

The Future of Housing Finance Reform

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Introduction

The U.S. housing finance system failed badly in the financial crisis, leading to hundreds of billions of dollars in losses from bad loans and millions of people losing their home or still at risk of foreclosure. Reform of this system remains vital for families looking to buy homes, for investors with funds to lend, and for taxpayers who deserve a stable financial system and protection from another expensive bailout. Yet housing finance reform was largely absent from the major financial regulatory reform bill enacted in July 2010, and there has been little subsequent policy progress. In particular, the future of Fannie Mae and Freddie Mac, the two government-sponsored enterprises that securitize and guarantee mortgages and that have been in conservatorship since September 2008, remains unclear and requires Congressional action. In the meantime, the United States is left with a system in which the government is involved with nearly all mortgage origination, taxpayers are left with mounting risks, and private incentives are muted.

This paper proposes a reform for the U.S. housing finance system that addresses the flaws of the old system and would leave a new system that can remain effective and stable over the long term.¹ The private sector would be the main supplier of capital for housing, while the U.S. government provides a secondary guarantee on conforming mortgage-backed securities (MBS). Competition plays a key role in the proposal, with multiple firms performing the securitization of eligible loans into government-backed MBS. Allowing for new entry into securitization would help eliminate the problem under which Fannie Mae and Freddie Mac are “too big to fail,” while competition would help ensure that any implicit subsidy from underpriced government insurance is pushed to homeowners in the form of lower interest rates rather than captured by the shareholders and management of financial industry firms. The paper discusses leading alternative plans, notably reform proposals with a smaller role for the government, including a fully private housing finance system in which there is no government guarantee on housing (or at least no explicit guarantee).

A focus of this paper is on transition steps to move forward with housing finance reform. It turns out that the policy levers to reach the system proposed here are the same ones that would be used to reach alternatives with a smaller role for the government. These actions include raising the price of the government guarantee, reducing the quantity of insurance offered by the government, narrowing the scope of mortgages eligible for the government insurance, and requiring firms that securitize government-insured MBS to arrange for more private capital to take losses before the government guarantee. Reducing or eliminating the government role in housing finance involves going further with these four policy levers—indeed, to end up with a fully private system or a system with a modest role for the government, the housing finance system will first transit through my proposed alternative that has a much greater role for the private sector than the status quo with Fannie and Freddie in conservatorship, and then keep going. Whether this is possible will depend on the societal and political reaction to the higher mortgage interest rates and reduced availability of credit that correspond to the increased protection for taxpayers from a system with a greater role for private capital. It is unclear

¹ This paper extends the work in Marron and Swagel (2010) and Swagel (2011).

whether a nearly or entirely private housing finance system is politically and socially feasible. But the way to find out is to start by adjusting the four policy levers above and see what is possible.

This implies that (the sometimes passionate) disagreements about the role of the government at the core of the policy debate over U.S. housing finance reform are misplaced: the next steps are the same for all plans now under serious consideration, namely that the price the government charges to insure mortgages should rise, the volume and scope of mortgages that the government offers to insure should decline, and the amount of private capital should increase.² The disagreement is over how far to turn the policy levers that affect the price and quantity of the government insurance and that in turn will affect the interest rates and types of mortgage products faced by American homebuyers. How far to go toward a private system will ultimately reflect a societal and political judgment about the role of homeownership and the degree to which Americans support public efforts to foster homeownership.

The alternative is to wait for reform until there is agreement over the endpoint. This agreement is not likely to be reached any time soon in our fractured political system, and waiting to start with housing finance reform is a choice in itself—a choice to keep the two existing GSEs in government control and to have virtually no role for private capital. Indeed, private providers of capital will naturally hesitate to invest in non-guaranteed housing-related assets until the status of the GSEs is clear. The longer that conservatorship continues, the more likely it is that it becomes permanent, with Fannie Mae and Freddie Mac in government hands forever. This would mean a long-run housing finance system that most acutely puts taxpayers at risk while missing out on the possibilities for innovation that are most likely to occur with a system driven by private sector involvement and incentives.

It should be noted at the outset that reforms that better protect taxpayers than in the old system will almost certainly lead to higher mortgage interest rates (spreads over Treasuries) than before the crisis. In the past, proponents of reforms were sometimes labeled as being “anti-housing” for the very reason that reform would lead to higher rates and thus diminished access to credit. While this protection is a feature of a reformed system (that is, a “feature” and not a “bug”), it is still the case that higher rates will affect the housing market. An appropriate response would for the transition to a new system to phase in gradually. It would be important as well to put in place subsidies to ensure that vulnerable segments of the population have appropriate access to housing, including rental housing. In keeping with other measures discussed here, these reforms should be transparent and explicit.

This paper first discusses the goals of a housing finance reform, then sets out a particular proposal and discusses its implication and potential concerns with the model. The relationship of the proposal to other plans is then considered, followed by a discussion of transition steps toward both my proposal and other alternatives for the long-term future of the housing finance system.

² This leaves out one salient alternative: a housing finance system that is entirely government-run. This option appears to have entirely disappeared from the set of policies being discussed. As discussed below, however, a nationalized housing finance system in a sense remains a default outcome, since nearly all funding for housing is now provided or guaranteed by the government with little private capital at risk ahead of the taxpayer guarantee. If no reform is undertaken, then a nationalized housing finance system will be the result.

Goals of Reform

Reform of the housing finance system must balance among potentially competing goals. Notably, a government guarantee in even a limited form would contribute to market stability and the availability of mortgage financing, but give rise to moral hazard and increase the risks facing taxpayers. There is no one perfect solution; my proposed set of choices is discussed below. Before discussing my approach, however, it is useful to set out the goals of housing finance reform. These include:

1. Supporting homeownership by providing a framework under which mortgage financing is available at reasonable interest rates across all market conditions and in the form of desirable products such as long-term fixed rate loans. This goal is important both to individual families looking to become homeowners and to the overall economy, of which residential construction is an important component. This goal does not translate into a blanket guarantee that mortgages will be available for all potential homeowners or at any particular (e.g., low) interest rate. Indeed, policies to promote homeownership among specific groups, including low- and moderate-income families should be explicit rather than implicit as under the former system. At the same time, I see it as a political and social reality that future U.S. governments will intervene if potential homebuyers cannot obtain mortgage financing (such as during a financial crisis) and reform must take this into account to end up with a stable housing finance system. Putting these considerations together leads to a continued role for the government in providing a secondary credit guarantee for housing, at least for the foreseeable future.
2. Protecting taxpayers by ensuring that substantial private capital takes losses ahead of any government guarantee, and that taxpayers are compensated appropriately for taking on risk. Having private capital at risk both protects taxpayers directly and provides incentives for prudent lending practices. Ensuring that the role of the government is transparent will also help protect taxpayers against the build-up of hidden risks such as in the old model in which much of the benefits of the implicit government support went to private shareholders and management while taxpayers were left with the costly aftermath of rescuing Fannie and Freddie. Any public support for housing should be explicit, on-budget, and subject to a vote of Congress.
3. Protecting the financial system and the economy against systemic risks. Housing finance reform should move toward a system in which firms can fail and government officials do not feel forced to intervene to avoid severe negative implications for financial markets and the economy. The dominant market shares of Fannie and Freddie as non-agency securitization collapsed in 2008 meant that a failure of the firms would have had a severe impact on the availability of mortgage credit and on the broad economy. Moreover, Fannie and Freddie securities were embedded throughout the financial system, so that a default in the fall of 2008 would have required wide-scale recapitalization by U.S. banks at just the time when raising capital was difficult.³ There were also international repercussions of a possible GSE default given the substantial foreign holdings of GSE

