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The Demise of Fannie Mae and Freddie Mac: Housing Finance Reform and the Potential Impacts on the Real Estate Market

by Brian Shaffer

Over the last few years, the Federal National Mortgage Association and the Federal Home Loan Corporation, commonly known as Fannie Mae and Freddie Mac ("Fannie" and "Freddie") have been criticized for contributing to the housing bubble and the resulting economic meltdown. Regardless of whether such blame is rightfully placed, it is undeniable that Fannie and Freddie hold significant influence over the housing market and are often credited with helping facilitate the expansion of the secondary mortgage market and the popularization of mortgage-backed securities. However, as the economy crumbled in late 2008, Fannie and Freddie were placed into the conservatorship of the Federal Housing Finance Agency ("FHFA"), leading to a taxpayer-funded bailout of approximately $150 billion to date. Some experts predict that the final cost of the bailout could reach as high as $300 billion. This has understandably led to calls for substantial reforms in the housing finance market. Given the prevalent role that Fannie and Freddie occupy in the mortgage market, any reform of Fannie and Freddie has the potential to substantially impact the California real estate market and the economy as a whole. Some of the proposed reforms and their potential consequences on the housing market are discussed below.

The Rise and Fall of Fannie and Freddie

Fannie was created by the government in the 1930s during the Great Depression. It was initially established as a government-sponsored enterprise ("GSE"), but it became a publicly traded company in the 1960s. Freddie is also GSE, which was created in the 1970s to further expand the secondary mortgage market. In plain terms, Fannie and Freddie buy mortgages in the secondary mortgage market, pool them with other mortgages, and sell them to investors on the open market as mortgage-backed securities. This process allows the primary lender (*i.e.,* the lender selling the mortgage) to reinvest those funds, thereby allowing the primary lender to make more loans.

Fannie and Freddie generate revenue by charging a "guarantee" fee on loans that it purchases and securitizes. Essentially, Fannie and Freddie guarantee that the principal and interest on the underlying loan will be paid regardless of whether the borrower actually repays and, therefore, Fannie and Freddie assume the credit risk for these loans. While the US government does not explicitly guarantee these mortgages, there is a widely-held belief that Fannie and Freddie securities are backed by an "implied" federal guarantee.

As the subprime mortgage market flourished in the 2000s, Fannie and Freddie extended their guarantees to riskier mortgages. When the housing market began to crumble, and adjustable-rate mortgages began to re-set at higher rates, mortgages began to default at an astonishing pace, and Fannie's and Freddie's ability to honor their debts and guarantees was strained. In September 2008, the FHFA placed Fannie and Freddie into conservatorship under the Housing and Economic Recovery Act in order to ensure that Fannie and Freddie could honor their debts and guarantees, thus leading to the Treasury Department's multi-billion dollar bailout.

There is a widely-held belief that Fannie and Freddie, by proliferating the secondary mortgage market for risky loans, were substantial contributors to the economic collapse. Further, the enormity of the taxpayer-funded bailout has led some to demand that the government remove itself from the housing finance market. Some of the suggested reforms are discussed below, many of which may have substantial impacts on the housing market and the economic recovery in general.

The Administration's Plan

On February 11, 2011, the Department of the Treasury and the Department of Housing and Urban Development issued a report to Congress unveiling the Obama Administration's plan (the “Plan”) to reform the housing finance market. The Plan calls for reduced government support for the housing finance industry and a gradual winding-down of Fannie and Freddie over several years. The government's reduced role will be facilitated by a number of means, including increasing the “guarantee fee” charged to those banks who sell their mortgages to Fannie and Freddie and increasing the minimum required down payment for home purchases to 10%. The Plan also seeks to remedy the “fundamental flaws” in the mortgage finance market that, according to the Administration, fueled the housing crash. These flaws will be corrected by reforming loan origination and securitization practices and by reforming loan servicing and foreclosure processes.

