

10-2014

Who Should Be Providing Mortgage Credit to American Households?

David J. Reiss

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Reiss, David J., "Who Should Be Providing Mortgage Credit to American Households?" (2014). *Faculty Scholarship*. Paper 2.
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January 2014

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Research Papers

Accepted Paper Series

Research Paper No. 398

October 2014

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RESPONSE:
Who Should Be Providing
Mortgage Credit to American
Households?

David Reiss*

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I. THE AMERICAN HOUSING FINANCE SYSTEM

Who should be providing mortgage credit to American households? Given that the residential mortgage market is a ten-trillion-dollar one, the answer we come up with had better be right, or we may suffer another brutal financial crisis sooner than we would like. Indeed, the stakes are as high as they

* Professor of Law, Brooklyn Law School. This Article draws from earlier work of mine, including a comment letter to the Federal Housing Finance Agency, *Comment on the Federal Housing Finance Agency's Strategic Plan: Fiscal Years 2013-2017*, Soc. Sci. Res. Network (June 18, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2086514, as well as assorted articles and blog posts.

were in the Great Depression when the foundation of our current system was first laid down.

Unfortunately, the housing finance experts of the 1930s seemed to have a greater clarity of purpose when designing their housing finance system. Part of the problem today is that debates over the housing finance system have been muddled by broader ideological battles and entrenched special interests, as well as by plain old inertia and the fear of change. Instead of merely responding to the latest proposal coming out of Washington, D.C., it is worth taking a step back to evaluate the full range of options available to us. After all, whatever course we decide upon will shape the housing market for generations to come.

In *For the Protection of Investors and the Public: Why Fannie Mae's Mortgage-Backed Securities Should Be Subject to the Disclosure Requirements of the Securities Act of 1933*, Brent Horton argues that "the best way to reduce risk taking at Fannie Mae is to subject its MBS offerings to the disclosure requirements of the Securities Act of 1933."¹ I disagree. While disclosure obviously has an important role to play in the regulation of publicly traded companies, the problems inherent in Fannie Mae's structure are greater than those that increased disclosure can address.

Horton's article mainly addresses Fannie Mae, but my views apply equally to its sibling corporation, Freddie Mac. Fannie and Freddie are commonly referred to as government-sponsored enterprises (GSEs). They each have

1. Brent J. Horton, *For the Protection of Investors and the Public: Why Fannie Mae's Mortgage-Backed Securities Should Be Subject to the Disclosure Requirements of the Securities Act of 1933*, 89 TUL. L. REV. __ (2014).

a dual mandate that is built into the special charters given to them by Congress. On the one hand, they are supposed to maximize shareholder value as privately owned companies. On the other, they are supposed to increase home ownership opportunities for low- and moderate-income households and residents of underserved communities. These two missions have been in tension with each other over the years. The GSE model resulted in massive losses for the two companies during the financial crisis. Taxpayers bore these losses until the housing markets recovered, lifting the GSEs along with them. In our postcrisis world, we are left with this question: what should be done with Fannie and Freddie?

II. WHAT SHOULD BE DONE WITH FANNIE AND FREDDIE?

There are four broad positions regarding the appropriate role of Fannie and Freddie in the housing finance market. First, Fannie and Freddie are generally doing the job that they were designed to do, although their powers and those of their regulators should be tweaked. Second, Fannie and Freddie are generally doing their job, but they do not do enough to promote their affordable housing goals. Third, Fannie and Freddie should be nationalized because the federal government has taken on most of the risk associated with them already. And finally, Fannie and Freddie should be privatized because they pose a systemic risk to the financial system.

This Response takes the fourth position. In particular, it argues that the GSEs' special relationship with the federal government should be terminated and the two companies should be privatized. Until they entered conservatorship, this position had

been considered a political nonstarter, particularly because Fannie and Freddie have many allies in the Democratic and Republican parties. Due to recent events, this is now one of the options on the table for a postconservatorship Fannie and Freddie.