³ Banks with holdings of GSE preferred stock suffered losses but not on a scale that threatened the stability of the overall finance system, though the losses were widely seen as “unfair” because of the perception that the expected government support for Fannie and Freddie would encompass these holdings.

securities, but domestic considerations alone would have led to government intervention.⁴ Avoiding systemic risk ultimately requires a system in which no firm is too big to fail. There is broad consensus that the GSE retained portfolios should be wound down over time, since these were the principal driving factor behind the two firms' massive borrowing. Additionally, a system in which there are more firms undertaking securitization will move away from having any one of them as too important to fail.

4. Clarifying the roles of the private sector and the public sector. A new housing finance system should recognize the relative strengths of the private sector and of the government and make a clear delineation between public and private roles. Public policy functions such as acting as a backstop source of demand for mortgages and subsidizing affordable housing activities should be carried out by the government, while private firms should undertake securitization. The provision of a government guarantee on mortgages (or MBS), even a secondary guarantee, inevitably affects private incentives and creates moral hazard, but at least the role of the government and the scope of any guarantee should be made explicit.
5. Fostering competition and innovation by opening up the securitization function to entry by new firms and by ensuring that private incentives drive business decisions (within the constraints entailed by other goals). Restoring the dominant role of private capital in securitization and guaranty is important to ensure that market discipline allocates resources, and to drive innovation. While the financial crisis obviously gave financial innovation a bad name, innovation is still important to ensuring that the benefits of the financial system reach broadly within the economy. Under conservatorship, the GSEs have been instructed by their regulator to focus on "core business activities and loss mitigation." (See DeMarco 2011). This has led to a narrowing of the availability of mortgage credit, including for refinancing. While mortgage loans were too easily obtained in the run-up to the recent financial crisis, an argument can be made that the pendulum has swung too far in the other direction. Entry and innovation would allow private providers of capital to more broadly extend lending—but with substantial private capital at risk.
6. Providing for continued public support for affordable housing. Affordable-housing activities should continue, but under the direction of governmental agencies rather than private firms such as the GSEs with contradictory missions and incentives. Support for affordable housing should be more effectively targeted than the diffuse subsidies involved in the old system, in which a government subsidy was provided to all conforming mortgages order to support homeownership of families with low and moderate incomes. The future housing finance system should further allow for a balance of

⁴ It is often noted that the need to reassure international investors also drove support for Fannie and Freddie. It is correct that global investors perceived that there was a government guarantee on the two firms' debt and one could then take the next step to envision that a failure to make good on this implicit support could have led to a flight from U.S. assets writ large, including Treasury securities, with damaging impacts on the U.S. economy. On the other hand, global investors have shifted their holdings away from GSE securities in the wake of the crisis, reportedly because of concerns about U.S. support for Fannie and Freddie into the future—and global investors have shifted into U.S. Treasury securities as a safe haven. Without seeking to minimize the role of global factors in decisions taken during the crisis, even if concerns over the responses of global investors played a role in motivating the government support for Fannie and Freddie in conservatorship, the support would have materialized on the strength of the first two factors alone.

support between ownership and rental housing to meet the needs of Americans of all incomes. The activities of the GSEs in supporting financing of multifamily residential buildings (apartments) should be examined as part of any public support for affordable housing.

7. Arriving at a housing finance system that can remain stable over time. Reform proposals must take into account the unfortunate reality that future financial crises are inevitable. A system that will prove unworkable during or following the next crisis is not suitable for the long-term.

Deciding on a specific housing finance reform involves choosing a tradeoff between these goals. The central question to be addressed is over the role of the government. A government guarantee for mortgage-related securities, for example, would ensure that financing is available in all market conditions but put taxpayers at risk of having to (once again) make good on the guarantee. This risk can be mitigated by requiring substantial private capital to take losses ahead of the government (as is proposed just below), but taxpayers will still be put at risk and private incentives affected—once there is a government guarantee there is no way to avoid moral hazard.

At the same time, it is impossible to commit a future government not to intervene in housing. Indeed, the long history of support for housing and the recent experience of the financial crisis suggest that the government will act if mortgage financing is not available to American families. This intervention will come about both because it would be politically untenable for mortgages to be unavailable and because housing-related securities are such an important part of the U.S. financial system. At the end of 2010, mortgages represented nearly \$14 trillion (with \$10.5 trillion being home loans) of the almost \$53 trillion in total U.S. credit market debt at the end of 2010. Agency- and GSE-backed securities represented \$7.6 trillion of the \$53 trillion total.⁵ There should be no doubt that the government would intervene if these large segments of the financial system locked up—after all, the Treasury and the Federal Reserve both intervened directly to stabilize money market mutual funds in fall 2008, when the funds were just under \$3.8 billion of the \$52.4 trillion in credit market debt. Moreover, a crisis in the secondary mortgage market would likely affect the primary market for origination, again motivating a government intervention.

This suggests that government involvement in housing finance is latent and that market participants will act as if there is a public backstop even if government officials say otherwise. Indeed, if this is correct, then a system in which there is ostensibly no government role will actually revert to one of the chief problems of the pre-conservatorship GSEs: an implicit government backstop on housing without appropriate compensation to taxpayers for taking on this risk. The proposal discussed in the next section takes it as a given that there will be a government backstop on housing for the foreseeable future and focuses on how to improve incentives and boost innovation and growth while better protecting taxpayers than in the past.

⁵ These figures are from the Flow of Funds statistics from the Federal Reserve Board.

A Proposed Long-Term Reform of the Housing Finance System

My proposal for the housing finance system is along the lines of the third option put forward by the Treasury Department (2011) in its February 2011 report on options for housing finance reform. Proposals with broadly similar features have been put forward by several other organizations, including the Mortgage Bankers Association, the Center for American Progress, and others. The proposal involves the following elements:

