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Commentary: 10 years after going into conservatorship, Fannie and Freddie need real reform

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It has been a decade since the global financial crisis hit with full force, leaving in its wake breathtaking economic and social devastation. Much of the financial system has been restructured since to reduce the possibility that we ever again suffer such events. But one major piece of unfinished business remains: the restructuring of Fannie Mae and Freddie Mac.

Fannie and Freddie, the government-sponsored enterprises that purchase mortgage loans from lenders and package them into securities that they guarantee, are among the nation's most important financial institutions. They guarantee almost half of all the mortgage debt outstanding. When they faltered during the dark days of 2008, the government had little choice but to push them into conservatorship because their toppling would have wiped out the critical housing market, pushing a nation already in recession into an economic depression.

Yet their stay in conservatorship, intended as a "timeout" to stabilize the housing finance system as Congress decided what to do with the behemoths, has turned into a decade-long limbo. Policymakers have repeatedly failed to muster the political will to make the difficult decisions required for revision.

Mythology around Fannie and Freddie has complicated the challenge. Most pernicious is the view that it was their effort to expand lending to historically underserved families that caused the crisis. Some argue that the government's requirement that Fannie and Freddie help expand lending to these families caused them to inappropriately lower their lending standards in the lead-up to the crisis, which drove other private mortgage lenders to do the same and created the downward spiral of unsustainable debt that led to housing's collapse.

Although a compelling story, it is untrue. At the critical moment that subprime mortgage lending began to take off, Fannie and Freddie's role in the housing market didn't expand, as it would have if they were driving the speculation. Instead, their role declined. According to the Federal Reserve, their share of single-family mortgage debt outstanding fell from almost 44 percent at the end of 2003 to 35 percent just three years later when the bubble was ready to burst. It was then, in response to their falling market share — rather than the affordability requirements — that Fannie and Freddie made the fateful decision to expand their lending to lower-quality borrowers. Their subsequent failure certainly exacerbated the crisis, but it did not cause it.

Also part of the Fannie and Freddie mythology is that what they do — making long-term, fixed-rate, prepayable mortgages broadly available on terms most Americans can afford — could be done without any government support. It can't. Without the assurance that the government would step in to back their investment in the case of widespread financial catastrophe, investors in these loans would demand a return so high it would make long-term, fixed-rate mortgage loans too expensive for most American households.

These and similar misunderstandings about Fannie and Freddie have led many to misdiagnose the problem that we should be solving and argue for solutions that are economically and politically untenable, making an already challenging revision effort all but impossible.

So, what is the problem we should be solving? In short, it's the problem of excessive market power. As a privately owned duopoly on which the entire mortgage market has long depended, Fannie and Freddie had incentive to take on too much risk, knowing that the taxpayer would bail them out if their riskiest bets failed to pay off. And this is, of course, precisely what happened.

Although this problem has been contained since the government's intervention, conservatorship has brought its own problems. The great social value of the housing finance system we have is that it attracts capital from investors all over the world; that makes it easier for Americans to buy a home on terms they can afford. By leaving the future of this system unclear, we are chasing off much of the capital as investors look elsewhere for predictable returns on their long-term investments. Less investment means less innovation, higher costs and less access to credit. We are allowing our system to atrophy under the weight of our indecision.

This means the challenge is getting the system out of conservatorship in a way that makes it no longer reliant on privately owned institutions that we cannot allow to fail.

We have two choices. The first is to expand the number of privately owned institutions that do what Fannie and Freddie do so that any one of them could be allowed to fail without excessive market disruption. This move to multiple guarantors would remove the toxic incentives at the heart of the duopoly and increase competition among those that package and guarantee mortgages.

The second is to combine Fannie and Freddie into a single utility. This would remove the incentives that make market concentration problematic and maximize competition among mortgage lenders, allowing smaller lenders to access global capital markets without going through privately owned gatekeepers such as Fannie and Freddie.

We are skeptical of the likelihood and benefit of significant competition with Fannie and Freddie, so prefer the latter alternative, but either course is preferable to the status quo or a return to the old duopoly. And either course would need to begin in roughly the same way: by reducing our reliance on Fannie and Freddie to manage so much of the nation's securitization of mortgages and to assume so much of its mortgage credit risk.

To be sure, policymakers already have made important strides on both of these fronts. Fannie and Freddie's regulator has worked with them to build a platform to manage the issuance by both of a single mortgage-backed security and to begin selling off to private investors much of the credit risk in the mortgage loans they back.

Both efforts, however, will need to be expanded if they are to lay any meaningful groundwork for a new system. The common securitization platform is being built only to serve Fannie and Freddie and, on its current course, will only further entrench their dominance. To use the platform to reduce barriers to entry instead, either for additional guarantors to compete with Fannie and Freddie or for primary market participants to access the secondary market directly, the platform will need to be expanded to allow others to use it and to handle a wider array of functions.

Also, the risk-transfer effort remains overly reliant on investors who will quickly move elsewhere as alternative investments offer a better return. For a more durable means of transferring risk away from Fannie and Freddie, more private institutions that are willing to take credit risk through the economic cycle must be brought into the risk-transfer process.

Restructuring Fannie and Freddie is the last significant bit of unfinished business from the financial crisis. Policymakers should commit to revisions that reduce our dependence on Fannie and Freddie and begin the critical move to a more healthy, stable system. And they should do it sooner rather than later so that the system that enables most of us to buy a home is not once again upended in a crisis.

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