A. *Tweaking the Status Quo*

One taking the first view—that Fannie and Freddie are generally doing the job that they were designed to do—might argue that we should just come to terms with the fact that the government is already enmeshed in private markets and there is no reason to do things any differently in the context of housing finance. As such, there is no need to rock the boat when it comes to companies that are as enmeshed with the federal government as are Fannie and Freddie.

Horton himself takes this view, arguing that politics is the art of the attainable or, in the words of Otto von Bismarck, of “the next best.”² Horton writes, “The next best does not require dismantling Fannie Mae; the next best is to require Fannie Mae to inform investors—and the public—more about the mortgages it is purchasing and securitizing.”³ His proposal thus joins a long line of reform proposals that seek to tweak the status quo and argue that there is no need to extricate the federal government from its complicated relationship with Fannie or Freddie.

If Horton had written this article before the financial crisis, before Fannie and Freddie had gone into conservatorship, I might find his proposal more intriguing. But the

2. *Id.* at __ (quoting Otto von Bismarck, *quoted in THE OXFORD DICTIONARY OF AMERICAN QUOTATIONS* 530 (Margaret Miner & Hugh Rawson eds., 2d ed. 2006)).

3. *Id.* at __.

political winds have shifted substantially, such that "the next best" thing is qualitatively better than increased disclosure. The crisis has given us permission to think more broadly about what our housing finance system should look like going forward.

B. Increasing Fannie's Role in Developing Affordable Housing

Horton is also sympathetic to the argument that Fannie and Freddie are essential in efforts to place home ownership "within reach of all."⁴ Some argue that the GSEs' dual-mandate model is valuable because it ensures that private capital has a duty to serve low- and moderate-income households. Indeed, much of the opposition to GSE reform from Democrats in Congress arises from this concern over the future of the "duty to serve." Private capital has a history of overlooking certain segments of the mortgage market, and a duty to serve would ensure that it does not do so going forward. Democrats in particular have also favored the funding of a housing trust fund to provide capital dollars for the construction of affordable housing for low-income households.

These two policy objectives—the duty to serve and a housing trust fund—have encouraged some affordable housing advocates to favor some variant of the status quo, because the status quo can clearly deliver those two objectives. The problem with this approach is the same as with the first: Fannie and Freddie's dual mandates are in inherent tension with each other, and no tweak can resolve that tension. Indeed, the precrisis

4. *Id.* at ___ (quoting WALT WHITMAN, DEMOCRATIC VISTAS AND OTHER PAPERS 172 (Walter Scott 1888)).

GSEs put the interests of shareholders and management over the public interest. The GSEs also were some of the most politically powerful entities in Washington, D.C. Stronger medicine than mere tweaks is needed to protect the nation from restoring the GSEs to their precrisis size and power and also the real risks that are attendant in doing so.

C. Nationalization

In recent years, the federal government has insured or guaranteed 80%-90% of new residential mortgages through its instrumentality, the Federal Housing Administration (FHA), as well as through Fannie Mae and Freddie Mac, for which it is the conservator. Some believe that the federal government is the only entity that can provide mortgage credit in a stable way, and history is arguably on their side. Since the Great Depression, when the Home Owners Loan Corporation, the FHA, and Fannie Mae were created, the federal government has had a central role in the housing finance market. Some also believe that there is not enough private capital to replace the government-guaranteed capital in the market, even if there was sufficient political will to do so. Nationalization proposals are just seen as the natural extension of this state of affairs.

A variety of scholars and think tanks have proposed versions of a nationalized or partially nationalized housing finance system with a utilitylike securitizer at its heart. The bipartisan Johnson-Crapo housing finance reform bill contained aspects of a utilitylike securitizer.⁵ Bills like this appear dead in

⁵ Housing Finance Reform and Taxpayer Protection Act of 2014, S.1217, 113th Cong. § 321-327 (2014).

the water, however, with congressional reform not expected for years.