1. A secondary government backstop on conforming MBS. Private firms, including Fannie Mae and Freddie Mac and new competitors, securitize mortgages into MBS and provide a guarantee using private capital. The government sells an explicit government guarantee against default of conforming MBS. The guarantee kicks in only after private capital is wiped out, including both shareholders of the securitizing firm and other forms of private capital required to stand in front of the guarantee (discussed below). The government guarantees MBS but not any particular firm. The government regulator ensures that the quality of guaranteed MBS remains high and that participating firms have appropriate levels of private capital.
2. Entry and competition in securitization of conforming MBS. Other firms are allowed to purchase the secondary government insurance on the same terms as Fannie and Freddie, including the requirement for appropriate levels of private capital in a first loss position. New securitizing firms would provide beneficial competition in securitization that would help lower the cost of mortgages for homeowners by ensuring that the benefits of any subsidy from the government backstop reach Americans in the form of lower interest rates. Such a subsidy might occur, for example, if the price of the insurance is set too low compared to the risks being taken on by taxpayers. Allowing for entry and competition would also help ensure that enough firms eventually undertake securitization so that one could fail without destabilizing the housing sector, as was the concern with Fannie and Freddie in 2008.
3. The price of the insurance would rise and the quantity offered would shrink over time to foster a greater share for mortgage origination without a government guarantee. The non-guaranteed market would include both balance sheet lending by banks and a renewal of private label (non-guaranteed) securitization. While private label securitization failed badly in the recent financial crisis, a renewal under more strict regulation is still a desirable outcome to provide for a diversified funding base for housing finance, a more effective allocation of risk, and (hopefully) lower financing costs for borrowers. The future housing finance system should allow for a diversity of funding sources, including securitization. A key issue discussed below is whether non-guaranteed MBS can and will remain so, or whether a future government will feel compelled to provide an ex-post backstop.
4. Part of the government insurance premiums would fund affordable housing activities. These activities would be funded explicitly, with spending on the federal budget and undertaken with a vote of Congress (all in contrast to the previous system in which the GSEs were used to provide a

non-transparent and poorly targeted subsidy to homebuyers with low- and moderate-incomes). With a dedicated funding source, policy discussions regarding affordable housing can then turn to specifics of how to best utilize taxpayer resources to support both owner-occupied and rental housing. This discussion would include the appropriate role of the Federal Housing Administration (FHA). The activities of Fannie and Freddie in supplying financing for multi-family residential housing would have to be considered under the rubric of affordable housing, with compensation paid to taxpayers for an explicit secondary guarantee and then explicit subsidies in the other direction as part of the government budget to support affordable housing. Firms that purchase the secondary government insurance would face standards related to serving low- and moderate-income homebuyers in diverse regions, akin to the requirements of the Community Reinvestment Act (CRA), but would not have explicit goals for affordable housing as in the old housing finance system.

5. Fannie and Freddie would be sold back to the private sector, with no special status such as backstop lines of credit at the Treasury and no retained portfolios (at least for a considerable period). The future versions of Fannie and Freddie would focus on securitization; the firms would utilize their existing systems to buy loans and securitize them into MBS and purchase the secondary government guarantee. Until there is sufficient entry into securitization so that Fannie and Freddie are no longer too important to fail, the two firms would not be allowed (or need) to amass portfolios of retained assets with the concomitant borrowing that led to systemic risk in the old system. Fannie and Freddie would have instead modest portfolios of whole loans to accommodate the construction of MBS. This restriction on portfolios would be lifted once there is sufficient entry by new securitizers. The new entrants would likely be banks with substantial mortgage origination, and these banks would have portfolios. If demand for housing-related assets were to flag in a future financial crisis, the Federal Reserve could purchase MBS as was done in the recent crisis (or the Treasury could do so with a vote of Congress), but there would no longer be a need or role for the GSE portfolios to act as a public-minded buyer of last resort for housing-related assets. As discussed below, the existing retained portfolios would be allowed to run off over time, and a good bank/bad bank approach used to recoup as much value as possible for taxpayers to offset some of the costs of the GSE rescues, while ensuring that pre-conservatorship shareholders appropriately realize no value for their holdings.
6. Transition steps should begin immediately to prepare for an increased role for the private sector and competition in securitization. These steps would include actions by the Securities and Exchange Commission (SEC) to preserve features of the TBA (“To Be Announced”) market that contribute to improved liquidity and lower borrowing costs and make it easier for originators to provide borrowers with a reasonably lengthy period to lock in an interest rate before closing on a loan. (See Vickery and Wright (2010) for a discussion). The GSE regulator and other parts of the government would face a number of tasks, including devising a system by which to price the secondary government insurance and setting standards for the amount and quality of private sector capital that firms are required to hold in front of the guarantee. It would be useful as well for the housing finance regulator to require the firms to improve their disclosures of loan-level on mortgage performance, and to move to a common format for future MBS. This latter step would both

improve liquidity for new MBS in the near term and set the stage for entry by new firms undertaking securitization.

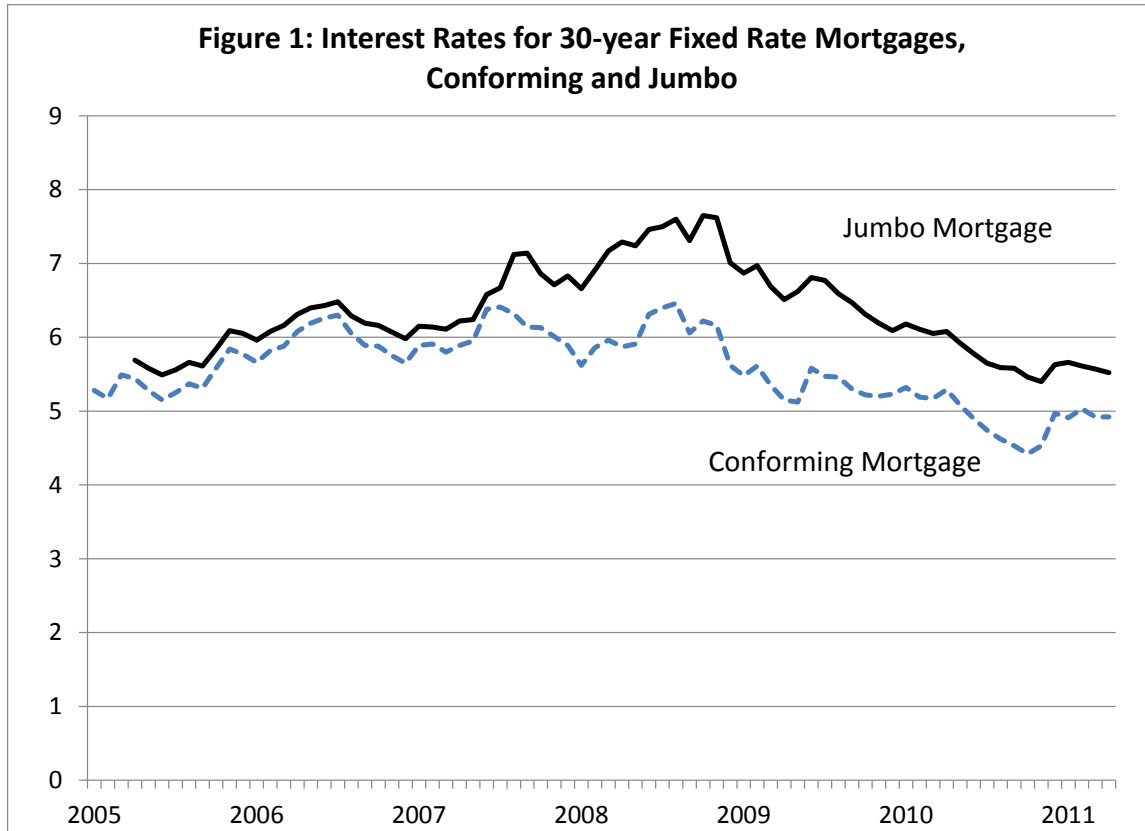
This proposal meets the goals set out above. The secondary guarantee from the government would ensure that housing finance is available in all market conditions, including in the next financial crisis, and this system could remain stable so long as the government has the financial capacity to make good on its guarantee (no small matter given events in Europe and the projected trajectory of the U.S. fiscal position). As discussed in Swagel (2011), the government guarantee is likely necessary to ensure the broad availability of the 30- and 15-year fixed rate mortgage products that are the overwhelming choice of American homebuyers. Having substantial private capital in a first loss position, along with strict regulation, would both protect taxpayers and give market-based incentives for prudent origination. Competition by additional firms performing securitization of conforming loans would help push the benefit of any implicit subsidy from underpriced insurance through to homebuyers rather than having some of it go to shareholders and management, while entry eventually would give rise to a system in which it is possible for regulators to allow firms to fail without severely affecting the availability of mortgage credit.

