Housing Finance Policy:
Eliminating Fannie Mae and Freddie Mac without Legislation
Current State of the Housing Market

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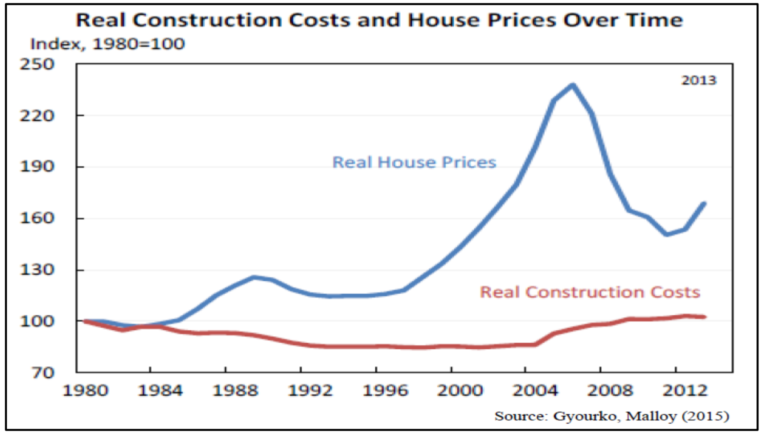
The views expressed are those of the Edward Pinto alone and do not necessarily represent those of the American Enterprise Institute

Why my Colleagues and I developed a plan to eliminate Fannie Mae and Freddie Mac without legislation

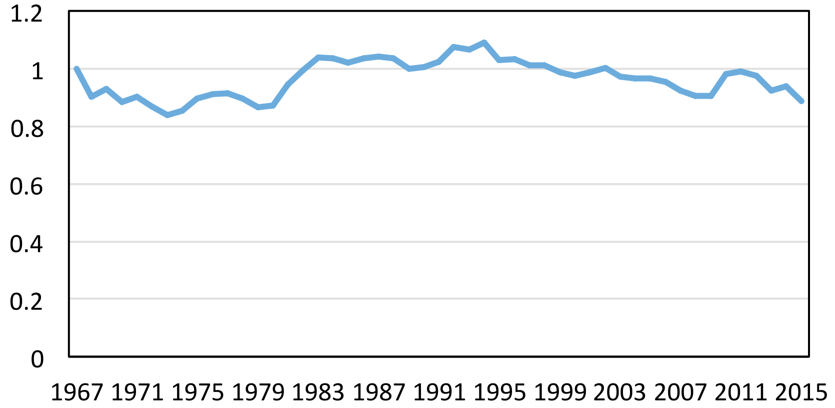
Government Policies Distort the Housing Market

In large markets where effective bargaining occurs, prices remain stable, but not for housing market where government policies distort prices



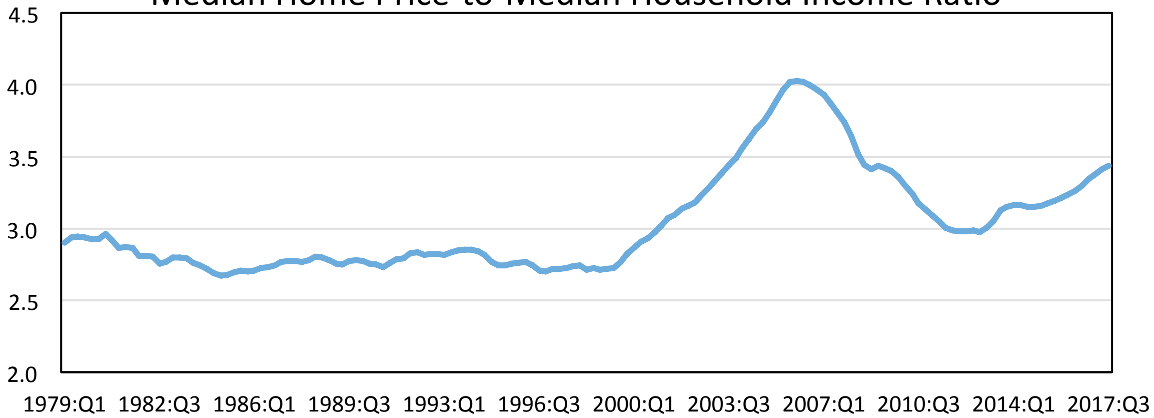
Source: White House Housing Development Toolkit, October 2016

Average Real New Car Price/Real Household Median Income (With 1967=1)



Raff, D.M.G. & Trajtenberg, M. (1995), "Quality-Adjusted Prices for the American Automobile Inc
National Bureau of Economic Research, Inc.; Gordon, R.J. (1990), The Measurement of Durable G
National Bureau of Economic Research, Inc. and U.S. Department of Commerce, Bureau of Econ
National Income and Product Accounts.

Median Home Price-to-Median Household Income Ratio*



* Calculated as median house price divided by median household income.
Source: Zillow.

Why We've Developed This Plan

Reforming or eliminating the GSEs and decreasing the risk of taxpayer-funded bailouts through legislation will be difficult.

- Policy disagreements in the Senate, and between the Senate and the House, make it unlikely that there will be financial reform legislation in 2018.
- However, the Trump administration could, *without any legislation*, create a stable housing finance market by:
  - Eliminating the GSEs over time,
  - Reforming the FHA, and
  - Turning the government-dominated US housing finance system into a predominantly private-sector system based on free market principles.

The Plan is unique:

- No other reform proposal creates a safer and more stable housing market, gets the taxpayers off the hook, and helps Treasury reduce the debt by billions of dollars annually

How Our Plan Would Work

Gradual wind-down of the GSEs.

- Through a series of steps, we would gradually wind down the GSEs
  - by reducing their conforming loan limits (the maximum size of the mortgages they are allowed to buy), and
  - by eliminating other GSE products that do not promote home ownership

- As the wind-down progresses, larger and larger portions of the housing market will be taken over the private sector—banks, S&Ls, credit unions and private MBS (PMBS).

How Our Plan Would Work

FHFA's role:

- The steps we recommend can be taken by FHFA as conservator (not as regulator) of the GSEs.
- In January 2019, President Trump will have an opportunity to appoint a new director of the FHFA who will be able to take the steps we recommend

What is the effect of government policies like the GSEs on housing costs, particularly first-time buyers?

Government Housing Policy Creates an Economics Free Zone

- **Law of the Marginal Buyer:** In a seller's market, prices rise faster than incomes as long as marginal buyer, who sets the price for all, has access to higher leverage. Determines not only price level, but also degree of stability, as price is not necessarily equal to value.

- **Fisher's Law:** [I]n a seller's market, when choice is restricted and the seller virtually dictates sales terms, more liberal credit is likely to be capitalized in price.*

- **Law of Ignorance:** Policy makers ignore principles of supply, demand, and housing finance, resulting in an economics free zone. Cross-subsidies and expanded access to credit push up demand against a regulation-constrained supply.

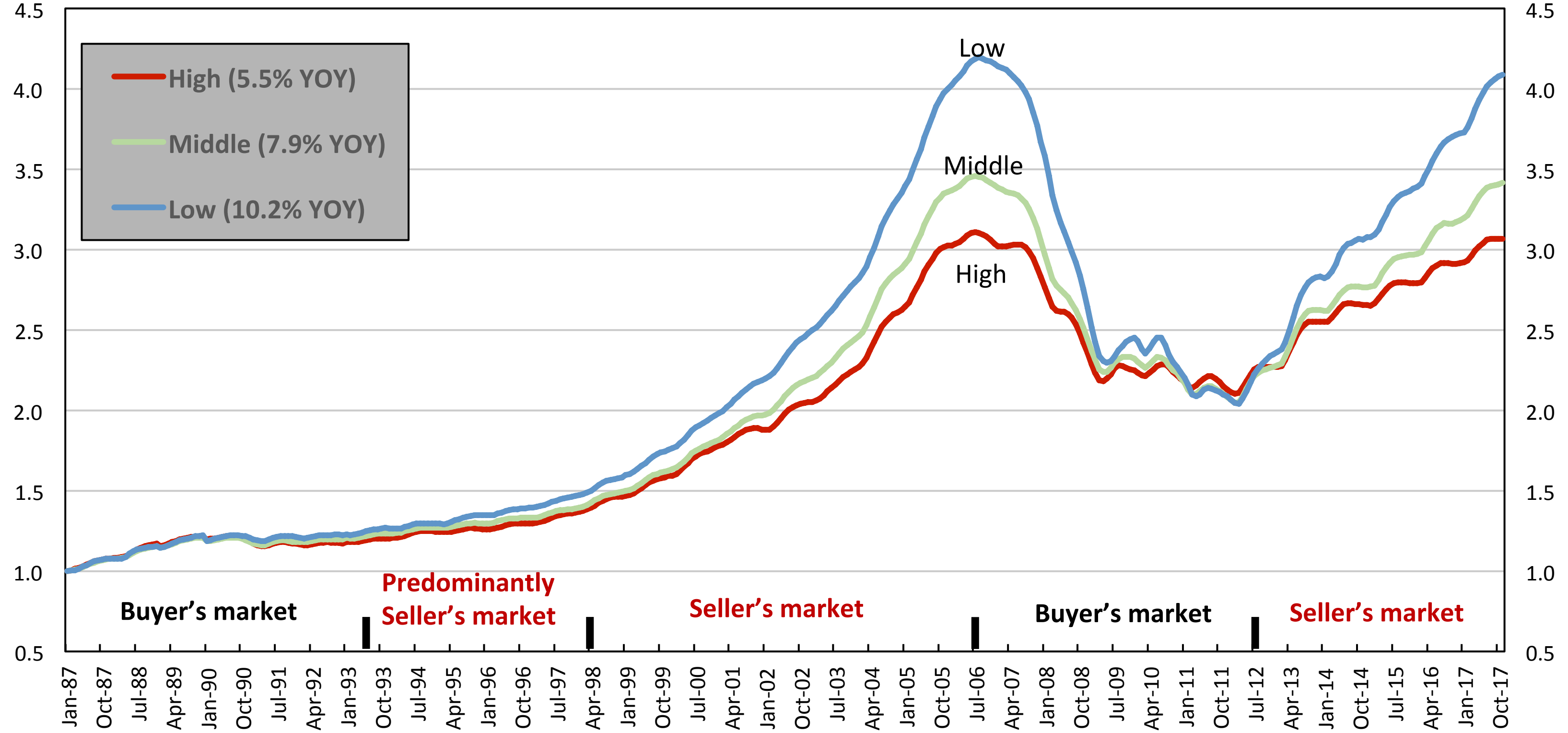
* Fisher, *Financing Home Ownership*, NBER, 1951 (FHA's first chief economist)

