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High Stakes in Housing Finance Reform

By Sara Rosen Wartell and Barry Zigas

Fannie Mae's August 5 announcement that it turned the corner on its losses and sees its credit book emerging from the mortgage crisis stronger than ever highlights the high stakes that policymakers will be playing for beginning on August 17. That's when the Obama administration convenes in Washington the first of a promised series of conferences on the federal government's future role in mortgage finance to foster sustainable homeownership and affordable rental housing.

How that role is defined in the coming months will help determine whether American consumers will continue to have the access to affordable long-term, fixed-rate mortgages on standard terms from lenders of all sizes and in all localities that they have enjoyed since the New Deal of the 1930's.We believe federal support is a critical part of sustaining a deep and liquid supply of capital for housing to meet the needs of a growing and changing population, both renters and owners. But one lesson from the now three-year-old home mortgage crisis is that such support should be explicit, transparently and effectively priced, and guarantee only the securities backed by qualified mortgages—not the financial services entities that create those securities, such as Fannie Mae and Freddie Mac.

This federal insurance that users would pay for also must require that lenders who tap this federal guarantee fulfill a basic duty to serve the credit needs in all neighborhoods, all the time, with community banks and credit unions of all sizes having fair access to the capital available in the secondary market through home mortgage securitization. This means offering sustainable, stable mortgage products that serve a full range of borrowers, including those with good credit but less wealth for a down payment.

Demographers tell us that diverse, low- and moderate-income communities will make up a larger and larger share of our society in future years. But experience tells us that without effective oversight and regulation, such communities can fall prey to a two-tiered market in which they get inferior financial products (including mortgages) at higher prices. Federal support for secondary mortgage markets alongside innovation to develop safe financial products for these and other markets will require federal mandates tied to this support as well as partnerships between public and private capital. Congress should include all of these features in any overhaul of our nation's mortgage finance markets.

Another key issue: How to insure countercyclical liquidity when private capital dries up or prefers other investments over mortgages. Fannie and Freddie used to provide this function through their investment portfolios, buying home mortgage securities in the secondary market when private capital retreated to the sidelines Their conservatorship ended this option, ultimately leading the Federal Reserve to step in to

finance more than $1 trillion of mortgage bonds to support the market and stabilize mortgage interest rates. Private capital has returned to this market as the Fed wound down its program.

But what if private investor demand dries up again? The Fed boasts no mandate to play this role in the future. Nor is there any guidance to indicate when the central bank should do so. Private sector balance sheets are pro-cyclical, not countercyclical. Government may need to retain the ability to step in when private investors will not to assure a constant and affordable stream of capital for housing. This is why housing finance reform must include a clear mechanism for how to accomplish this.

Clearly, then, the coming debate this month cannot be only about Fannie Mae and Freddie Mac. The two former government-sponsored enterprises made serious errors by moving away from their bread-and-butter business of purchasing fully documented loans on standard terms in the last years of the housing and credit boom, and by acquiring big stakes in less creditworthy Alt-A mortgages. These decisions proved to be their undoing, leading to the government's effective takeover in 2008. But various inquiries and hearings over the past two years consistently conclude that pressure from the unregulated "shadow banking" market driven by hot money and a fee-driven business model created a race to the bottom in home mortgage underwriting and credit standards—a race that fatally weakened the entire financial system.

Effective mortgage finance reform must insure that any company that wants to issue securities backed by mortgages, whether enjoying an explicit federal guarantee or not, submit to comparable safety, soundness and capital requirements to protect the market from a repeat of the excesses from which we have still not recovered. The primary market reforms in the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act are an important and essential step in controlling risk, but they are not enough.

There will be strong pressure on the Obama administration and Congress to limit its attention to Fannie and Freddie, and nothing else. This would be a huge mistake. Form must follow function in this debate. The most important question is not whether the new mortgage market is dominated by new types of financial services "utilities," cooperatives, mutual associations, or some form of entity that includes government ownership.

The most important question asked by conference participants and policy makers must be this: What functions must the new home mortgage financing model deliver in order to rebuild communities and strengthen families, protect consumers, and provide a stable supply of affordable mortgage finance to meet the country's housing needs? The answer will determine the future of homeownership—that key piece of the American Dream—in our nation in the coming decades.

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