The GSEs' regulator, the Federal Housing Finance Agency (FHFA), has taken some steps in the direction of nationalization with its common securitization platform. This platform seeks to combine the back-office functions of Fannie and Freddie into one entity. This regulatory initiative may have more impact in the long run than those of the current do-nothing Congress. Whether led by regulators or Congress, if GSE reform settles on a single guarantor model, it is likely that model will be regulated like a utility company.

This approach gives up on the notion that the private sector should be in the lead position of evaluating mortgages and bearing the risk of loss from underwriting them. This is inconsistent with what we know of how markets should work. Generally, it is considered appropriate for the government to step into the market if there is a market failure. Market failures in the housing markets typically fall into two categories: those caused by excessive information costs and those caused by uninsurable risks.⁶ Given that market players have access to an extraordinarily detailed level of information about borrowers (reduced to a simple FICO score) and homes (through mandatory appraisals), a market failure would appear to have to result from uninsurable risks. As noted, some have argued that there is not enough private capital to support the entire

6. David Reiss, *Landlords of Last Resort: Should the Government Subsidize the Mortgages of Privately-Owned, Small Multifamily Buildings?*, 31 W. NEW ENG. L. REV. 915, 940 (2009) (quoting James R. Follain & Edward J. Szymanoski, *A Framework for Evaluating Government's Evolving Role in Multifamily Mortgage Markets*, 1 CITYSCAPE: J. POL'Y DEV. & RES. 151, 154 (1995)).

U.S. mortgage market. Even if that were true, however, there is no theoretical reason why private capital should not be in a first-loss position for large swaths of that market. And it is important to remember what is at stake: if government funds are in the first-loss position, then taxpayers are stuck holding the bag at the end of each bust.

D. Privatization

Some, including me, believe that private capital can, and should, take a bigger role in the provision of residential mortgage finance. There is some question as to how much capacity private capital has, given the size of the residential mortgage market. But there is no doubt that private capital can do more than the measly share of new mortgages that it has been originating in recent years. The long-term health of the U.S. housing finance system is best assured by having private capital assume as much of the credit risk as it can responsibly handle. It follows that Fannie and Freddie's functions should be transferred to the private sector pursuant to a carefully planned transition.

III. A HOUSING FINANCE SYSTEM FOR THE TWENTY-FIRST CENTURY

A housing finance system for the twenty-first century should achieve three goals: (1) put private capital in a first-loss position, (2) ensure that the federal government can act as a lender of last resort for the mortgage market, and (3) maintain an ongoing role for the federal government in the segments of the market that private capital does not sufficiently fund.

A. *Private Capital*

The government's goal for the private housing finance market should be to provide sustainable credit to the wide swath of borrowers who have ready access to private financial institutions. The private housing finance industry's share of the conforming market should expand over time as it demonstrates its ability to responsibly increase the availability of sustainable credit. This can be achieved by a gradual lowering of the conforming loan limits that are applicable to Fannie and Freddie.

This private capital should also be subject to consumer protection regulation to ensure that it is not put to predatory uses. The Consumer Financial Protection Bureau has rules in place to provide such consumer protection. It will also be important to continue to monitor whether low- and moderate-income households and neighborhoods are receiving sufficient amounts of mortgage credit. The federal government may need to take additional steps to overcome any market failure in submarkets in order to ensure that all communities have access to a vibrant mortgage market.

While it is important to make residential credit broadly available, lenders will be doing borrowers no favors if their loans are not sustainable. The federal government should come up with a metric that balances responsible underwriting with access to credit. Developing a metric is important because of the pressure to increase access to residential mortgage credit by a range of players—consumer advocates, lenders, and politicians, to name just a few. But credit that cannot be sustained by home owners leads to mortgage default and foreclosure. Home

owners should not be taking out mortgages with payments that they cannot consistently make year in and year out.

