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Fannie and Freddie May Foment Another Crisis

By John H. Cochrane And Amit Seru

Fannie Mae and Freddie Mac were supposed to be reformed after the 2008-09 financial crisis. The failure of these government-sponsored enterprises, which funnel money to mortgages, led to the crisis and a taxpayerfunded bailout. In typical Washing--ton fashion, they're back and bigger than ever. In addition to risking another meltdown, they have crowded out private lenders and stifled innovation that could have improved U.S. mortgage markets.

GSEs don't make loans directly to home buyers. Banks, and increasingly nonbank lenders such as Rocket, originate mortgages. Fannie and Freddie buy these mortgages, bundle them into securities and sell them to investors, who provide the underlying money.

Banks have long made mortgage loans, getting the money from deposits, debt sales, equity issues and private securitization. But the government thought it could do securitization better and funnel more money to mortgages at lower rates. *

To juice sales, Fannie and Fred--die guaranteed the mortgages in their securities. If a homeowner defaulted, Fannie and Freddie * were supposed to make up the difference. The GSEs should charge enough and cover defaults, but in 2008 Treasury made up the difference when the housing market melted down.

The Dodd-Frank Act of 2010 and other laws and regulations were supposed to curb the GSEs' influence and allow a more vibrant private market to emerge. Instead, the Federal Housing Finance Agency, which oversees Fannie and Freddie, raised loan limits, loosened credit standards, and expanded programs such as first-time home-buyer incentives and special refinancing options. Today the GSEs finance mortgages up to $1.1 million, edging out private lenders that once handled jumbo loans.

Tighter bank regulation such as Dodd-Frank's ability-to-repay rule, and scrutiny by the Consumer Financial Protection Bureau, moved more business to the GSEs. Strict capital and liability- risk regulations— such as Basel III capital requirements and Dodd-Frank's riskretention rules— clobbered the private securitization market, which accounted for 40% of mortgage- backed securities before 2008.

Fannie and Freddie now back more than 60% of new mortgages, compared with roughly 45% before the 2008 financial crisis. When you add in Federal Housing Administration and Veterans Affairs loans, the government backs nearly 85% of today's mortgage market.

The GSEs' loan portfolio stands at $7.5 trillion. They are widely regarded as too big to fail, to let security holders bear some risk. Among those holders, the Federal Reserve owns $2.2 trillion in mortgage- backed securities—effectively a massive infusion of printed money into the housing market, intended to hold down mortgage rates.

The government is again on the hook if house prices, now higher than in 2008, take a tumble. That this hasn't already happened is due in part to good luck and a decade of ultralow interest rates. It's also partly thanks to reforms under former FHFA Director Mark Calabria, who built substantial capital before it was needed in the pandemic.

More deeply, the government takeover of mortgage finance severely limits innovation. Mortgage originators will make only loans that conform to Fannie and Freddie's rules. The 30-year fixed-rate mortgage is a prime example. This product, designed in the 1940s, is unsuited to many of today's homeowners.

If you take out a 3% mortgage and rates rise to 7%, you can't take the 3% with you if you move. Other countries allow homeowners to take that protection with them. Many families then decline to move to take a better job, so there are fewer houses for other families to buy. A well-functioning private market would offer more dynamic mortgage structures—adjustablerate options, shared-equity models, or fixed-rate loans with built-in flexibility.

This river of subsidy should at least make homes more affordable. But it doesn't. Subsidizing demand in the face of supply restrictions sends prices up. House prices are higher than ever, with the median home up nearly 40% since 2020. The subsidy, along with others such as the mortgage interest tax deduction, has ended up in the pockets of aging baby boomers who own houses, not the new home buyers who were the purported beneficiaries. It hasn't even visibly lowered interest rates. The spread between 30-year mortgage rates and the 30year Treasury rate is wider than it was in the 1990s.

Markets, not bureaucrats, should determine how mortgages work. The first Trump administration's reform effort stalled. The second one has a chance to get it right. Technology, data and new financial tools offer ways to allow expanded access to credit without the distortions of government dominance.

Fannie and Freddie can't continue to be the only game in town. America needs a mortgage market that works—not a government monopoly. Every time the government tries to cut out the middleman and lend money to voters, disaster follows. Just look at student loans.

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