arguably the largest single subsidy provided for housing, as housing-related income tax reductions in 2009 cut $180.73 billion from federal revenue.

Second, since 1997, home sellers have been able to largely avoid paying capital gains taxes. Regulations restrict this capital gain exemption to once every three years, but there are exceptions even for this rule. In theory, reduced capital gains taxes would be positive for economic growth. However, this is problematic because it creates an exemption that unnaturally incentivizes investments just in housing and distorts the natural flow of resources.

Third, the government has recently turned to using tax credits to encourage citizens to become homeowners. The First-Time Homebuyer Credit program, first begun in 2008 and extended through April 2010, was essentially cash handed out to anyone who hadn't purchased a new home in the past three years. The program has been largely panned as a failure, since housing metrics supported by the credit—including sales, housing starts and building permits—have all recessed from their gains in the wake of the credit's conclusion. At best, the credit provided only a temporary gain.

These combined distortions put upward pressure on the price of housing, increasing the value of homeowner investments in housing. However, the unnatural price support attracts resources away from other possible investments, creating bubbles and slowing the growth of other industries.

In order to end the distortions in the housing market that favor homeownership with federal subsidization, a number of steps are needed, including eliminating the GSEs, reforming the tax code to get rid of favoritism, and overhauling the whole federal housing finance system to change the way FHFA and FHA interact with the market. The more recent activities under Making Home Affordable programs are also distorting the market and would need to be wound down.

Anything short of completely eliminating any GSE model, even simply keeping a limited government guarantee in the housing finance sector somewhere, will inevitably lead to more taxpayer losses. The likelihood of another, smaller, housing bubble would be high. Catering to pleas for the government to guarantee mortgages would require establishing hybrid agencies with similar troubles as the GSEs, putting the taxpayer back at risk of bailing out the housing market again.

Create a Single Framework for Housing Finance Regulation

As part of a commitment to avoid distorting the market, the government's approach to regulating housing finance should be from a single perspective, not favoring one segment of the housing market over the other. There are different forms of housing—ranging from single family housing to multifamily structures to various forms of renting. And within homeownership, there are different types of mortgages—fixed rate mortgages (FRM), adjustable rate mortgages (ARM), and a range of terms, the most popular being the 30-year FRM.

As previously mentioned, the government is not

good at picking winners and losers, and favoring one segment in this market over the next would create distortions eventually leading to unintended consequences. The Treasury Department, HUD, FHFA and Congress should avoid favoring homeownership over rental housing, single-family home over multifamily units, or 30-year FRMs over any other mortgage model including 15-year FRMs and 1-year ARMs.

One of the main reasons the government should not favor one mortgage type over another is that changes in the market influence the desirability of various housing models. The Cambridge Winter Center for Financial Institutions Policy argues that high rates of employment volatility combined with the increased rate of divorce have made homeownership more volatile and the 30-year fixed rate mortgage and other long-term loans less desirable. Such loans are also unfavorable for banks without a government guarantee. It is likely that, with the move to private sector housing finance, mortgage terms and structures will look much different and need to change over time as the market ebbs and flows. Having the government favor one or two types with its regulatory structure would defeat the purpose of trying to end distortions.

The Exception for the Very Poor

The government could feasibly engage the market well below the poverty level to help develop multi-family housing opportunities without significantly distorting the market.

One option would be to have the FHA offer matching contributions towards a down payment for very low-income families that have high underwriting standards, and carefully monitor the homeowner's success in making mortgage payments. This would minimize taxpayer risks, relative to FHA loans, and provide the new homeowners with wealth to build on.

Alternatively the FHA could provide temporary rental housing units to very low-income families and transition the care for these individuals to state and local governments. Any activities by the FHA to help very low-income families should be done within a clearly defined, fixed portion of the market in which the government would be allowed to operate. This would prevent the government from manufacturing cheap credit again, creating another housing bubble.

HOW SHOULD CONSUMERS BE PROTECTED?

A. SUMMARY

A reformed housing finance regulatory structure should result in a market that aligns business and consumer interests more acutely, instead of restricting certain business practices and products ad hoc. This alignment would best come with a combination of changes including promoting transparency, forcefully prosecuting fraud and creating incentives for consumers to better educate themselves about their mortgage purchases.

TREASURY'S QUESTIONS

- How should the housing finance system support sound market practice?
- What is the best way for the housing finance system to help ensure consumers are protected from unfair, abusive or deceptive practices?

REASON'S PRINCIPLES

- Government should promote transparency.
- Make the consequences of criminal behavior clear, prosecute fraud and incentivize consumer relations best practices.

B. ANALYSIS

From claims of widespread predatory lending to the successful push for a consumer financial protection agency in one form or another, there has been an increased call for more consumer protection in the wake of the financial meltdown. Housing finance is an area of particular concern for consumer advocates, as homeowners taking on unaffordable mortgages were at the center of the crisis.

Some have argued for increased consumer protection standards, such as requiring mortgage products to list repayment procedures under various economic scenarios, requiring contracts be limited to a certain number of pages in plain English, or asking for caps on mortgage payments, such as Spain's requirement that mortgage payments not exceed 35 percent of the borrower's annual income. Already the Dodd-Frank Act has levied new rules on mortgage originators aimed at

protecting borrowers, including requirements lenders to check credit histories, income levels and employment status.

However, this is the wrong approach, as it continues to treat consumers like children and may restrict their options. Furthermore, these protections did not prove to be much help in Spain—or other European nations—which experienced a devastating housing bubble as well. It would be preferable to reform the housing finance regulatory structure to align business and consumer interests more acutely.

