The Daily Dish

GSE Reforms

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Eakinomics: GSE Reforms

The tale of the housing government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, has become familiar to many. The GSEs had as their core business guaranteeing the payments on mortgage-backed securities (MBSs) in those cases where borrowers defaulted on the underlying mortgages. They vastly increased their exposure to housing risk by holding large portfolios of those MBSs. Despite their undiversified, large exposure to housing risk, they held tiny amounts of equity capital as a cushion against losses. Even so, they were able to borrow cheaply because of a large array of government-granted special privileges. It was the ultimate in crony capitalism, using the power of the government to generate huge private profits.

Of course, it all came tumbling down in the crisis, and the taxpayer ended up on the hook for the largest government bailout in history. Remarkably, they remain wards of the state to this day.

AAF's Meghan Milloy has a timely reminder of the need to release Fannie and Freddie from conservatorship in the process of real GSE reform. But what should such a reform look like? She offers 5 principles:

1. Priority should be put on action and on truly reforming the system. Things are essentially unchanged since the crisis, and it is past time to restore the role of the private sector.

2. Reform should focus on protecting taxpayers and ensuring that there is not a repeat of the largest bailout ever. One way to "de-risk" their portfolios is through the increased use of private mortgage insurance (PMI) to transfer the risk to the private market.

3. Reform has to be broader than just the GSEs. Reform of the Federal Housing Administration (FHA) and Federal Housing Finance Agency (FHFA) should be on the table. Good reform should consider the full range of federal backing of housing finance and ensure that regulators and their regulations strike a balance in proper oversight while retaining sufficient liquidity of the market, especially during times of severe economic stress.

4. Housing reform must remove barriers to entry for competition in the primary and secondary mortgage markets. AAF has previously estimated that the bottom line effects of Dodd-Frank and Basel III regulations may result in 20 percent fewer loans resulting in 600,000 fewer home sales. Real housing finance reform must take into account how all applicable regulations affect affordability and barriers to entry, especially for private capital.

5. Reform should promote best practices within FHFA and should work to bolster a strong, competitive primary market.

It is far past time for Congress to take on housing finance reform. It is a truly bipartisan issue, has large consequences for the growth of the economy and welfare of the middle class, and thus should be at the top of the policy agenda. Instead, there is little talk of reform and even — hard to believe — some who simply want to recapitalize the GSEs and return to the dangerous ways that led to the crisis. That should be unthinkable, and

Congress should act accordingly.