Since Early 1990s Government Housing Policies Have Resulted in Higher and More Volatile Home Prices Trends, Particularly at the Entry Level

These trends have developed since the advent of aggressive "affordable housing" efforts that began in 1992

As a result, government policies have made it more difficult –not easier—for low-and moderate-income families to buy homes

CoreLogic Case-Shiller Tiered Home Price Index by Price Tier (Low, Middle, and High) (1987=1), through Nov 2017

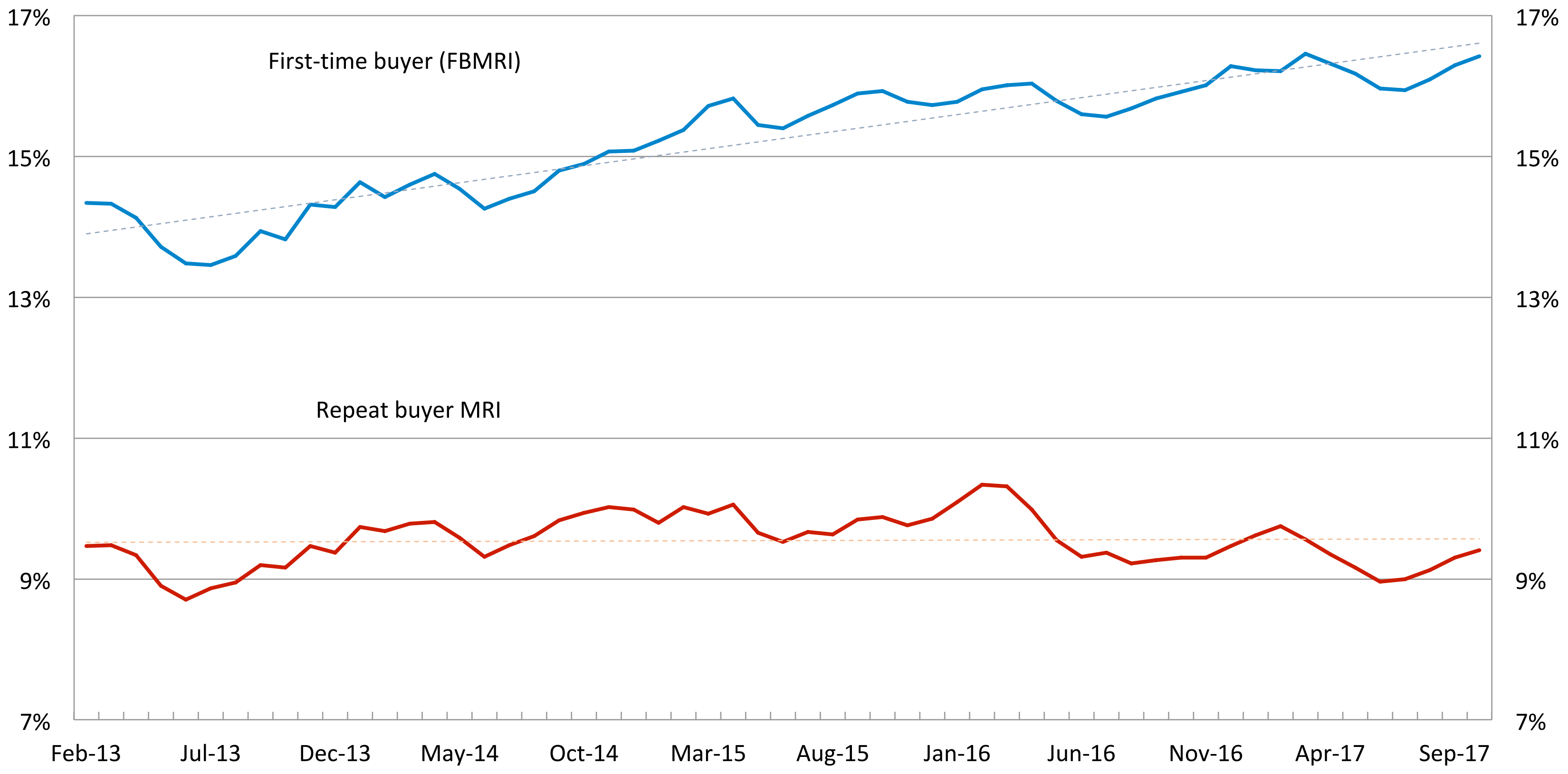


* A seller's market: an economic situation in which goods are scarce and sellers can keep prices high. (Google.com)

**A buyer's market: an economic situation in which goods are plentiful and buyers can keep prices down. (Google.com)

Source: CoreLogic Case-Shiller (Data: Nov-17, Pub: Jan-18), compiled by John Burns Consulting and AEI Center on Housing Markets and Finance (www.HousingRisk.org)

Government Polices Are Hurting First time Home Buyers by Driving up Prices and Forcing Them to Take on More Risk



Source: National Mortgage Risk Index, AEI Center on Housing Markets and Finance

Historically “Affordable Housing” Mandates Have Eased Credit and Promoted Price Instability

- 1950s: National Housing Act amendments result in 30-year and minimal down payment loans becoming commonplace
- 1960s: Congress expands FHA to lower-income families unable to meet normal FHA credit requirements
- 1977, 1995: Community Reinvestment Act requires use of innovative and flexible lending practices to address LMI buyers
- 1992: Congress mandates GSE affordable housing goals
- 2008: Congress makes GSE affordable housing goals tighter and adds duty-to-serve

Today: recent drafts and plans, including the Corker draft, are no different

- Promote and ensure access to affordable mortgage credit and affordable housing, including to underserved borrowers
- “Market Access Fund”, “Market Access Plan”, “Market Access Agreement”
- “Access” appears 62 times in 80 pages and yet garnered no Democratic sponsors

Such mandates seek to provide a “free lunch”, but ignore the fact that the marginal buyer determines not only price levels, but also their degree of stability, because price does not necessarily equal value.

Plan’s Benefits to Low- and Moderate-Income Homebuyers, the Treasury and Taxpayers

A Stable Housing Market Helps Low- and Moderate Income (LMI) Homebuyers

- Greatly reducing government support will slow home price growth and homes will become more affordable for first-time LMI buyers.

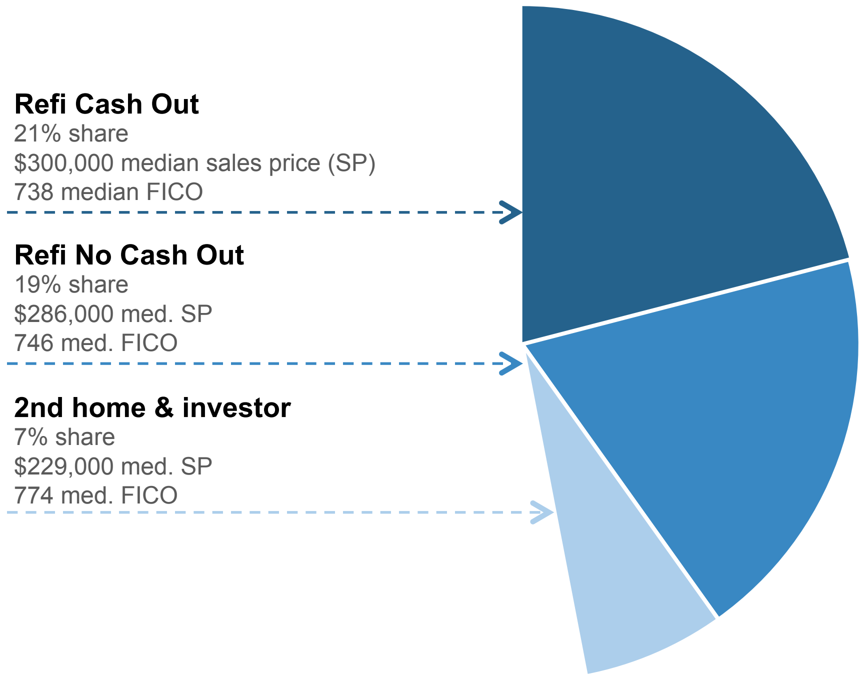
Benefits from our plan flow to the Treasury and the taxpayers

- GSEs’ securities compete with Treasury securities, and we estimate that eliminating this competition will save the Treasury $17 to $29 billion annually in interest costs.
- Reduces government guaranteed private debt (now about $15 trillion) by $5 trillion (about 35 percent) and all government debt by 16 percent.
- Greatly reduces the risk of taxpayer-funded bailouts.

What do the GSEs actually do for prospective homebuyers and what does it cost the taxpayers to support the GSEs?

Principle: the only plausible reason for government to back the housing market is to help low- or moderate income families buy homes

An evaluation of the GSEs 2017 business shows that the GSEs fail to meet this simple test



Almost half of the GSEs' 2017 volume wasn't even related to buying a primary residence. These borrowers could be served by the private sector

Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Another 41% went to help well-to-do buyers

Of which 25 percentage points went to well-to-do repeat buyers of primary residences and 16 percentage points went to well-to-do first-time buyers.

