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## Fixing Fannie and Freddie for Good

By Mark Zandi and Jim Parrott, December 15, 2015

IN the longstanding debate about what should be done to overhaul Fannie Mae and Freddie Mac, the mortgage behemoths that taxpayers rescued at the height of the financial crisis, a growing number of groups, including several hedge funds and other investors, as well as civil rights groups and consumer advocates, are offering a surprising answer: Go back to the very system we just bailed out.

In September 2008, after the two institutions had racked up tens of billions in losses that had wiped out their capital, and amid fears about what their insolvency might mean for the American housing market and the wider economy, the then newly created Federal Housing Finance Agency stepped in to place Fannie and Freddie in conservatorship. Taxpayers have backstopped the two institutions and their mortgage securities ever since.

Yet, hard as it is to imagine, given the colossal scale of this bailout and the dramatic effect that their failure had on the broader economy, many are arguing that we should now resurrect Fannie and Freddie as the privately owned but taxpayer-backed oligopoly whose collapse contributed mightily to the financial turmoil and resulting Great Recession.

More surprising still, one of the primary reasons offered by many proponents of this view is that we cannot end their stranglehold without decreasing competition in the mortgage market.

This view isn't merely counterintuitive; it's wrong.

Fannie Mae and Freddie Mac are among the largest financial institutions in the world, currently purchasing roughly one-half of the mortgages issued by lenders in the United States. They package and create securities out of these loans, and provide guarantees to the investors that they will be paid their principal and interest under any economic scenario. They thus act as critical gatekeepers in

determining what kinds of mortgage loans lenders can make, and who gets a loan and under what terms.

The concern is that any move to reform Fannie and Freddie by diminishing their dominance of the housing finance system will inevitably mean that the nation's biggest banks will swoop in to take over their gatekeeping role. If they do, then these banks will use that power to their advantage, squeezing out smaller competitors.

This would indeed be a bad outcome. We would simply be swapping one dysfunctional system dependent on too-big-to-fail institutions for another with the same problem.

If this were what reforming Fannie and Freddie was all about, then the critics of reform would be right. But it's not.

The point of the kind of reform that we support is to end the system's dependence on too-big-to-fail institutions. It is critical to ensure that no institution central to the system has an incentive to take on excessive risk, knowing that taxpayers will bail them out if things go wrong, as happened with Fannie and Freddie and could happen in a system overly dominated by other too-big-to-fail institutions.

One of us, Mark Zandi, is on the board of a mortgage insurer; the other, Jim Parrott, advises several financial institutions in the housing finance industry. Some of these institutions could benefit from Fannie and Freddie reform, while others may suffer. But our focus is not the interests of these institutions, any more than it is those of the big banks or the shareholders of Fannie and Freddie. The aim of reform should be to create a healthier housing finance system, which means, among other things, one with greater competition.

In winding down Fannie and Freddie's duopoly, Congress could and, we have long argued, should explicitly prohibit institutions that make mortgage loans from also playing the role of gatekeeper to the secondary market of mortgage-backed securities. Congress could also cap the market share of any single gatekeeper at a low enough level to preclude market concentration, or it could even create new gatekeepers to ensure that smaller lenders never are locked out of making mortgage loans.

Legislative reform could be a long time coming, however, given the complex politics of the issue. In the meantime, the F.H.F.A. should work to ease the mortgage giants' unhealthy hold on the market.

The agency has already taken two steps that hold great promise: requiring that Fannie and Freddie share the risk they take when guaranteeing mortgage

securities with a broad range of private financial institutions, and that they develop a common platform for offering securities on mortgage loans.

Done right, these steps could eventually open up the market to greater competition, reducing the dominance of Fannie and Freddie without enabling other too-big-to-fail institutions to take their place.

It is simply not true that we are forced to choose between one system dominated by Fannie Mae and Freddie Mac and another dominated by a few huge banks. The argument is at best ill considered, and at worst a red herring that will undermine any attempt to achieve significant reform.

There is no reason we can't create a dynamic mortgage market with plenty of competition, free of an unhealthy dependence on institutions we cannot afford to let fail. As we consider reforming the role of Fannie Mae and Freddie Mac, we should settle for nothing less.

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