Having the price of the secondary insurance (the so-called “guarantee fee” or “g-fee”) rise over time and the quantity of government insurance capacity decline, together with the requirement of private capital, would foster a larger share of mortgages that are originated without a government guarantee. This would be useful both to limit risks to taxpayers and to have a segment of the mortgage market that is more innovative than the intentionally cautious conditions under which the government guarantee will be made available. This innovation could be especially useful for potential homeowners with imperfect credit records or modest down-payments, who today find it difficult to access the government-guaranteed market other than through the Federal Housing Administration (FHA).

This system would also provide a ready way for the Federal Reserve to make mortgage liquidity available again if needed, by purchasing government-backed mortgage backed securities as it has done repeatedly in the past several years. The U.S. government would then appropriately act as a potential backstop source of demand for housing and not private firms through the GSE portfolios, as in the old system.

At the same time, this proposal will not eliminate all changes in mortgage interest rates, and the government will not guarantee a low interest for homebuyers. In fact, having more private capital in front of the government will likely lead to higher interest rates (higher interest rate spreads over assets seen as risk-free such as Treasury securities), reflecting the cost of the guarantee and the compensation demanded by private capital sources for taking on the risk of the first-loss position in housing. Zandi and deRitis (2011) calculate that the cost of the private first-loss coverage will add 42 basis points to mortgage interest rates in a situation in which the government backstop kicks in after a 25 percent decline in home prices and private markets demand a 20 percent return on equity. They calculate, however, that there would be an additional 80 basis point increase in mortgage rates without the

government backstop. As shown in Figure 1, this total of 122 basis points (42 + 80) is somewhat larger than the 60 to 100 basis point interest rate spread in recent months between conforming mortgages with a government guarantee and so-called jumbo mortgages for amounts greater than the conforming loan limit that do not have the government guarantee. The spread in recent months, however, is for the situation in which there is only a modest market share for non-guaranteed mortgages such as jumbo. The return required by market participants and thus the spread over guaranteed loans could be much higher in the case of a reform that required markets to absorb a considerably larger amount of housing credit risk.



Issues with this proposed long-term housing finance system

As noted above, any proposal inevitably involves tradeoffs among the several goals of reform. Potential concerns with the choices made here include:

The existence of the government guarantee in the first place will distort the market and put taxpayers at risk. Wallison, Pollock, and Pinto (2011) discuss the pitfalls of a guarantee and the potential benefits of a fully private system. The main problem is that it is difficult to see a full private system as a realistic possibility in the United States any time soon. Americans are not likely to be satisfied with the mortgage products that result from a fully private system (including the high cost of fixed rate mortgages compared to adjustable rate loans), and in any case there would be an expectation that the government

would step in during a crisis. In effect, a system that is ostensibly private would recreate a chief flaw of the old model, in which the government provided implicit backing to the GSEs without adequate compensation to taxpayers.

Ultimately, the question of whether a private model is possible depends on the impacts of eliminating the government guarantee. Zandi and deRitis (2011) calculate that higher interest rates in a private system without a government backstop would lead to a 375,000 annual decline in home sales, an 8 percent decline in home prices, and a one percentage point drop in the homeownership rate. The impacts would be felt especially by potential borrowers with imperfect credit histories. In the face of a financial crisis, a system without a government backstop would likely see considerably larger increases in mortgage interest rates and reduced credit availability. During the recent financial crisis, for example, government actions including explicit support for the GSEs and Fed purchases of MBS meant that mortgage credit remained available throughout the crisis even while other credit market exhibited severe strains.

The experience of other countries that have ostensibly private housing finance systems is of limited use. As discussed in Swagel (2011) and by Min (2011), other countries such as Denmark that do not have GSEs or explicit government guarantees on mortgages instead have government guarantees on the banking system, and thus indirectly on housing. Government support for housing is likewise evident in Canada, where Min (2010) notes that government agencies originate or insure over two-thirds of mortgages either directly through the Canadian Mortgage and Housing Corporation (25 percent of market share) or indirectly through guarantees on private mortgage insurers (45 percent market share). There is nothing wrong with the Danish or Canadian systems of mortgage finance or with housing finance systems in other countries with high rates of homeownership, but these do not necessarily provide models or ready lessons for the United States. If anything, the experience of Denmark in the crisis suggests that government backing is latent: Denmark in October 2008 set up an explicit guarantee program for bank deposits and debt that were not already covered by the then-extant government backing.

One might see a secondary government guarantee as a second-best approach compared to the first-best alternative of a fully private system, but if the private system is unattainable, then it is preferable to make the taxpayer exposure explicit and charge for it rather than allowing the government backstop to remain implicit and be given away for free. And in any case, as discussed below in the context of the transition to a new long-term housing system, the model I propose with a secondary government backstop is a way station on the reform path toward a private system.

This proposal would not recreate the problems of the old system—there would be substantially more private capital involved and an explicit rather than implicit role of the government, and allowing for entry and competition would fundamentally alter the status of firms such as Fannie and Freddie that perform securitization.

The government inevitably charges too little for insurance. The experience of programs such as for flood insurance suggests that it is difficult for the government to price risk—it typically charges too little for insurance. To the extent that government charges too little for the secondary backstop on conforming MBS, this gives rise to an implicit subsidy. One response is that even the best attempt at pricing the secondary government insurance would be better than a price of zero, which is the price that would hold in a system that is notionally private but in which there is an ex-post bailout. Still, it is impossible to know in advance whether a bailout is indeed inevitable. The approach taken in this proposal is to have competition between securitizing firms that purchase the secondary government guarantee help ensure that any subsidy goes to homeowners rather than to shareholders and management of financial firms—that is, to assume that a subsidy will exist and design the policy to take this into account.

The initial steps in reform would continue to have the government offer to insure all conforming mortgages, meaning that the government would face the difficult problem of setting a price for the secondary backstop. As reform proceeds, it would be useful to have the price of the guarantee rise by enough so that firms undertaking securitization do not seek to have insurance for all conforming MBS. This could be done directly through a schedule by which the insurance price rises, or by gradually reducing the amount of insurance capacity offered by the government and then having the insurance price set through an auction (with a minimum price set by the government). The auction price would then provide information on the value that market participants place on the guarantee. If the quantity lever is used, the government could also put into place a so-called “safety valve” under which unlimited insurance would be offered at a certain price if the price for the insurance set in the auction rises above this level—this would effectively set a ceiling for the insurance price in addition to the floor.