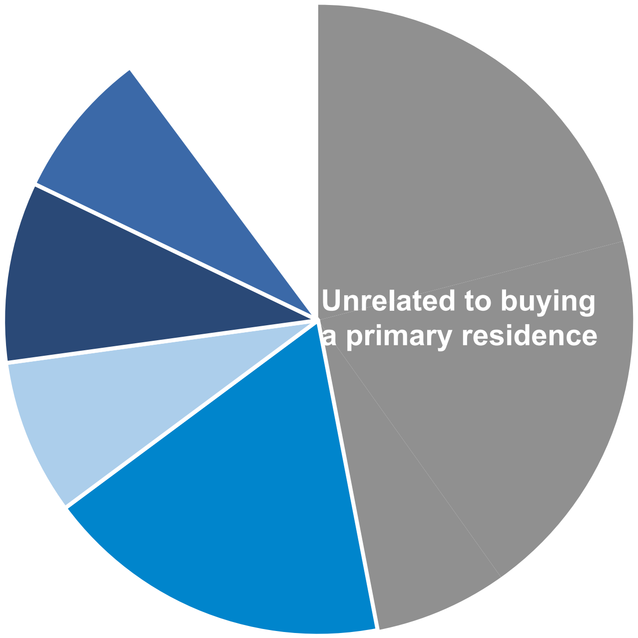
These buyers could be served by the private sector

First-time buyer (FTB) w.>85% CLTV & loan>$250,000
8% share
$353,000 med. SP
746 med. FICO

FTB w.<=85% CLTV
9% share
$280,000 med. SP
752 FICO

Repeat buyer w. >85% CLTV & loan >$250,000
8% share
$365,000 med. SP
755 FICO

Repeat buyer w. <=85% CLTV
18% share
$327,000 med. SP
774 med. FICO

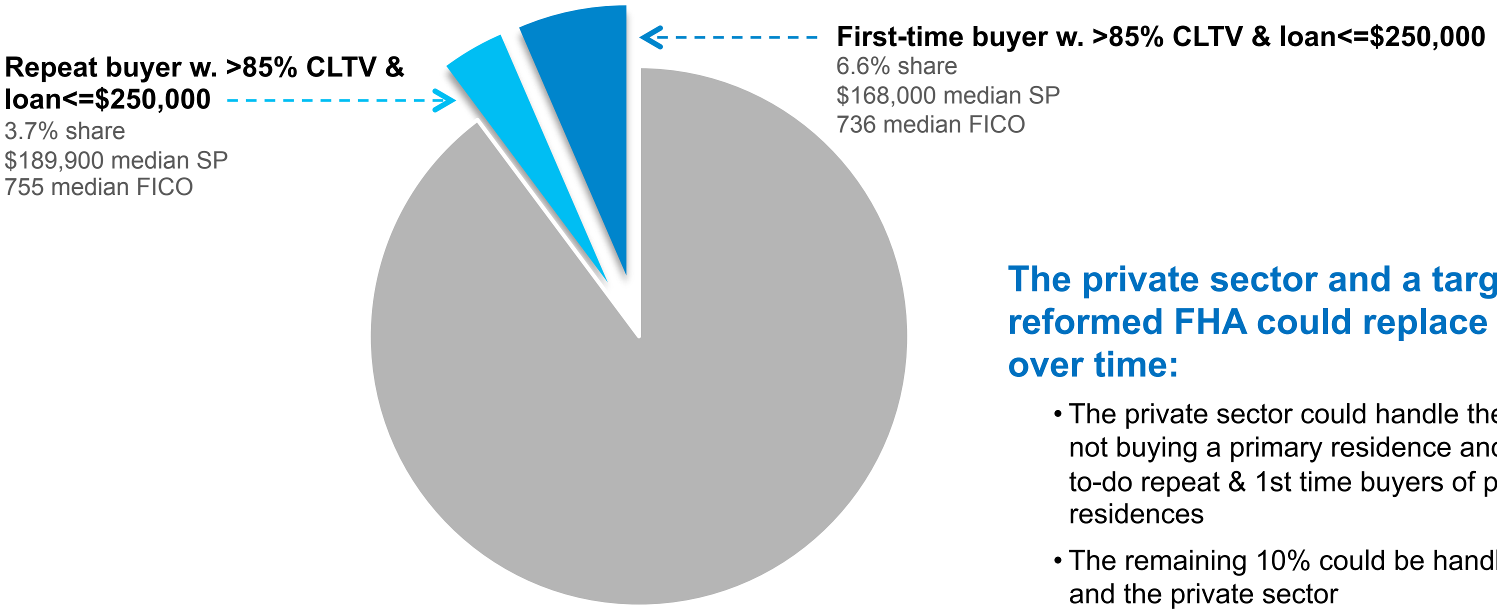


Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Only 1 in 10 GSE dollars went to buyers of more modest homes

Only 6.5% (1 in 16) GSE Dollars went to first-time buyers of more modest homes and only 3.7% (1 in 30) GSE Dollars went to repeat buyers of more modest homes.

The GSEs "spend" an estimated $3 billion/year on cross-subsidies to higher credit risk borrowers, most of whom are not low- or moderate income



The private sector and a targeted and reformed FHA could replace the GSEs over time:

- The private sector could handle the 50% who are not buying a primary residence and the 40% well-to-do repeat & 1st time buyers of primary residences
- The remaining 10% could be handled by the FHA and the private sector

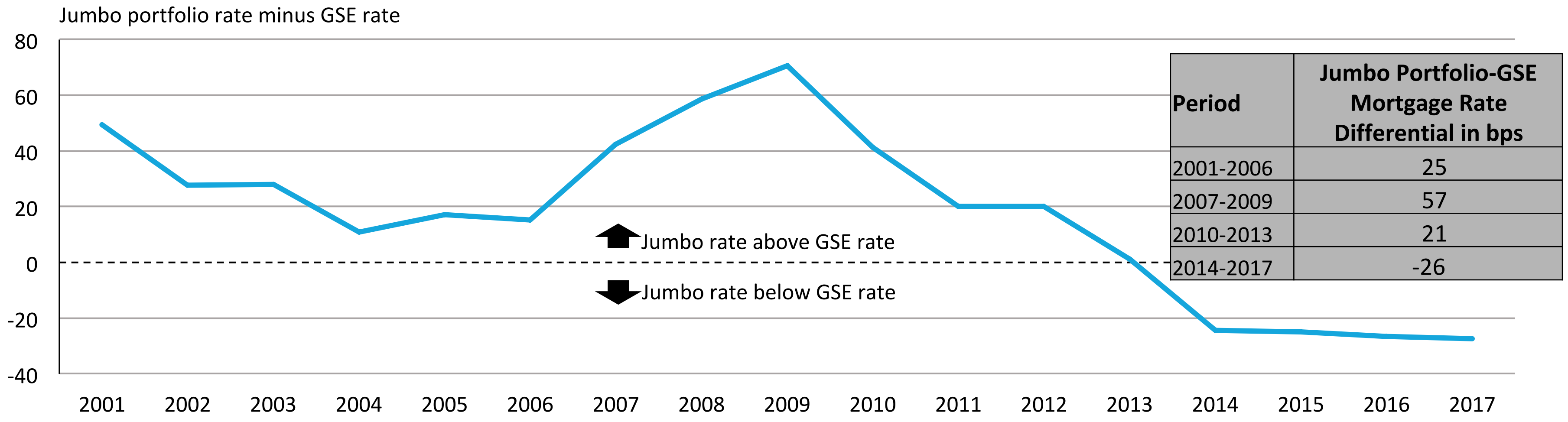
Source: AEI Center for Housing Markets and Finance. All share percentages based on dollars (YTD Aug. 2017)

Do the GSEs actually reduce mortgage rates and are they necessary for the 30 year fixed rate mortgage

Jumbo Portfolio-GSE Mortgage Rate Differential

Before the financial crisis, the GSEs reduced mortgage rates by taking risks for which they were not compensated

- Since 2009, the GSEs have been required to recognize risk in their pricing of mortgages, driving up their mortgage rates
- Since 2014, mortgage rates for private portfolio whole loans have been below GSE rates — after controlling for the risk characteristics of the mortgages



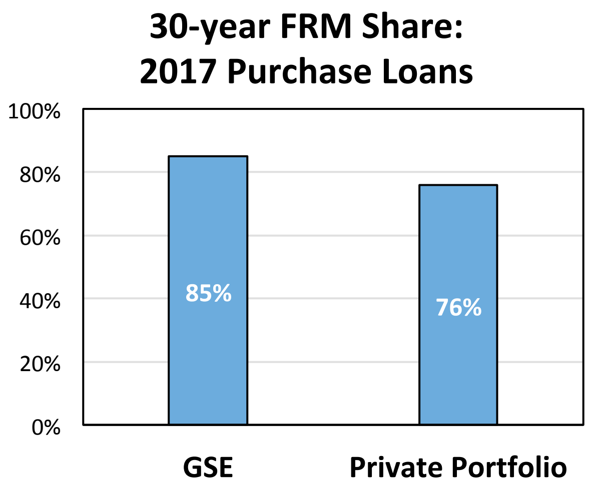
Period	Jumbo Portfolio-GSE Mortgage Rate Differential in bps
2001-2006	25
2007-2009	57
2010-2013	21
2014-2017	-26

Note. Spread pertains to 1-unit, primary owner-occupied 30-year fixed-rate home purchase loans between 90% and 110% of the applicable conforming loan limit. Data for 2017 cover January-September. Portfolio loans refer to private portfolio whole loans.
Source. Authors' calculations using data from CoreLogic©.

What Does the Purchase Loan Market Look Like Today?