The Plan lays out three options to accomplish these broad goals and to reduce Fannie's and Freddie's imprint on the mortgage market. Option 1 calls for a privatized system of housing finance with the government's role strictly limited to insuring or guaranteeing mortgage loans to specific disadvantaged groups currently assisted by the Federal Housing Administration (“FHA”), the USDA, and the Department of Veterans' Affairs. This is the most drastic option for reducing the government's role in housing finance, leaving the “vast majority of the mortgage market to the private sector.” With Option 2, the FHA and other narrowly targeted programs would provide access to mortgage credit for low and moderate income borrowers, but would allow a “backstop mechanism” to allow for increased government involvement during a housing crisis. This would allow the government to “lay low” during normal times, but scale up its activities when private capital withdraws from the market during times of financial crisis. Finally, Option 3 calls for a privatized system of housing finance, where private guarantor companies would provide guarantees for mortgage-backed securities that meet strict underwriting standards. A government reinsurer would then provide reinsurance to the holders of these mortgage-backed securities, which would only be paid if the private mortgage guarantors cannot pay. Arguably, under Option 3, the government effectively insures the mortgage-backed securities market, and thereby does not stray too far from the previous model employed by Fannie and Freddie.

Republican Proposals

Republicans in Senate and House of Representatives have also joined the calls for reform in the housing finance market. Senators John McCain (R-Ariz.) and Orinn Hatch (R-Utah) have unveiled a bill that would disband Fannie and Freddie, or turn them completely into private entities, within 5 years. Another bill introduced by House Republicans would increase the guarantee fees charged by Fannie and Freddie, thus pricing Fannie and Freddie out of the market and encouraging more private investment.

Somewhat surprisingly, the proposals by the Obama Administration and the Republicans are consistent in principle, namely that the government drastically reduce its role in the housing finance market. While Democrats and Republicans will undoubtedly squabble over the specific mechanism for reform, substantial reform for the housing finance market is highly likely over the coming years.

Impacts on the Real Estate Market

While it is unknown how the mortgage finance market will ultimately be reformed, it seems to be a certainty that significant reforms will be enacted in the coming years. The common thread in the vast majority of the proposed reforms is the reduced role of government, combined with a significant increase in private sector involvement. Housing market reform is a monumental task and, as described below, may have some substantial impacts on California's housing market and the burgeoning economic recovery.

First, some experts say that the private market is not ready to handle the burden that will be left by Fannie's and Freddie's departure. Fannie and Freddie have been pillars of the housing finance market for decades, and removing those pillars will further destabilize an already shaky real estate market. Thus, if Fannie and Freddie are wound down too quickly, and if the government does not give the private market enough time to develop, the recovery of the real estate market might be further prolonged.

Second, some predict that the withdrawal of the government from the mortgage finance market will lead to a spike in mortgage interest rates. Such an increase in mortgage rates could mean that fewer Americans are able to obtain affordable mortgages. This could have a significant impact on the housing market. If mortgages become more expensive, fewer homebuyers will be able to purchase a home, leading to a continued lag in demand for housing and leading to a more prolonged real estate slump. Further, some experts predict that total reliance on Wall Street will result in fewer fixed-rate mortgages, as banks tend to prefer variable rate mortgages that fluctuate with the market. Such a shift from fixed to adjustable rate mortgages may force consumers to shoulder the risk of fluctuating rates, thus putting consumers' homes at risk and potentially further depressing the demand for home purchases.

Third, housing finance reform could prove to be a boon for the rental market. Obama's Plan explicitly recognizes that home ownership is not appropriate for all Americans and it emphasizes the need for other forms of housing, such as multi-family rental options. As more and more people are priced out of purchasing a home because of rising interest rates, the demand for affordable rental properties could increase. Thus, housing finance reform could lead to increased opportunities for developers of rental housing.

Those advocating for a government withdrawal from the housing finance market say that reforms are needed to prevent another multi-billion dollar taxpayer bailout during the next housing crash. However, as detailed above, the reforms aimed at mitigating the effects of the *next* market crash may further prolong the effects of the *current* one. While the impacts of housing market reform are far from certain, it is undeniable that the market will be significantly different without Fannie and Freddie. Housing finance reform is a development that warrants close attention, as it has the potential to significantly affect the California real estate market.