What's next for U.S. housing finance?

↳ By Alex J. Pollock

With the new administration of President Donald Trump, and simultaneous Republican majorities in both houses of the Congress, can the U.S. look forward to meaningful reform of Fannie Mae, Freddie Mac, and American housing finance?

My view is that it is highly unlikely. The interested parties and the policy ideas are simply too fragmented for a politically energetic solution to emerge and be enacted. Many powerful interest groups are fond of the subsidies that Fannie and Freddie pass on to them from the taxpayers. At the same time, a dissonant chorus of well-intentioned theoreticians promote mutually inconsistent proposals.

The topic of the debates, the American housing finance sector, is genuinely huge, with $10.2 trillion in outstanding mortgage loans. That is a number about equal to the combined GDPs of Germany, France, the United Kingdom and Canada.

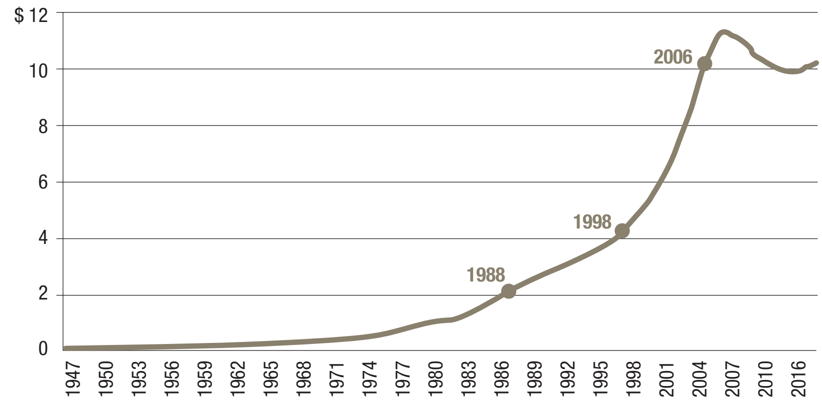
U.S. housing finance also has a troubled history. It collapsed in the 1980s, when based on the savings and loan model, and required a $150 billion taxpayer bailout. The bonds sold to finance that bailout won't be paid in full for another 13 years from now – until 2030. The 1980s U.S. housing finance scandal led to the abolition of the government's housing finance promoter and regulator of the time, the Federal Home Loan Bank Board, in 1989. One of the lessons drawn by American financial regulators at that point was that housing finance needed to focus on the securitization of mortgages, a less-than-perfect conclusion.

So, the U.S. tried again, this time with a model which featured at its core securitization and the "government-sponsored enterprises" [GSEs], Fannie Mae and Freddie Mac. Fannie and Freddie rapidly expanded mortgage credit by issuing trillions of dollars in mortgage-backed securities and debt in highly leveraged balance sheets, which always depended on the so-called "implicit" guarantee of the U.S. Government. That was a mistake, but they and the politicians who promoted them foolishly claimed that this model was "the envy of the world." Both government-sponsored and private mortgage securitization inflated. The increase in outstanding mortgage loans was remarkable, as shown in Graph 1, and was accompanied by political cheering.

Total American mortgage loans reached $2 trillion in 1988. By 2006, during the golden years of Fannie and Freddie, they had quintupled to $10 trillion. Nominal GDP increased by 2.6 times during this period, so mortgage debt was growing far faster the economy for years, a clear danger sign in retrospect. There was an acceleration after 1998, when mortgages crossed $4 trillion. Today, after the fall, total mortgage loans are at about the same level as in 2006, having gone basically sideways for a decade.

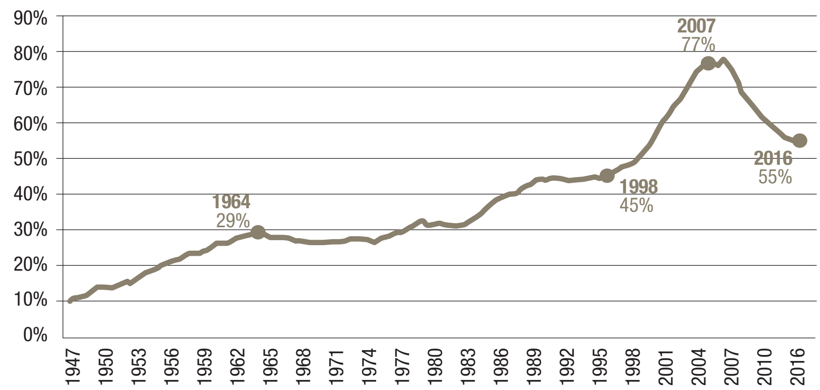
Graph 2 shifts to the long-term growth of total U.S. mortgage loans relative to the size of the