- Private portfolio investors in whole loans are very active: total of 570,000 purchase loans for a total of $228 bil. originated in 2016 (HMDA data)
- Private portfolio investors, consisting largely of depositories, are active at all price points
- The 30-year FRM is widely used today – even by private portfolio investors

Loan Amount (in $1,000)	Distribution of 2016 Purchase Loans: by Loan Amount		Private Portfolio as a % of (GSE + Private Portfolio)
	GSE	Private Portfolio	
Total Count	1,612,000	570,000	-
≤ 214	48%	43%	24%
214 < & ≤ 417	47%	20%	14%
417 < & ≤ 626	5%	17%	56%
> 626	0%	20%	100%
Total	100%	100%	26%



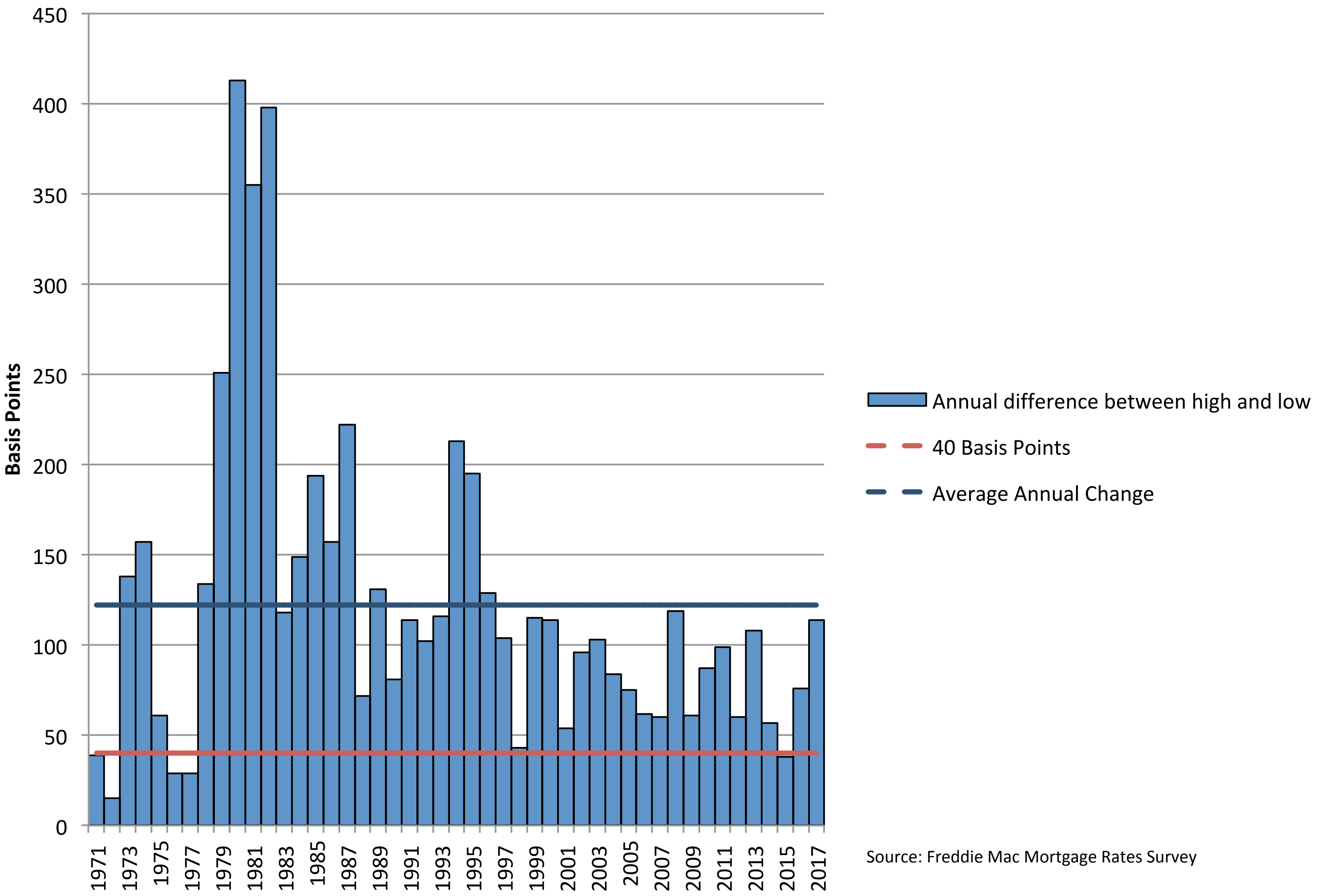
Source Table: HMDA data for 1-4 unit, primary owner-occupied conventional purchase loans. GSE loan totals come from AEI's National Mortgage Risk Index (NMRI). Private portfolio loan totals are the difference between HMDA and NMRI totals. Total counts are rounded to the nearest 1,000. GSE loans in Hawaii with loan amounts greater than $626,000 are bucketed with loans in the $417,000 to $626,000 bin.
Source Chart: Authors' calculations using data from CoreLogic©.

What will happen to the market if the GSEs role were eliminated over time?

Life is possible without the GSE TBA market

- The GSE TBA market subsidizes rate locks for mortgagors
- As GSEs are phased out, there would be no impact in the first few years, then the GSE TBA market would gradually become less liquid
- The Ginnie Mae TBA market would still provide a good hedge for lenders
- Just as these TBA markets evolved naturally to meet a need, a PMBS TBA market or other hedging solutions would develop naturally if there were a need

Average variation in conforming 30-year mortgage rates for the period 1971 to 2017



Source: Freddie Mac Mortgage Rates Survey

Phasing out the GSEs would restrain unduly rapid house price inflation

- Removing GSE and FHA risk subsidies will slow demand growth, especially during a seller’s market when supply is constrained

- FHA would continue to support qualified first time homebuyers

- Rechanneling national saving toward productivity-increasing investment would enhance growth

GSEs are not necessary to prevent disaster in stressful times

- GSE activities contributed greatly to excess risk-taking in the pre-crisis years (Minsky effects, underpricing of risks)

- Risk was concentrated in the GSEs, which had very little capital—their failure triggered sharply elevated market fears

- GSE activities are once again contributing (along with the FHA) to excess risk-taking as in the pre-crisis years (Minsky effects, underpricing of risks)

- Countercyclical capital and risk transfer rules that spread default risk among a wide array of private sector entities are more powerful protection against the need for government bailouts

Preventing a return to widespread subprime lending: The Role of Private Mortgage Insurance and Private Mortgage Insurers Eligibility Requirements (PMERs)

Higher Standards Than Government Backed Loans

- Inflationary credit easing and price instability do not come about *in spite of* government support for housing finance but *because of* that government backing.

- Despite the gradual elimination of the GSEs, the private housing finance market will remain stable and free of the kind of subprime loans that caused the financial crisis

Shift to Mainly a Prime Market

- Prior to 1992 Affordable Housing Goals, Fannie and Freddie acquired only prime mortgages.

- Smaller GSE footprint likely to result in largely prime loan market
  - Natural result because most investors prefer higher quality loans
    - *Some* still prefer low-quality/subprime loans

- As already noted, “Affordable Housing” mandates have eased credit and promoted price instability

Market-Based Enhancements

- Keep PMBS market free of low quality and subprime mortgages
  - Require enhancements that operate according to market principles
  - Private sector entities take risks on mortgage quality and include the costs of these risks in the cost of the mortgage itself.
  - Make risky mortgages more expensive and thus less attractive to borrowers.
  - PMI
  - Credit enhancements from other insurers
  - Other risk absorbing credit enhancements.

FHA reforms and homeownership

FHA Lending for Sustainability and Wealth-Building

- To prevent a flow of mortgages to the FHA as the GSEs' footprint is reduced, HUD Secretary should make commensurate reductions in FHA's loan limits
- Focus the FHA on sustainable and wealth-building home purchases by low and moderate income families
  - Limit to buyers of existing homes with incomes less that 3 times area median income (AMI) and new homes with incomes less that 4 times AMI
    - Allow private sector to handle the rest
  - To incent a supply increase in economical new homes, limit loans on new construction to a floor area of <1800 sq. ft.
  - Provide consumer disclosure of loan's likelihood to default under stress conditions
  - Adopt mortgage insurance pricing and underwriting changes so as to crowd in loan terms of 20 years or less and crowd out 30 year loans
  - Ensure that FHA's underwriting standards do not:
    - Result in higher concentrations of delinquencies & claims in low- and moderate-income neighborhoods
    - Promote higher real home prices during extended periods of a seller's market

Reliable wealth building as central focus of federal homeownership policy

- Low-Income, First-Time Homebuyer (LIFT Home) Tax Credit
  - A transparent, targeted, on-budget, upfront tax-credit more effective than today's system based on high risk lending to marginal buyers and opaque cross-subsidies.
  - Over 10 years, places some 4 million first-time, low-income home buyers on the path to wealth building, with a fifty percent reduction in default risk
    - Frees up an estimated 1.2 million low-income rentals
  - To incent a supply increase in economical new homes, limit size of eligible newly constructed homes to less than 1800 sq. ft.
  - Limit to private loans not guaranteed by a government mortgage guarantee
    - FHA, VA, RHS, Fannie, and Freddie already benefit from housing subsidies
  - Limit to loans of <=20 years
    - One-time, refundable credit used to buy down a loan's interest rate for at least 5 years
  - Cost estimated at $4 billion/year (400,000 x $10,000 average credit)
    - An estimated 120,000 low-income rental units would be expected to be freed up annually as low-income renters purchase homes
    - Funding
      - Eliminate mortgage interest deduction on second homes--savings of about $2 billion/yr.
      - Identify and repurpose $2 billion/year in HUD funding

