Maintaining Core Functions of the Housing Finance System

By the CAP Housing Team

If Congress develops a new housing finance reform system, it is likely to change or eliminate Fannie Mae and Freddie Mac, the government-sponsored enterprises, or GSEs, that have supported our nation's housing system since the New Deal.

Making this change is necessary because the very structure of the GSEs contributed to their financial failure in 2008. Due to the so-called implicit guarantee—which the GSEs routinely insisted did not exist—these companies enjoyed all the benefits of a federal guarantee without any of the costs. Their funding costs were cheaper, giving their portfolio an advantage; their equity costs were lower, because the guarantee substituted for a risk premium; and their regulator, already weaker due to structural differences from other financial regulators, permitted gross undercapitalization.

However, as these changes are made, it is critical to understand some crucial roles that Fannie and Freddie have played to ensure that any new system can perform these functions at least as well as the GSEs did, if not better.

Enable the widespread availability and affordability of the 30-year, fixed-rate mortgage

By providing a guarantee of the timely payment of principal and interest to investors in mortgage-backed securities, Fannie and Freddie have enabled the widespread availability of the 30-year, fixed-rate mortgage. Without a government guarantee, the 30-year, fixed-rate mortgage would be available to far fewer borrowers and at a higher cost.

Because Fannie and Freddie guarantee the mortgages and thereby take the credit risk on mortgage-backed securities, investors only need to consider risks that are easier to understand and protect against. What's more, the guarantee is a key component of the very deep and liquid to-be-announced, or TBA, market, which enables investors to get in and out of the market quickly and easily. Consequently, a much wider array of investors are willing to put capital into the mortgage market. It is likely that without a government guarantee, there will simply not be enough capital available to fund the $13 trillion U.S. mortgage market. Capital would also be more likely to flee during times of market distress, making our downturns more severe.

The guarantee also makes mortgages more affordable for American families. Not only does the private sector demand a premium for risk taking, but the guarantee drives down costs by improving the functioning of the securities market. That's why House Republican plans to largely privatize the mortgage market would drive mortgage rates nearly a percentage point higher.

The future housing system needs more private capital, but it also needs a federal guarantee on mortgage-backed securities. But unlike Fannie and Freddie, the new guarantee should be explicit and paid for by premiums that fund sufficient reserves. This will help ensure that taxpayers do not end up on the hook for large losses, as they were after the failure of Fannie and Freddie.

Drive the mortgage market toward more responsible products and make it work better

By setting standards for loan characteristics, servicing requirements, and documentation for loans they guarantee, Fannie and Freddie have driven the market toward more responsible practices. Because lenders want to sell their loans to Fannie and Freddie, they have an incentive to create the safe, sustainable, well-underwritten loans that Fannie and Freddie will buy. Fannie and Freddie's regulation of mortgage servicers gives homeowners a better shot of avoiding unnecessary foreclosures.

Along with the guarantee, this standardization permits the TBA market to function, which benefits both borrowers and investors.

The new housing finance system should have the capacity and authority to create similar standards that produce equally beneficial results.

Pursue a mission to reach all qualified borrowers

Prior to conservatorship, Fannie and Freddie served underserved markets and borrowers in a variety of ways:

- **Enabling borrowers across the country to obtain access to the same mortgage terms and prices.** By pooling mortgage risk on a national basis and by providing standardization, Fannie and Freddie enable mortgages to be offered on the same terms regardless of geographic location. As a result, families can have a very good sense of their options for purchasing a home even before they begin the mortgage process, and they are in a better position to shop for a good deal.

- **Purchasing loans from low-income and other disadvantaged communities.** Fannie and Freddie are subject to a series of affordable housing targets for loans to underserved communities and populations. These goals played a key role in leveraging Fannie and Freddie's market power to serve groups and geographies that mortgage lenders tend to underserve.

- **Supporting innovation in responsible products to serve underserved markets.** Over the years, Fannie Mae and Freddie Mac have participated in numerous partnerships that test and put into service innovative products that help underserved borrowers—for example, borrowers who would be successful homeowners if they could save for a down payment and borrowers who must rely on nontraditional sources to document their income. Research on programs that targeted these harder-to-serve borrowers shows that they promote sustainable homeownership and wealth building.

- **Capitalizing the National Housing Trust Fund and the Capital Magnet Fund.** Although their conservator has refused to allow them to do so, Fannie and Freddie have a legal responsibility to capitalize the National Housing Trust Fund and the Capital Magnet Fund. The Housing Trust Fund finances the production, preservation, rehabilitation, and operation of affordable rental units for low- and extremely low-income renters, while the Capital Magnet Fund gives grants to nonprofits to finance affordable housing and related community development projects. Together these projects can mitigate rising cost burdens and the severe lack of housing for low-income populations.

The housing finance system of the future should build on past successes in serving these communities and borrowers. It can do so by:

- Ensuring that the new system has an affirmative duty to serve all borrowers and geographies

- Capitalizing the National Housing Trust Fund and Capital Magnet Fund

- Creating a new Market Access Fund that provides research and development funds and limited credit enhancement to support innovative and sustainable products