Eventually a reform that proceeds far enough so that the government provides insurance for MBS with less than 100 percent of conforming mortgages will address the pricing problem by allowing the government to auction off its insurance. In the meantime, however, or if reform brings in private capital but does not reduce the government share sufficiently, allowing for competition will at least help shape the beneficiaries of any implicit government subsidy.

The guarantee presents serious difficulties for the regulator. In addition to having to price the secondary insurance, government agencies would need to ensure that the quality of conforming mortgages included in guaranteed MBS remains high, that securitizing firms maintain appropriate levels of high-quality private capital, and that these firms do not use financial engineering to extend the secondary backstop on conforming MBS to cover other parts of their balance sheets. These all stem from the presence of the guarantee and indeed present challenges for the regulator—but at least these issues can be understood in advance and the regulator will know to focus on them. Moreover, the proposal above would have the entire capital of securitizing firm at risk ahead of taxpayers, even while the secondary government insurance would cover only the guaranteed MBS and not firms’ other

liabilities. This asymmetry protects taxpayers and could be seen as appropriate in light of the extraordinary situation in which the government extends a guarantee to private-sector liabilities.⁶

The regulator would also need to guard against anti-competitive behavior on the part of securitizing firms, including both the existing two GSEs and new entrants, that might seek to carve up the pool of conforming mortgages and MBS. The advantage of competition in this model derives from having a single liquid pool of conforming mortgages that go into guaranteed MBS—indeed, a useful immediate reform discussed below would be to unify the now-separate Fannie and Freddie MBS pools. A new firm might eventually seek to carve out its own guaranteed conforming MBS in order to demand better terms on mortgages it purchases from other originating banks. The regulator must guard against this, likely in coordination with banking regulators (one could imagine that eventually these regulators would be merged). In effect, firms that want to securitize conforming mortgages with a guarantee would be told that they can enter this market and purchase the secondary government backstop, but with the limitation that they must maintain the same purchase terms on all qualifying conforming mortgages—they must maintain a single pool within the confines of the guaranteed mortgage market.

Large banks would benefit from this proposal, and this new model would further narrow the role of community banks. It would be reasonable to expect that the initial new entrants purchasing the secondary government insurance would be mortgage originators with enough production to securitize their own conforming MBS. This reform model thus provides new opportunities to large banks. But the purpose is to provide competition in securitization, where previously Fannie and Freddie became too large to be allowed to fail, and to ensure that housing finance is available if an institution does fail. In the context of housing finance, the large banks would provide beneficial competition for Fannie and Freddie.

Smaller institutions including community banks would continue to play an important role in originating mortgages. As noted above, an important responsibility of regulators would be to ensure that the system of conforming MBS remains open to all financial institutions, including smaller banks that originate and wish to sell off whole loans for securitization. Moreover, as housing finance reform continues, the higher price of insurance for the government backstop would tend to increase the desirability of balance sheet lending. Nonetheless, it is correct that this new system would provide a new opportunity for large banks but this in turn would provide benefits for consumers and for the financial system as a whole.⁷

⁶ The situation would be analogous to the ability of the FDIC to seize all of the assets of a failed bank to cover the claims of the insured deposits.

⁷ An earlier discussion of similar ideas in Swagel (2011) was supported by the Clearing House Association, which is an organization of large banks. This proposal was initially put forward in Marron and Swagel (2010) and in Swagel (2010), before any discussions with this organization or others. All ideas in this work and those past ones are mine alone.

Relationship to other Reform Proposals

The policy proposal of a secondary government backstop discussed in this paper is similar in some respects to the third of the three options in the February 2011 Department of the Treasury white paper on housing finance reform (Treasury 2011). It turns out, however, that this proposal is also closely related to the other two options put forward by the Treasury Department. Table 1 below summarizes the three proposals, while Figure 2 below provides a graphical depiction.

All reform proposals would represent movement away from the current housing finance system, in which the GSEs are in conservatorship, all conforming MBS receive the government guarantee through Fannie and Freddie, there is virtually no private label securitization, there is little private capital ahead of the government guarantee other than homeowner downpayments supplemented in some cases by private mortgage insurance, and the government is involved in more than 90 percent of mortgages through the two GSEs and government agencies such as the FHA. The third Treasury option would change this by bringing in private capital and raising the price of the guarantee fee (while my proposal would add competition from new securitizers).

Treasury option two would have the government insure MBS with only a modest part of the conforming market in normal times—perhaps 10 percent—and a larger share, possibly 100 percent, during periods in which mortgage financing becomes constrained.⁸ Treasury option one is for a private housing finance system outside the FHA, which would continue to serve homebuyers with low- and moderate-incomes (the FHA continues in all three Treasury options).

Rather than seeing these as three separate proposals, it is useful to note that they differ by the settings of the policy levers of the price and quantity of the government backstop, the scope of conforming mortgages, and the amount of required private capital. These policy levers are summarized in Table 2, below. The settings for these four policy levers determine the share of conforming mortgages that will be covered by the government insurance and thus the choice between the three Treasury options—with a decreasing role for the government as the policy levers are turned. A high enough price for the government insurance, for example, would eventually reduce the share of insured MBS from 100 percent (option 3) to something smaller (moving from option 3 to option 2) and then ultimately to zero (option 1) if the price of the insurance is set high enough and the government is willing to abide by the implications of a private housing finance system for interest rates and credit availability.⁹

The initial steps for any reform plan would be to gradually require private capital ahead of the government guarantee, narrow the scope of conforming mortgages, and increase the price or decrease the quantity of the secondary government insurance. This would take the system from the current state to Treasury option three in which there is a secondary government backstop on conforming mortgage-backed securities and private capital in a first-loss position, but the government would still offer to

⁸ Option two as proposed in Treasury (2011) does not include private capital ahead of the government guarantee, but it is difficult to imagine a situation in which this would be desirable. The discussion here thus adds this feature to the proposal, making the government guarantee secondary to the private capital.

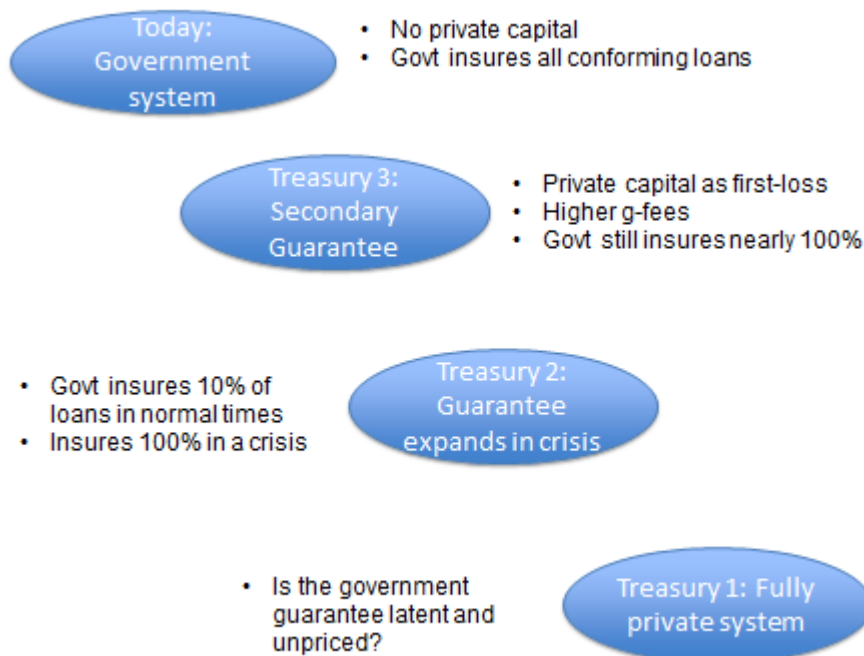
⁹ These impacts are discussed in detail in Swagel (2011).

insure MBS containing all conforming mortgages. This option would pose the difficulty of pricing the government insurance without an auction (since all conforming mortgages can obtain the insurance).