B. Liquidity

The FHA, along with the rest of the government-supported sector of the housing finance market, should always be ready to provide liquidity during a financial crisis. This means that the government's housing finance infrastructure should be able to ramp up almost immediately if private credit were to disappear overnight.

C. Affordable and Sustainable Mortgages

The FHA should continue to provide mortgages to first-time home buyers and low- and moderate-income borrowers. But otherwise, we should look to private capital to price risk and fund mortgages to the extent that it can do so. And as with privately funded loans, the FHA should ensure that the mortgages they originate are sustainable for their borrowers.

These three components—appropriately-regulated private capital in a first-loss position, the federal government as a lender of last resort, and a government role in the segment of the market that private capital does not sufficiently fund—give us a housing finance system that may last through the end of the twenty-first century.

IV. THE RISK OF DOING NOTHING

Horton rightly notes that the reform of GSEs like Fannie is the biggest "piece of unfinished business" left over from the

financial crisis.⁷ Our do-nothing Congress is aware that the residential mortgage market we create today will likely be the one our grandchildren use. Congress is also aware that we have, at most, one chance to get it right. We can only hope that the political will to reform the GSEs can overcome Congress' deep ideological divide before we hit our next housing finance crisis, whatever and whenever that might be.

And yet, there is no question that the federal government has not moved with sufficient speed to establish a workable infrastructure for the housing finance market. Some commentators identify benefits of a slow approach—time to get consensus, time to get rules right, time for trial and error before committing for the long term. Few identify the costs of regulatory uncertainty—failure to get buy-in for capital-intensive ventures, atrophy of existing resources, and limited investor interest.

I believe that there is a good chance that five or ten years from now, Fannie and Freddie will be in the midst of another bailout. This next crisis will be directly caused by the executive and legislative branches of the federal government. Members of those branches may say, "Nobody could have known that this crisis was going to happen, nobody is at fault." That will not be true, but nobody will be punished in any case. That is because the crisis will result from inaction, the most fearsome of government flaws.

Fannie and Freddie have been in a state of limbo since they entered conservatorship in

7. Horton, *supra* note 1, at ___ (quoting Nick Timiraos, *Five Years Later, Fannie Mae, Freddie Mac Remain Unfinished Business*, WALL ST. J. (Sept. 6, 2013, 8:04 PM), <http://online.wsj.com/news/articles/SB10001424127887323423804579022672911329450>).

2008. The conservatorships have gone on for far too long for such complex entities to remain well-run. All sorts of operational risks are likely to be cropping up in the two companies as employees sit around (or walk out the door) waiting for Congress to act.

Fannie and Freddie's regulator, the Federal Housing Finance Agency (FHFA), can administratively move housing finance reform forward to some extent on its own. To the extent that it does so, it needs to determine how safety and soundness are best balanced with access to credit. Federal housing finance policy typically goes off the rails when those two goals get mixed up. The FHFA should ensure that FHFA's safety and soundness goals are clearly set forth and that other goals for Fannie and Freddie are designed to work in harmony with them.

V. CONCLUSION

Fundamentally, the federal government needs to determine what the housing finance system should look like for the twenty-first century. There is not one right answer to that question. There is also an ideological component to the answer. I believe that a broad swath of the populace favors a system in which private capital (albeit heavily regulated private capital) should be put at risk for a large swath of residential mortgages. Moreover, I believe that there is a broad consensus that the taxpayer should only be on the hook for major liquidity crises and for initiatives that provide home ownership opportunities to low- and moderate-income households. I believe that a broad swath of the electorate would stand behind such a plan whether it was initiated by the Obama Administration or by Congress.

Too much of the debate about our housing finance system is driven by fear of change, often expressed as concerns about the transition from our current system to whatever comes next. But we need to make clear what we want from our new system and then design it and the transition to get there. If we do not, we will end up with the "next, next best" option. We should do better than that.