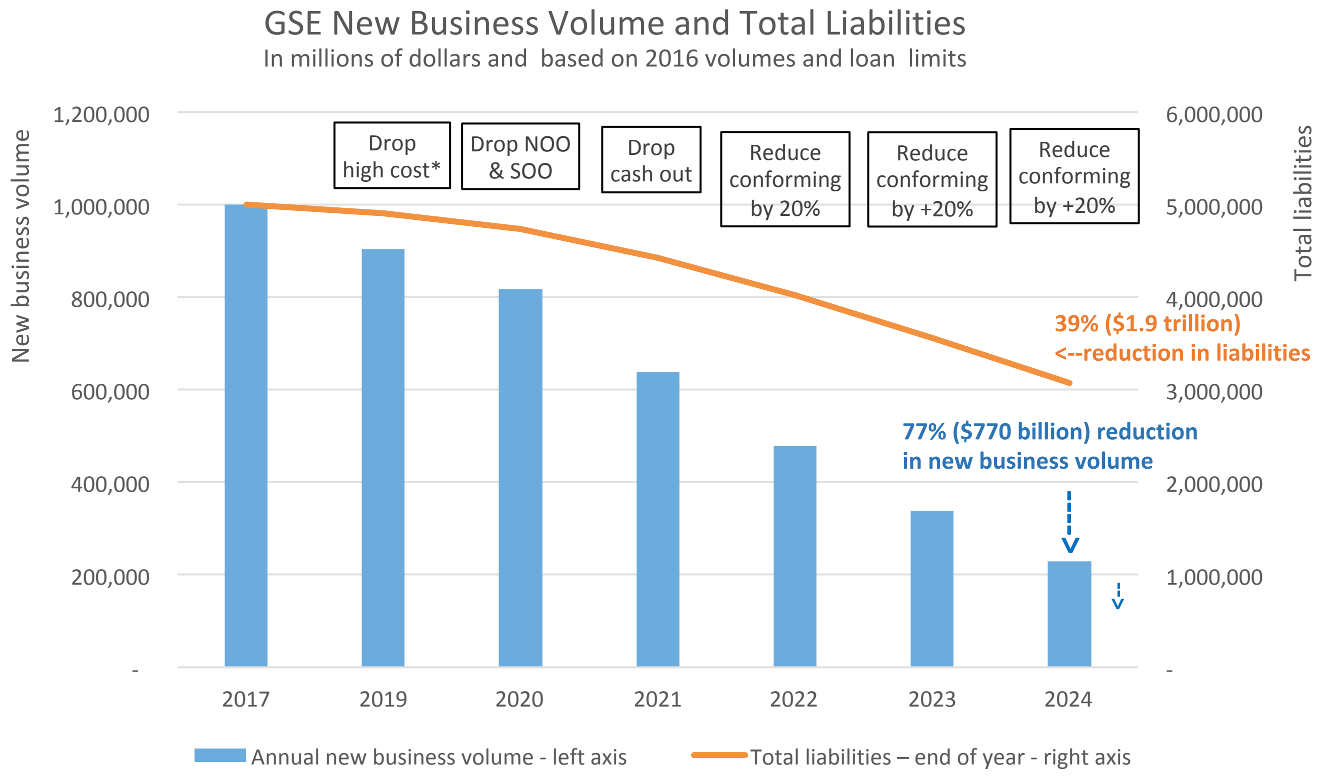
Cost savings to the Treasury without the GSEs

Cost Saving for Treasury: Background

- **GSE MBS competes with Treasury debt in the credit markets. Eliminating this GSE competition would reduce the Treasury's borrowing cost**
- **By how much? The Fed's QE program provides a new way to estimate this cost saving**
- **Basics of QE**
    - Fed acquired more than $3½ trillion in Treasury securities and agency MBS (GSE and Ginnie)
    - Consensus view: QE reduced longer-term rates, though size of the effect is debated
- **Magnitude of QE rate effect**
    - We use rule of thumb from John Williams, president of FRB-SF
    - $600 billion purchase (the size of QE2) lowered the 10-year Treasury rate 15-25 bps
- **Result: eliminating $5 trillion in GSE MBS would lower Treasury borrowing cost by 20 to 33 bps**
    - This translates to an annual cost saving of $17 to $29 billion
    - Full cost saving could take a decade or more to be realized

The plan and FHFA's role

A Largely Privatized Market, While Gradually Winding Down the GSEs



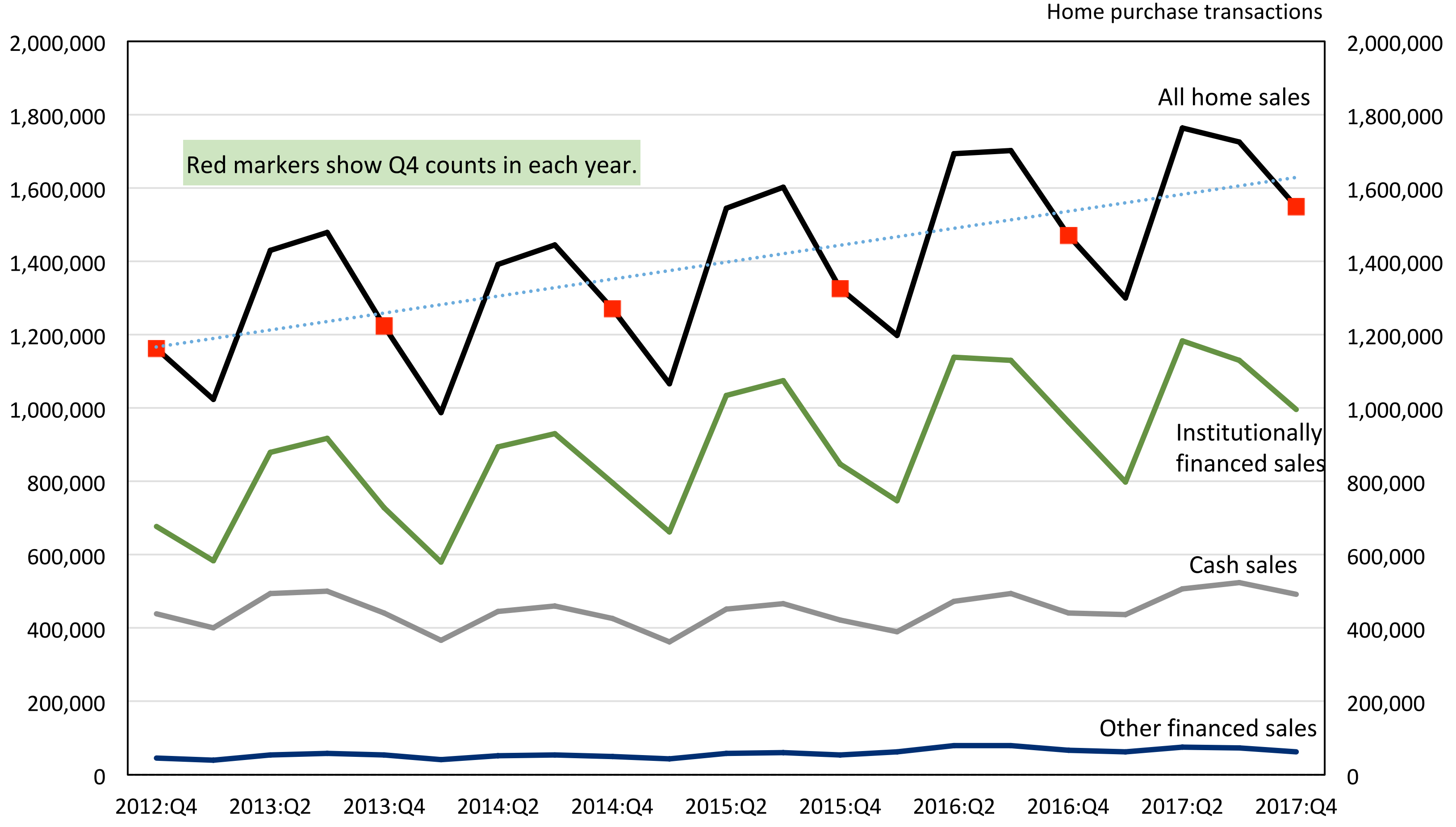
* The high cost area limits were put in place in 2008 to cover areas of the country where home prices were especially high, mostly east and west coasts. They are now about $200,000 higher than the standard limit of $417,000 ($424,100. and $453,100 in 2017 and 2018 respectively)