Table 1: Options for Replacing the GSEs

	Details	Plans with broadly similar features
Current status in Conservatorship	All conforming mortgages are insured, with no private capital other than downpayments/PMI.	
Treasury Option 3: Government guarantees available for broad swath of mortgages at all times	Government offers to insure MBS with most or all conforming mortgages but with considerable private capital ahead of taxpayers and a narrower scope of conforming loans.	Center for American Progress Mortgage Bankers Association Marron and Swagel (2010)
Treasury Option 2: Government guarantees a small share of mortgages in normal times and a larger role in a crisis	Government auctions secondary insurance on MBS that include 10 percent of conforming mortgages in normal times but scales up to insure all conforming loans in a crisis.	Scharfstein and Sunderan (2011)
Treasury Option 1: Fully private market	No explicit government role: private capital funds housing and there is no government guarantee (outside FHA).	Wallison et al (2011) House Financial Services Committee

Figure 2: Options for Housing Finance Reform



The key question in deciding how far to move from option three to two and perhaps ultimately to option one is the impact of the smaller government backstop in terms of higher mortgage interest rates, lower availability of popular mortgage products such as 30-year fixed-rate loans, and the consequent effects on homeownership and residential construction. These impacts in turn will determine the extent to which America’s society and political system can abide by a particular reform.

Table 2: Policy levers for Housing Finance Reform

Policy Lever	What policy would entail	Impact
Price for government insurance on MBS (guarantee fee)	Charge a higher price for the government guarantee on MBS.	Higher mortgage interest rates as the increased “g-fee” is passed on to home buyers
Amount of government insurance capacity	Auction off a limited amount of government insurance on MBS.	Offering to insure only a limited amount of conforming mortgages would increase the guarantee fee (as set in an auction) and thus interest rates.
Definition of conforming loans that qualify for a guarantee	Lower the loan limit for conforming loans or otherwise narrow the scope of mortgages that qualify for the guarantee.	Will foster a non-guaranteed market by forcing some mortgage loans outside the conforming standard. These non-guaranteed loans could face higher interest rates (they will not pay the insurance but will not benefit from the guarantee).
Amount of private capital required in front of the guarantee	Require securitizing firms to arrange for private capital to take losses before taxpayers.	Limits government risk but mortgage interest rates will rise, reflecting the cost of the private capital.

The potential for long-term stability differs between the three options. Option three is stable by design, because the continuous presence of the government backstop will ensure that mortgage financing is available across all market conditions, though interest rates will still vary with the returns required by private providers of capital.

Option two has a more limited taxpayer exposure, while providing the government with the ability to scale up to provide a guarantee for all mortgages if needed in a crisis. In normal times, the government insurance capacity would be auctioned off, providing a market-based indication of the value of the government backstop. A foundation of this proposal would be that the 90 percent of mortgages issued without a guarantee in normal times would not receive an ex-post backstop when a crisis hits. The government would insure all mortgages going forward, according to this proposal, but not those already extant. The challenge is for this commitment to be maintained if severe strains develop in the

secondary market and this leads to reduced availability of credit for new lending (including as market participants start to anticipate the government determination of a crisis and the ramping up of the federal guarantee).

A further concern is that once the (inevitable) next crisis occurs—when the Financial Stability Oversight Council (FSOC) decides to offer insurance coverage for all new mortgages—it is possible that political forces could lead this situation to last indefinitely, with all mortgages guaranteed. In other words, it is not clear that option two provides for a stable housing finance system. If this is the case, it might be better to stick with an option in which a larger share of conforming mortgages are eligible for a secondary government guarantee from the beginning—whether this is Treasury option three with a secondary guarantee available for all conforming MBS or some intermediate between options two and three in which the price or quantity of the government insurance is set so that less than 100 percent of conforming MBS but substantially more than 10 percent are insured. This intermediate ground with a substantial but not complete role for the government likely provides the best balance between a stable housing finance system and a salient role for private incentives. Policymakers and regulators could then focus on ensuring that a large amount of high-quality private capital takes losses in front of the government and on better regulation of mortgage origination and other housing-related activities. This would avoid the uncertainty inherent in a system such as Treasury’s option two, in which market participants would seek to anticipate when the FSOC would declare a crisis, or in Treasury option one, which would also face with the looming uncertainty of an ad hoc government intervention.

Transition Steps to the Long Term Housing Finance System

While there is not yet a consensus on the eventual degree of government involvement in housing finance, the policy steps to move forward on reform as summarized in Table 2 are the same regardless of whether the final outcome is Treasury option three, two, one, or something in between. This section discusses details of these steps as well as other actions that would be useful to take as part of the transition to a new long-term housing finance system. Importantly, these steps can begin today, even while Fannie and Freddie remain in conservatorship. This is important because long-term changes to the status of the two firms requires Congressional action to change the firms’ charters—and this action might well come toward the end of the reform process rather than at the beginning. It would be useful for reform to commence, with steps that include the following.

Develop a government insurance capability to price, offer, and make good on the secondary backstop on conforming MBS. The U.S. government today guarantees Fannie and Freddie as institutions, but does not have the ability to price a guarantee on particular MBS or the systems to make good on credit defaults of insured securities. These capabilities would have to be developed for the proposal here and for Treasury options three and two—and for any future reform short of a move directly to a private market.

Adjust the scope of conforming mortgages eligible for the secondary government guarantee. Even with the recent decline in the conforming loan limit, some mortgages over \$600,000 remain eligible for a government guarantee. One way to limit taxpayer exposure and foster a larger role for non-guaranteed mortgages would be to consider further narrowing the scope of conforming loans. At the same time, the removal of the GSEs' former affordable housing requirements means that the government would no longer use securitization per se as a vehicle through which to subsidize homeownership for low-income families—this would be done instead through explicit subsidies carried out by government agencies. This means that the higher conforming loan limit in itself is no longer a concern as a poorly targeted subsidy for low-income families. The policy question should instead focus on the availability of mortgage financing as the conforming loan declines.