Graph 1 U.S. Outstanding Home Mortgages
1947-2016 (Trillions of Dollars)



Source: Board of Governors of the Federal Reserve, Z.1 Financial Accounts of the United States

Graph 2 Outstanding Home Mortgages as a % of GDP
1947-2016



Sources: Board of Governors of the Federal Reserve, Z.1 Financial Accounts of the United States; United States; U.S. Bureau of Economic Analysis economy, measured as a percent of GDP – and displays an instructive history.

In this graph, we see first the post-World War II U.S. mortgage credit boom which ran until 1964. Then mortgages as a percent of GDP were flat at about 30% for twenty years. They rose to 45% in the 1980s-1990s, then took off with the great mortgage bubble, reaching 77% in 2007 as disaster loomed.

At that point, as we know, the American housing finance sector with its post-1980s "improvements," had an even bigger collapse than before, including the failure of Fannie and Freddie. Among the bailouts of the time was a $189 billion crisis equity infusion in the deeply insolvent Fannie and Freddie by the taxpayers. Fannie and Freddie thus became subsidiaries of the U.S. Government. They remain so to this day, almost nine years after their humiliating failure.

Since the top of the bubble, total U.S. mortgages as a percent of GDP have fallen to 55%. This is sharply corrected from the peak, but is still a high level, historically speaking – equal to the proportion in 2002 and close to twice the level of 1964 or 1980.

Because of their government support, Fannie and Freddie remain powers in the American mortgage system. They guarantee or own $4.9 trillion of mortgage loans – or 48% of all the mortgage loans in the U.S. They have combined $5.3 trillion in total assets and $5.3 trillion in liabilities. You will readily see by arithmetic that they have no net worth to speak of.

The Treasury Department controls 79.9% of the common stock of Fannie and Freddie. Why not 80% or 100%? Because that would have forced the government to put Fannie and Freddie's $5 trillion of debt on the government's books – an outcome the government was and is desperate to avoid. Honest accounting is not going to happen, and the Treasury will continue whatever gyrations it takes to keep its Fannie and Freddie exposure as an off-balance sheet liability.

The Treasury Department also owns $189 billion of senior preferred stock in Fannie and Freddie, the bailout investment. This was the amount required to bring their net worth up to zero, where it remains. Although Fannie and Freddie are now reporting profits – a total of $20.1 billion for the year 2016 – virtually all of this is paid to the Treasury as dividends on the senior preferred stock, so there is no increase in their capital. The profits made by the government, at least for now, from owning these biggest companies in the mortgage business, and from absorbing half the country's mortgage credit risk, thus go to help reduce the annual government deficit.

At December 31, 2016, Fannie and Freddie's combined net worth was about $11 billion, compared to their assets of $5.3 trillion. This gives them a risible capital ratio of 0.2% – so close to zero that the difference doesn't matter.

Fannie and Freddie's principal business is guaranteeing mortgages. So here is an essential question: What is the value of $5 trillion in guarantees from guarantors with zero capital? Clearly the answer is that such guarantees by themselves have no value. Every bit of the value and all ability of Fannie and Freddie to report a profit comes not from themselves, but from the fact that the government truly (though not formally) guarantees their $5.3 trillion in liabilities. In this sense, it certainly seems fair that the Treasury continue to take all the profits which its guarantee creates.

The government is also involved in directly financing Fannie and Freddie's debt, for the U.S. central bank has in its investment portfolio the remarkable amount of $1.7 trillion of Fannie and Freddie's mortgage-backed securities. Thus, the Federal Reserve owns and has monetized one-third of Fannie and Freddie's liabilities and one-sixth of all the mortgages in the country. This is unorthodox central banking, to say the least. The Fed is still buying Fannie and Freddie's MBS, eight years after the 2009 end of the crisis, as they make new investments to replace any maturity or prepayment of principal. The Fed's interest rate risk position is exactly like that of a 1980s savings and loan institution: long-term, fixed rate mortgages funded short. How will that turn out? One must wonder.