** NOO: Non-Owner Occupied or investment properties and SOO: Secondary Owner Occupied or second homes.

Trends and Predictions for 2018 and Tracking Home Price Boom 2.0

NHMI for Home Purchase Transactions

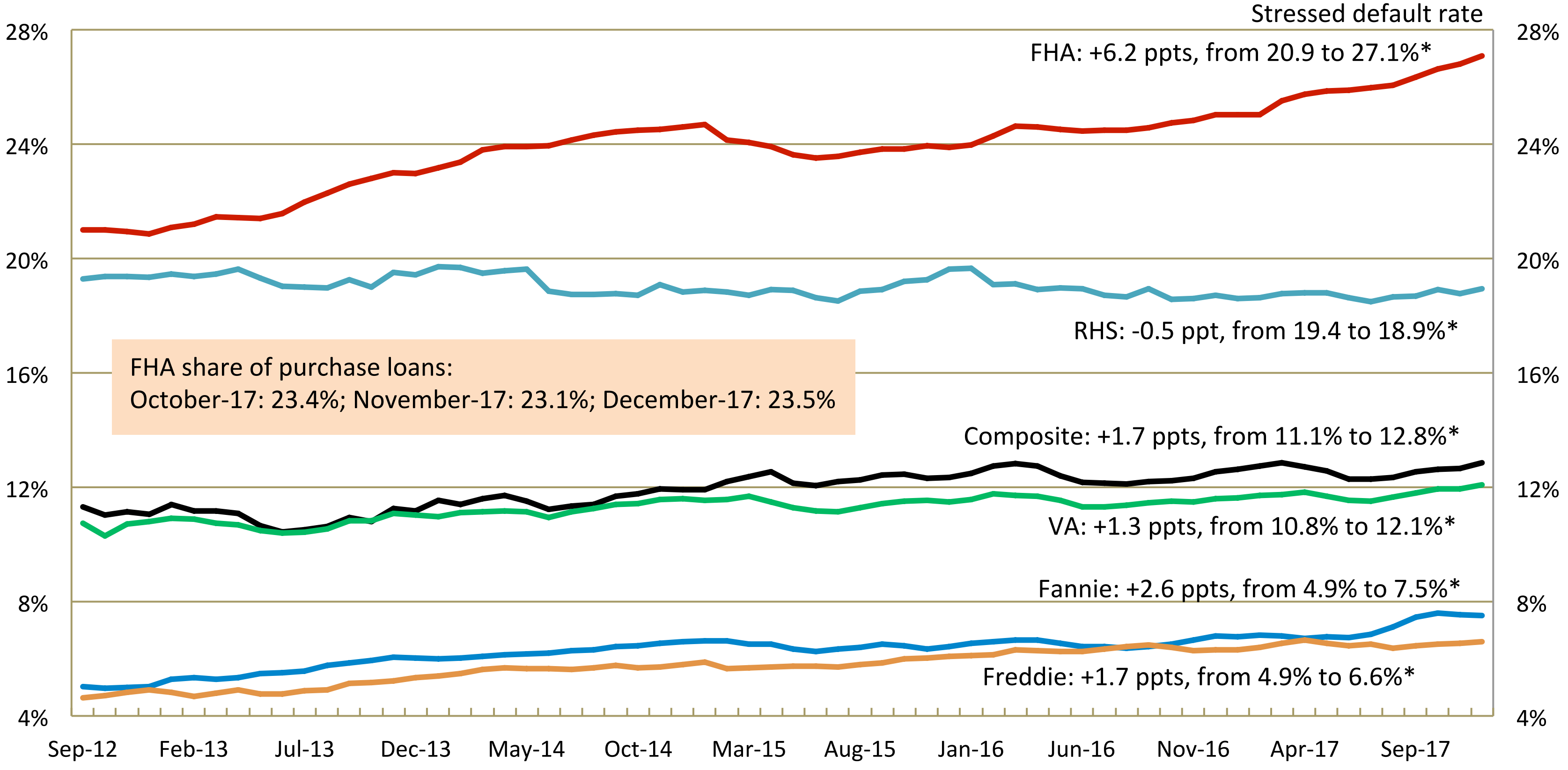
The national housing market remained strong. Demand for 2017:Q4 was up 5.4% from the prior year. Compared to the 2012:Q4 sales transactions by count have grown by 33.4%.
We expect sales growth to slow, with 2018 volume to be flat to a slight increase.



Source: AEI, Center on Housing Markets and Finance, www.HousingRisk.org, and First American Data Tree (DataTree.com).

Update: NMRI for Agency Home Purchase Loans

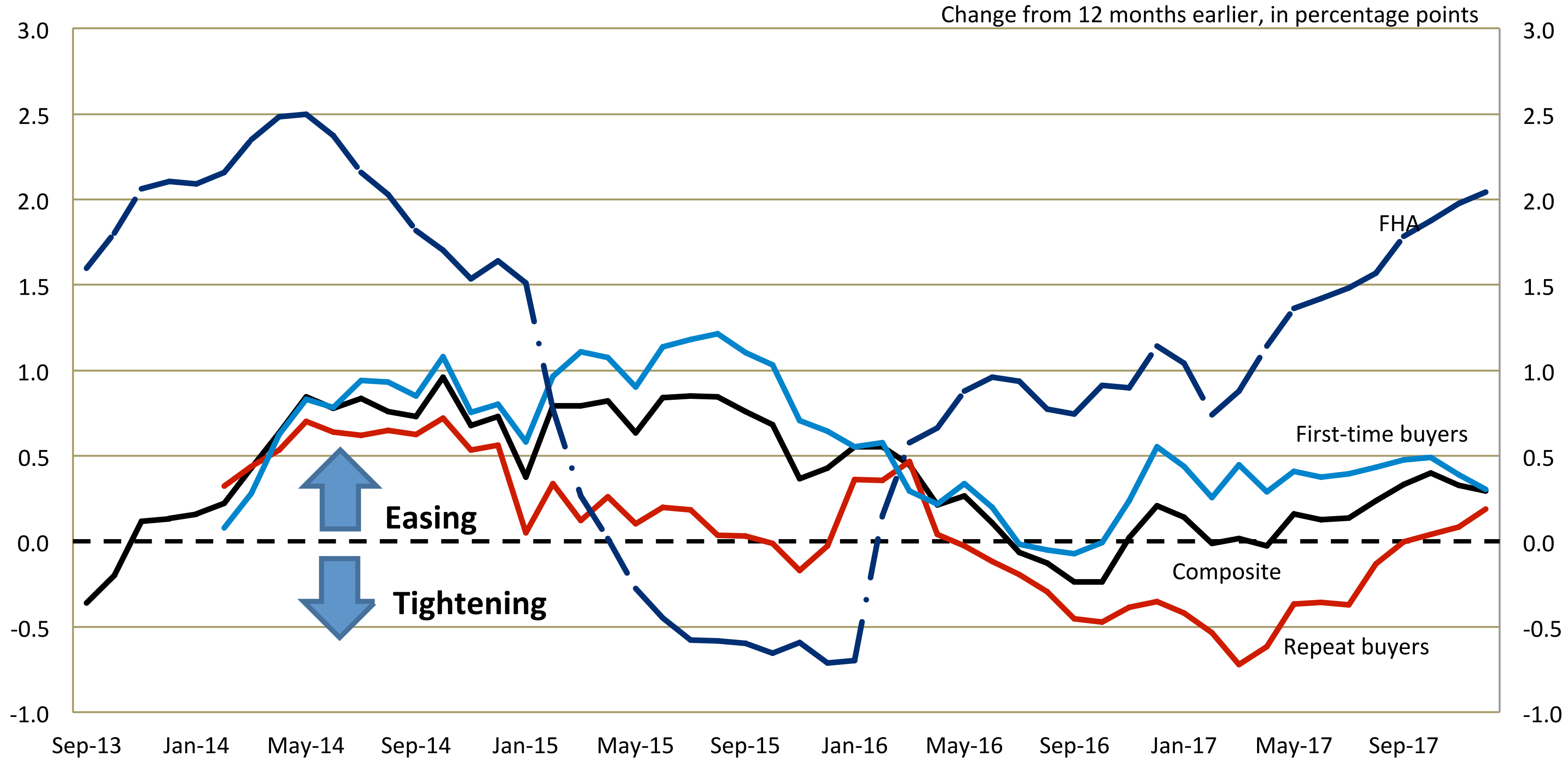
The NMRI continued to trend higher compared to a year ago, setting a series' high for the month of December. FHA set a series' highs at 27.1%.
We expect credit easing to continue in 2018, particularly for first-time buyers.



*Change from September 2013 to September 2017.
Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org. RHS is Rural Housing Service.

Update: Credit Easing Trend Continues, Led by FHA

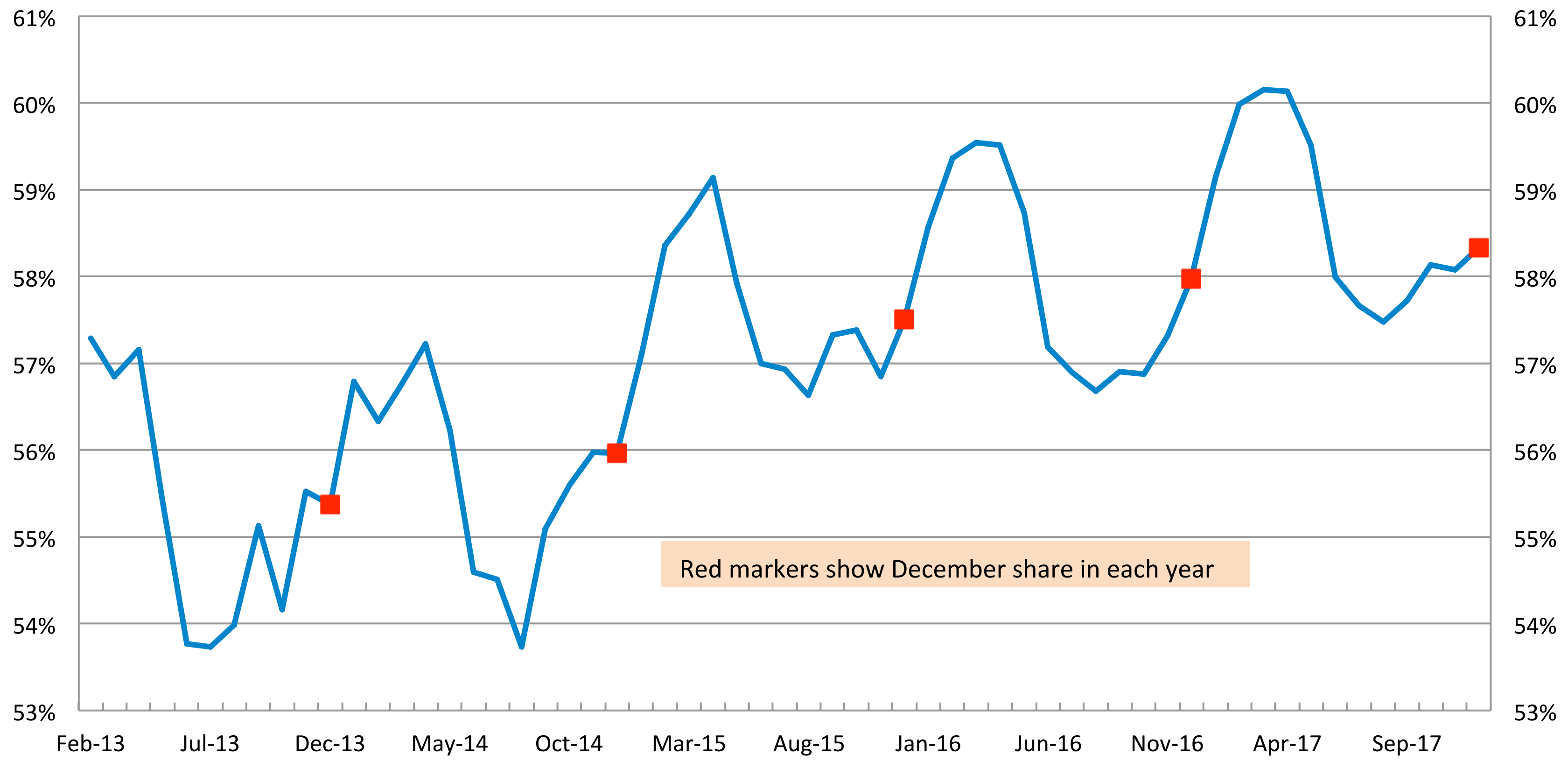
Composite NMRI for purchase increased from already elevated levels a year ago. The index now rising at 2% year-over-year for FHA and was slightly higher for first-time buyers and repeat buyers. First-time buyers in particular have been taking on greater leverage. For 2018 we expect continued easing for first-time buyers and FHA, helping fuel accelerating house price growth for entry-level homes. Entry-level homes will be less affordable and first-time buyers will be faced with a higher risk of default.