Bringing in private capital to take losses ahead of taxpayers. The so-called “Keep-well” agreements made between the Treasury Department and Fannie and Freddie when the two firms were taken into conservatorship will serve indefinitely to maintain a non-negative net worth and thus make it possible for the firms to make good on their financial obligations. This includes both debt service and MBS guarantees. With the stability of the firms assured, it is then possible to bring in private capital with a credible commitment to allow this new private capital to take losses—after all, losses among new suppliers of private capital could occur without affecting the stability of the overall firms.¹⁰

One approach to bringing in private capital would be for Fannie and Freddie to sell non-guaranteed tranches of conforming (guaranteed) MBS—Davidson (2011) and DeMarco (2011) both discuss such an option. These new securities would be akin to mezzanine debt. Homeowners would first lose their equity downpayments, and then these new securities would lose value before the guarantee from Fannie and Freddie (and thus taxpayers) covers the rest of the securitization. Initially a modest amount of these non-guaranteed securities could be auctioned off to gauge market interest and the impact on mortgage interest rates. This would present a challenge in that the new securities would initially trade in a relatively illiquid market, but a public schedule by which the amount of private capital would increase over time might help to attract investors. Private mortgage insurance (PMI) could also fill the role of additional capital, though the regulator of the future housing finance system would have to ensure that the incremental capital brought in by PMI firms was of high quality. PMI firms likely would have considerably less leverage than in the pre-crisis system and would be treated equally with other providers of private capital.

Supporting TBA pools to ensure liquidity. As discussed by Vickery and Wright (2010), the convention under which GSE mortgage-backed securities trade on a “to be announced” (TBA) basis contributes to improved liquidity and lower borrowing costs, including making it easier for originators to provide

¹⁰ This contrasts with the situation of the pre-conservatorship subordinated debt, which in the fall of 2008 was effectively guaranteed by the decision of the Treasury to stabilize the GSEs through the purchase of preferred stock.

borrowers with a reasonably lengthy period to lock in an interest rate before closing on a loan. Vickery and Wright explain that the homogeneity of MBS compared to other securities such as corporate bonds contributes to the liquidity benefits of the TBA market. The TBA structure is made possible by the GSEs' current exemption from SEC registration requirements. As part of reform, it would be useful for the SEC to allow a continued exemption of conforming MBS from registration requirements in order to facilitate the TBA market. In exchange, securitizers (both Fannie and Freddie and new entrants) would be required to provide additional loan-level disclosure about the characteristics of the mortgages in the pool to enable market participants to better evaluate the risks involved with particular MBS.

Standardization of a common MBS format. It would be useful as well for the regulator to ensure standardization of conforming MBS packaged by securitizing firms, including Fannie, Freddie, and new entrants. Standardization would include repayment terms and other conditions. This would avoid chopping up TBA pools as new entrants securitize MBS and would help maintain the benefits of liquidity now provided by the TBA structure. Fannie and Freddie MBS now have somewhat different characteristics and differential liquidity as a result (with Fannie securities having greater liquidity). Efforts to standardize conforming MBS would be aimed at maintaining overall liquidity of MBS trading even as new firms enter into securitization. Indeed, it would be useful to undertake this standardization immediately as an initial step in reform since it would both increase liquidity today and maintain it as the housing finance system evolves with reform. As noted above, new entrants would be required to issue MBS that trade within this common pool—new securitizers would provide beneficial competition overall, but this regulatory constraint would ensure that these entrants do not seek to chop up the market and thereby undo the benefits of standardization.

Standardizing future GSE securities and moving them into a common pool would turn existing GSE securities into so-called orphans—the existing markets are quite large but liquidity would decrease over time (this might be seen as akin to a Treasury security that becomes “off the run”). In return, however, these legacy securities would be covered by an explicit guarantee under reform—this tradeoff might be roughly fair and in any case there would be important benefits from the common pool going forward, since this would increase liquidity to support new mortgage origination.

Winding down the existing GSE portfolios of assets and guarantees. Fannie and Freddie would no longer have retained portfolios of MBS in the new housing finance system, at least until there is sufficient entry by new securitizers so that the two firms are no longer too important to be allowed to fail. The firms instead would have only warehouse portfolios of whole loans in the process of securitization. This leaves the important transition question of the disposition of the existing GSE assets (MBS and whole loans) and liabilities (guarantees and debt), which as of early 2011 included roughly \$600 billion of agency MBS; \$650 billion of whole loans; and \$250 billion of non-agency MBS. The net of these existing assets and liabilities is already on the federal balance sheet—taxpayers are on the hook as the consequence of

the decision by the federal government to backstop debt and guarantees when the firms were put into conservatorship.

A good firm/bad firm structure would wind down the portfolios in a way that facilitates a future re-privatization of Fannie and Freddie and helps recoup some of the taxpayer support for the two firms. Fannie and Freddie would each be split in two, into a good firm and a bad firm. The two “good firms” would have clean balance sheets with the valuable assets of the companies’ computer systems and networks through which they acquire mortgages from originators throughout the United States. These good firms would be sold back into private hands. The portfolios of legacy MBS, guarantees, and debt would remain with the old firms (the “bad firms”), which would have their net worth kept positive by the U.S. Treasury while their assets and liabilities run off. The 79.9 percent share of common stock and the \$150 billion of senior preferred shares held by the Treasury would likewise remain with the bad firms. The old firms would also own the new firms initially—that is, until the two new firms are sold off, as discussed next.

Returning Fannie and Freddie to the private sector. The separation of Fannie and Freddie into “good” and “bad” firms (new firms and old firms) would in effect leave the government providing a ring fence around the legacy liabilities in that the ongoing support of the Treasury would ensure that the firms make good on those liabilities. The two new good firms could then be sold back to private investors as profitable companies with clean balance sheets and functioning business systems. The proceeds of these sales would go to the old firms, and thus to taxpayers. It is unlikely that the proceeds of the public offerings of these new firms together with the dividends already paid to the government would recoup the \$150 billion that taxpayers put into Fannie and Freddie. The remaining net loss after the initial public offering, including any additional future capital needed to stabilize the old firms as they wind down, would constitute the overall cost of the GSE bailout.

Returning Fannie and Freddie to private hands in this fashion would appropriately ensure that pre-conservatorship common and preferred stockholders realize no value from their holdings. This is appropriate because the two firms were deeply insolvent when they were put into conservatorship, and any proceeds from the IPOs should first go to taxpayers. This differs from the situation with AIG in that AIG was illiquid but not insolvent, so pre-crisis shareholders will come out with some value, even though this value for holders of common stock will be greatly diluted by the government stake acquired in the rescue of that company.

The long-term goal is for the Fannie and Freddie to become private firms driven by private incentives—and firms that can fail if they become insolvent. The GSEs and other firms that securitize mortgages with a government guarantee would no longer be used as conduits for government policy—any such efforts such as to boost affordable housing would be done transparently and through explicitly-governmental programs. It should be noted that proposals for the government to use the GSEs while in conservatorship for purposes such as funding foreclosure avoidance, while perhaps driven by laudable objectives, run counter to the objectives of long term reform.

Programs to support affordable housing, including the future role of the GSEs' multi-family activities.

The reform proposal here provides a funding source for affordable housing activities from part of the premiums paid for the secondary government insurance, but these programs must be designed. In doing so, it would be useful to ensure that government subsidies for housing are transparent and well-targeted—in contrast to the implicit and diffuse subsidies involved in the old system in which the affordable housing goals and GSE portfolio purchases were used to boost homeownership. It would be useful as well to consider the balance of any public support between owner-occupied and rental housing.