In many respects, the consumer problems that developed during the bubble period were a matter of education. Homebuyers were not always sophisticated enough to understand their mortgage or did not want to take the time to learn about the details of what taking out a $750,000 loan with a ballooning interest rate in three years would mean for their ability to pay the bills. Nevertheless, simply demanding consumers become better educated will not solve the problem. Instead, the new housing finance regulatory framework should provide a range of changes, including promoting transparency, forcefully prosecuting fraud and creating incentives for consumers to become more informed.

First, promoting transparency should be a plank in any new housing finance system. The more consumers know about the firms they are borrowing from, the better consumers will be in selecting quality products and the more businesses will seek to provide quality service. Instead of limiting the length and wording of contracts, the regulatory framework should simply require that all standard contracts be made available online or on request from a firm's physical location so that simplicity would become a competitive advantage. The more accessible standard product contracts are, the more likely private consumer advocate institutions will set up websites where consumers can judge for themselves which firm would be the easiest to do business with. This system would reward action, instead of punishing inaction.

Second, the government should take more seriously its role as mediator of justice and forcefully prosecute fraud. Regulators should be tougher on mortgage lenders who don't uphold their fiduciary duties, or cheat their clients. Claims of fraud or dishonesty should be pursued with greater vigilance to create an expectation of enforcement. Regulators should leverage the importance of business reputation. If a particular firm were constantly under investigation for fraudulent businesses practices, that would certainly hurt its profit margin and thus create incentives to be more honest with high service quality.

Regulators shouldn't, however, punish negative outcomes that stem from uncertainty in the market. It is one thing to prosecute a firm that lies or deceives its clients. It is another thing to prosecute a firm because the market took a dip resulting in losses for its client. Firms offer services and products all the time that allow a consumer to take a risk in the market. Investing in a home when the market is on an upswing will appear to be an attractive investment to both client and firm. But there will always be some uncertainty about the direction of the market, and businesses should not be punished simply because the market turned and the product they offered caused their client to lose on the investment.

And third, incentivizing consumers to educate themselves would go a long way to avoid a host of problems in the future. Buying a house is a big deal, and consumers should take the time to understand what they are buying. It is not unreasonable to believe that if a consumer does not want to take the time to understand his mortgage, he may not be ready for homeownership. Firms cannot deceive or abuse prepared consumers.

Perhaps the best way to do this would be to remove safety nets for consumers by reducing their recourse to prosecute lenders. If consumers knew their options would be limited if their investment went bad, they would have more incentive to learn about the mortgage they are taking out. Homebuyers, for instance, shouldn't have much recourse after purchasing a home unless they can prove malicious intent to deceive. Businesses would be incentivized to make education easier, with consumers trying harder to educate themselves, as a competitive advantage. It would not be in the best interest of the lender for the borrower to be unable to pay. Without the GSEs encouraging high-risk lending, and the government tacitly promising to protect creditors from their bad investments, lenders' goals would align more closely with borrowers' goals, and

lenders would create contracts with a high likelihood of affordability for the borrower. Combining this with more transparency and harsh prosecution of real cases of fraud and abuse could profoundly increase consumer protection without any heavy-handed requirements of businesses directly restricting their practices or products they offer.

CONCLUSION

The U.S. government needs to change the way it thinks about homeownership. From departments in the executive branch to members of Congress, government's policy goal of increasing homeownership ultimately has not led to a better standard of living for all but to a catastrophic meltdown of the housing sector in America. The first goal of reform should be to stop promising about homeownership for its own sake.

With an economy and nation as dynamic as the United States, the government should let investors make their own decisions about how to use their capital and let individuals and families spend their money how they want. For some this might mean saving for a healthy down payment for a new home. For others it might mean never owning a home but investing or spending elsewhere. Ultimately, it will mean fewer mortgage defaults and a housing market that is less subject to political manipulation and bubble-induced price spikes.

The role of government should be to support a sustainable regulatory structure for the private sector financing of mortgages. Federal involvement in housing finance fundamentally distorts the market by placing unnatural upward pressure on home prices and downward pressure on mortgage yields. This isn't a stable system that benefits taxpayers in the long run. A reformed housing finance regulatory structure should be used to align business and consumer interests more acutely, prevent fraud and ensure the market is a just field for competition.

A key step in the process of reform will be dissolving Fannie Mae and Freddie Mac without replacing them with another market-distorting housing agency. The resulting change will require a significant change in the way of thinking about housing finance. The new market will be different than yesterday or today's housing market. Mortgage debt may not be as readily available as before, and prices will likely be different. But the goal shouldn't be to return to the market conditions of the bubble. That is unsustainable. Instead, the focus should be on building stable wealth over a long period of time while avoiding policies that distort the market and lead to calamitous results.

Principles

1. The role of government should be as regulator of the finance market, not a financer itself.
2. There should be no risk to taxpayers.
3. If it is impossible to fully remove government, then the government's role as financer should be as restricted as possible.
4. The government should repeal all policies and regulations that distort the market, and overtly favor increasing homeownership.
5. The government approach shouldn't favor one segment of the housing market over another.
6. Government should promote transparency.
7. The government should make the consequences of criminal behavior clear, prosecute fraud, and incentivize consumer relations best practices.

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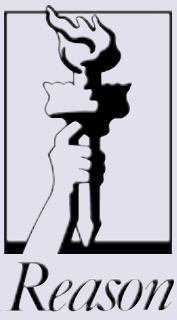

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