In the meantime, the Fed is reporting billions of dollars of short-term profits from investing in long-term fixed-rate mortgages and funding them with floating rate deposits. The bulk of this profit it then pays to the U.S. Treasury. The scheme reduces the government deficit in the short run by speculating in the interest rate risk of mortgages guaranteed by Fannie and Freddie and in turn guaranteed by the Treasury. The financial relationships of the Federal Reserve, the Treasury Department and Fannie and Freddie make an intriguing tangle. One plausible argument is that we should view them all together as one financial entity, the intertwined Treasury-Fed-Fannie-Freddie financial combine.

Viewed from the rest of the world, the American housing finance system is not only impressively big, but odd and indeed unique. The thing that makes it most odd continues to be the role and financial structure of Fannie and Freddie. In addition to their function of guaranteeing and massively concentrating mortgage credit risk, it is clear that they are entirely wards of the state and intertwined in a very complex fashion in the government's finances.

What's next for U.S. housing finance? Will Fannie and Freddie just continue forever as subsidiaries of the government? Nobody admits to liking the status quo very much. But the status quo has tremendous inertia and has proved highly resistant to change over the last eight years.

Do Fannie and Freddie as government subsidiaries represent a good model for American housing finance? For those (like me) who believe in competitive, private markets as the superior form of allocating resources and risk, the answer is obviously No. In particular, people like me think that reinstating anything like the former disastrous Fannie and Freddie "GSE" structure would be a monumental mistake. Many people do not want to see another government bailout of a Fannie and Freddie which have eternally zero capital. Many others correctly think that private capital should bear the principal credit risk in the mortgage market. Speculators who have bought the 20.1% of Fannie and Freddie's common stock which the government does not control, or who own the old, junior preferred stock whose non-cumulative dividends have not been paid for years, hope for some political event which will generate windfall gains for them.

All these people would like change, but there is no consensus proposal. Moreover, many other interests wouldn't mind seeing the old Fannie and Freddie come back, or even the current Fannie and Freddie continue.

For example, homebuilders like having the government guarantee mortgages so it's easier to sell houses, including bigger and more expensive houses. Realtors like anything which helps sell houses faster and increases their commissions. Investment banks find it easier and more profitable to sell mortgage-backed securities around the world when they are guaranteed by the U.S. Government. Then they can be marketed as so-called "rate products" where the investors don't have to worry about credit risk. In addition, these firms can then more make money selling swaps and options to hedge the interest rate risk of Fannie and Freddie MBS. Affordable housing groups like the subsidies which Fannie and Freddie used to pass out so freely, as do left-leaning politicians looking for ways to get money for their constituents without facing a vote in Congress.

For several years after the most recent housing crisis, it seemed that Fannie and Freddie's egregious failure, and their embarrassing bailout, would surely trigger some kind of fundamental reform. But it didn't. Bills were introduced in Congress, but didn't pass. Many plans for how to reform American housing finance in general and Fannie and Freddie in particular were published, and some of them widely circulated and debated, but years went by and nothing happened.

The Trump Administration would clearly have different ideas for housing finance reform than its predecessor, but in its early months, it has not so far articulated any specific recommendations. The new Secretary of the Treasury, Steven Mnuchin, has previously said that continuing government ownership of Fannie and Freddie is unacceptable, but has not yet provided any proposed path to change it.

In my opinion, no legislative reform proposals, whether from the new administration or elsewhere, have a high probability of success in any near term. But there is one possibility we should consider as the one that makes the most sense.

This requires admitting that we cannot get rid of Fannie and Freddie, and that we cannot stop the government from making them "too big to fail" whenever they next get themselves in trouble. However, we should in the meantime take away all the special government favors and sponsorship which allowed Fannie and Freddie to so distort the gigantic American housing finance market.

I propose that Fannie and Freddie should be treated in exactly the same way as every other trillion-dollar bank—that is, exactly the same as Citigroup, JPMorgan Chase, Bank of America, Well Fargo, and the like. They should have the same capital requirements—with a minimum of 5% equity capital to total assets. They should make equivalent payments to the government for their taxpayer credit support, just as the banks do for deposit insurance. They should lose their indefensible exemption from state and local corporate income taxes. They should be clearly designated as the "Systemically Important" institutions they so obviously are and be regulated just like the other big banks under the forceful hand of the Federal Reserve.

Life under these terms would be harder for Fannie and Freddie than just living on the free guarantee from the taxpayers as a subsidiary of the government. But the American housing finance sector would be healthier, more based on private capital, and less prone to entering yet another collapse.

It this scenario possible? Yes. Is it likely? No.

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