The future role of the FHA. Stricter standards for conforming mortgages, including increased requirements for down payments, have led lower-income borrowers who find it difficult to qualify for conforming loans to gravitate toward FHA-backed mortgage products. The market share of the FHA expanded considerably during the financial crisis as subprime origination dried up, but this has potentially exposed taxpayers to considerable risk.¹¹ Future policies aimed at affordable housing should address the targeting of federal subsidies through the FHA as a complement to the detailed proposals for government expenditures such as subsidies for rentals or homeownership.

Covered bonds and reforms of the Federal Home Loan Banks (FHLBs). Even with reform of Fannie and Freddie, the FHLBs will remain government-sponsored enterprises that provide housing finance with the benefit of a government backstop. While the issues with FHLBs are somewhat distinct from those of Fannie and Freddie, it is worth noting that the availability of financing for housing through FHLB advances largely crowds out the development of a covered bond market in the United States, since FHLB funding is generally lower-cost (reflecting in part the government backstop). A future task for housing finance reform will be to assess whether the FHLB system with a government guarantee is still needed, or whether the combination of a secondary government backstop on conforming MBS and the development of a covered bond market could substitute for the FHLBs.

The future of housing finance regulation. As discussed above, housing finance reform will entail significant challenges for the regulator, especially if the long-term system includes a government guarantee. For the foreseeable future as the housing finance system evolves with reform, the Federal Housing Finance Administration (FHFA) is likely to continue to regulate the existing GSEs and oversee the securitization and guaranty activities of new entrants. At the same time, it would be useful for the FHFA to work closely with bank regulators on issues of mutual concern, including the quality of conforming loan origination, the quantity and quality of capital held by banks that securitize conforming

¹¹ Barclays (2010) discusses potential taxpayer exposure through losses on FHA-backed mortgages, while Van Order and Yezer (2011) evaluate potential changes to FHA loan limits.

loans, and the competitive behavior of banks that become securitizers of conforming MBS. Over time, it could be that Fannie and Freddie are acquired by or themselves acquire mortgage originators so that the industry vertically integrates. It might then be reasonable to combine FHFA with a federal banking regulator. At the same time, the recent financial crisis revealed serious flaws in the regulation of securitization outside of the GSEs. Provisions of the Dodd-Frank financial regulatory reform legislation such as the risk retention requirements and associated qualifying residential mortgage exemption seek to address these flaws. A reform such as discussed here in which the future of housing finance involves a renewal of private label securitization will depend importantly on the success of these efforts. These considerations further highlight the importance of coordination between the FHFA and bank regulators.

Broader housing-related issues. While this paper focused on housing finance reform and especially on the future of Fannie Mae and Freddie Mac and mortgage securitization, a complete overhaul of the housing system in the wake of the crisis would also encompass reforms in tax policy, bank regulation, and policies relating to consumer protection. A full treatment of these issues is beyond the scope of this paper, but it is worth noting that policy actions in these areas could also reduce demand for housing such as through smaller tax preferences for housing. While a case can be made that the United States before the crisis put too much emphasis on the idea of homeownership, it is equally important to keep in mind that homeownership remains an aspirational goal in American society, with positive spillover effects on communities. There is a role for policies that promote homeownership. The key is to provide any support for housing in an appropriately targeted and effective fashion and to find the right balance between promoting homeownership and other uses of limited societal resources. Among the issues related to a housing finance reform are:

- Tax policy. The U.S. tax system includes three main preferences for housing: the deductibility of mortgage interest on mortgages up to \$1 million, the deductibility of state and local taxes including property taxes, and the exclusion from taxable income of the implicit rent from owner-occupied housing. Carroll, O’Hare, and Swagel (2011) calculate this support as totaling over \$300 billion in 2010, with the benefits accruing disproportionately to middle- and upper-income households. Limiting the tax preferences for housing would reduce the tax-induced bias that favors housing over other forms of investment. This could boost overall economic efficiency but have a negative impact on housing demand and thus on home prices.
- Overall financial regulation. Capital markets will be affected by changes in overall financial sector regulation, including the effects of Basel III rules on capital and liquidity requirements, and the risk-retention requirements of Dodd-Frank and related scope of the so-called QRM exception. In general, more robust regulatory requirements will tend to reduce the riskiness of financial sector activities but potentially at some cost to the availability of credit, including in housing markets.
- Consumer protection. Activities of the new Consumer Financial Protection Bureau (CFPB) will affect housing, notably including changes to the so-called TILA and RESPA disclosures (Truth in

Lending Act and Real Estate Settlement Procedures Act). The CFPB has announced that it is working on changes under the rubric of “Know before you owe,” with a goal of having simplified forms and improved disclosure by July 2012.

This list illustrates that many steps will be required to move forward with housing finance reform. The key question, however, is over the future role of the government in providing a guarantee for mortgages. This inevitably involves making a tradeoff between considerations of market stability and credit availability that would be ensured with government involvement and the concomitant increases in taxpayer risk and strategic behavior by firms that go along with a government guarantee.

As this discussion of the transition illustrates, the policy levers are the same to move forward with any of the three main reform proposals: to increase the amount of private capital that takes losses ahead of taxpayers, reduce the scope of any guarantee, and increase the price or reduce the quantity offered of the guarantee. Moving forward on these policy levers would begin a process that would bring the U.S. housing finance system first to a status akin to the third Treasury option and then gradually moving toward Treasury option two and then one.

Conclusion

While there are today fierce arguments about the future of housing finance in general and the role of the government in particular, this paper illustrates that the steps to take for housing finance reform are the same for all of the main reform proposals (leaving aside the possibility of keeping the GSEs in conservatorship with the intent of having them stay part of the government). This suggests that housing finance reform can move forward even before there is agreement on the end state for the role of the government. Moreover, important initial transition steps can be initiated by the current GSE regulator acting under its legal authority as conservator. This means that it is possible to move forward immediately.

It is also desirable to do so, because any of the three main reform proposals discussed in this paper are preferable to the current situation in which there is no private capital ahead of the government, taxpayers are not appropriately compensated for the housing-related risks they are taking on through unlimited support for Fannie and Freddie, and private incentives and the potential for innovation are largely absent. Importantly, the longer the GSEs remain in conservatorship, the more likely it becomes that they remain there forever—and that taxpayers take on all the risks of housing finance. By the same token, steps to provide certainty about the future of the U.S. housing finance system can help boost the housing sector today—after all, private providers of capital will naturally hesitate to invest in housing until they understand the future role of the government.

While there is far from a societal consensus on this role, the way to find out what is possible in a long-term housing finance system is to start with reform by gradually increasing the role of the private sector

and of private capital and diminishing that of the government. As a nation we can then judge the impact on mortgage interest rates and the availability of housing financing and thus the political and social feasibility of further reducing or eliminating the government role in housing finance. The open question is the extent to which mortgage interest rates will increase as reform proceeds—and the corresponding willingness of society and of the political system to abide by the impacts of reform. Ultimately, a stable system for the long-term must be one that enjoys broad support.

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