Note: Includes all types of NMRI purchase loans (primary owner-occupied, second home, and investor loans).
Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org.

Update: Agency First-Time Buyer Mortgage Share Continues Growth

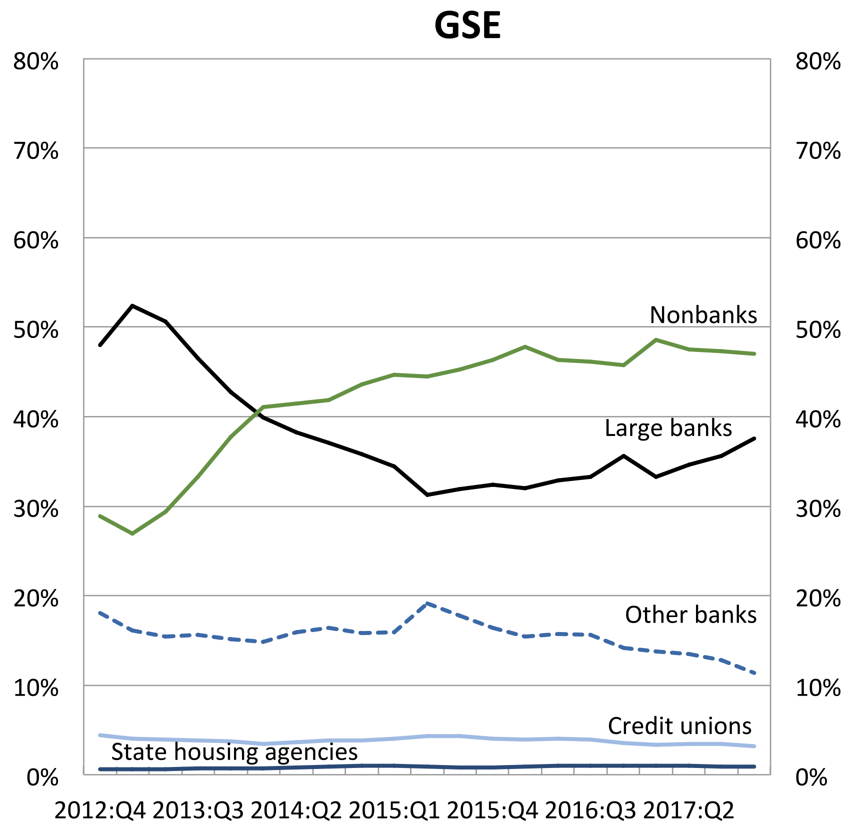
The Agency First-Time Buyer Mortgage Share Index set a new series high for December, coming in at 58.3%, up from 58.0% a year ago and from 55.3% four years ago. Given its current high level, we expect only modest increases in 2018.

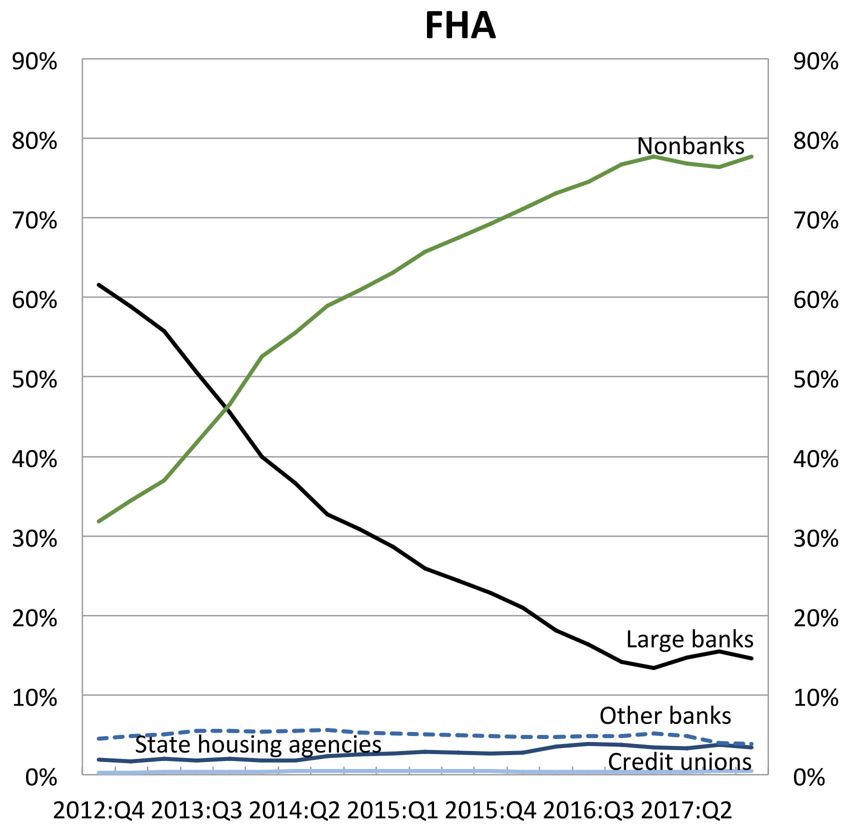


Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org.

NHMI-Origination Shares by Lender Type, Agency Purchase Loans

Nonbank market share has stabilized at 46-48%. The GSE Large banks' share has rebounded to 38% from its low of 31% in 2015:Q2, while Other banks' share has declined 5 ppts. over the past two years to a series low of 11.4% in 2017:Q4. The dramatic FHA market shift from large banks to nonbanks has ended.



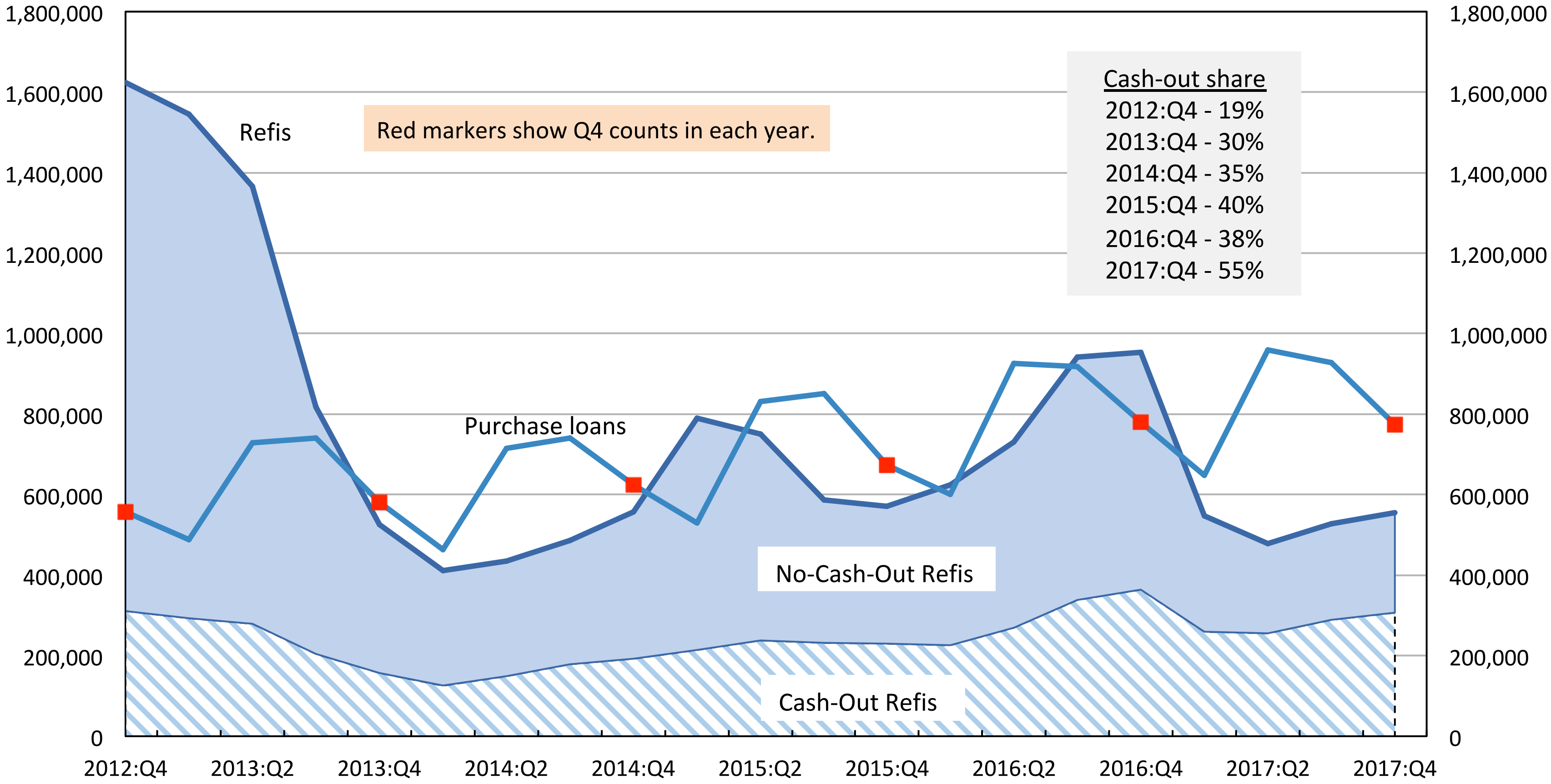


Note: Data are for Agency loan market only.

Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org.

NHMI-Agency Refi and Purchase Loan Counts

Agency purchase volume (by count) was down a tad from 2016:Q4. The majority of refi lending is now Cash-Out refis, which accounted for 55% of all refis during the current quarter. No-Cash Out refi volume has declined sharply with the decline in mortgage rates in 2016. We expect 2018 cash-out share and volume to increase.

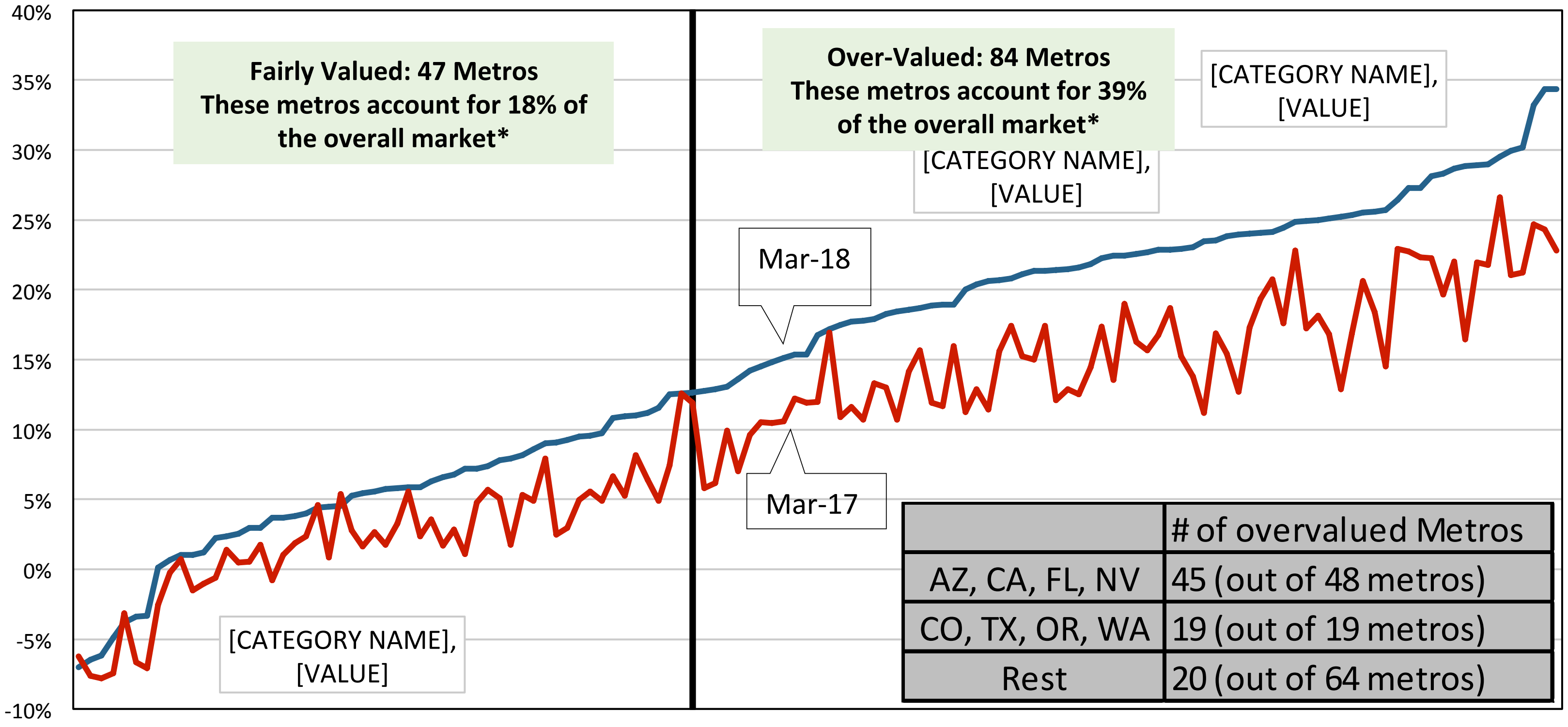


Note: Data are for Agency loan market only.
Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org.

Update: John Burns Intrinsic Home Values

Over the past year the valuations of the vast majority of metros have increased – the most in the metros that were already highly valued . Almost 60% of metros tracked by John Burns are overvalued today. These overvalued metros are largely concentrated in CA, NV, FL, and AZ, (the Sand States—ground zero in last boom/bust) and CO, TX, OR, and WA (states that largely sat out the last boom/bust).

National Intrinsic Home Value Index: +16%



*Based on 2016 HMDA

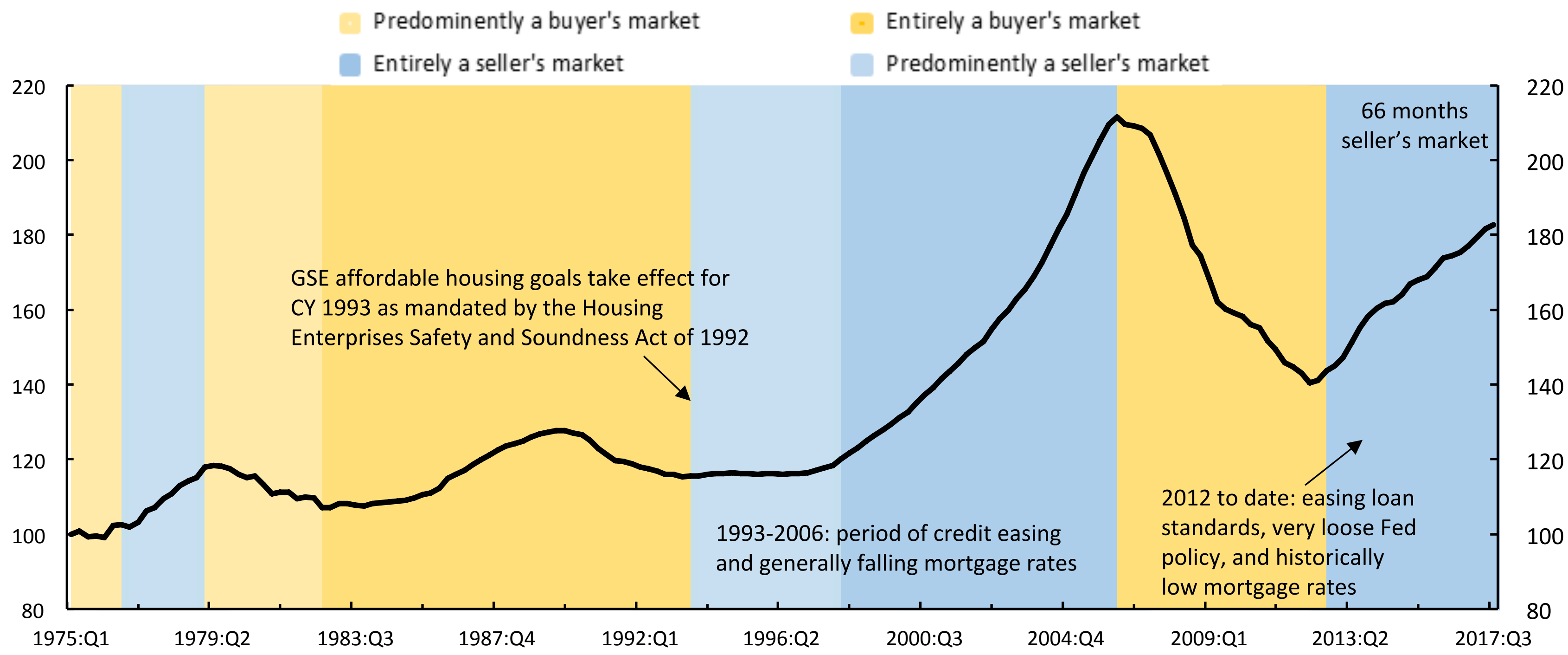
Note: The Intrinsic Home Value Index shows current price versus intrinsic value assuming 6% mortgage rate. It tracks 131 metros in the U.S.

Source: AEI Center on Housing Markets and Finance , www.HousingRisk.org, and John Burns Real Estate Consulting.

Unforgiving Home Price Cycles: Booms Fueled by Increasing Leverage in a Seller's Market, Followed by Mean Reversion

Fueled by growing loan leverage and tight supplies, real home prices have increased 30% since early 2012 trough. Contrary to prevailing view, post-crisis underwriting/regulatory changes promote rather than constrain a boom. Pattern similar to initial years of price boom that began in 1998. If trend continues, risk of serious house price correction increases.

Spliced Quarterly Real House Price Index (1975:Q1 = 100) , through 2017:Q3*



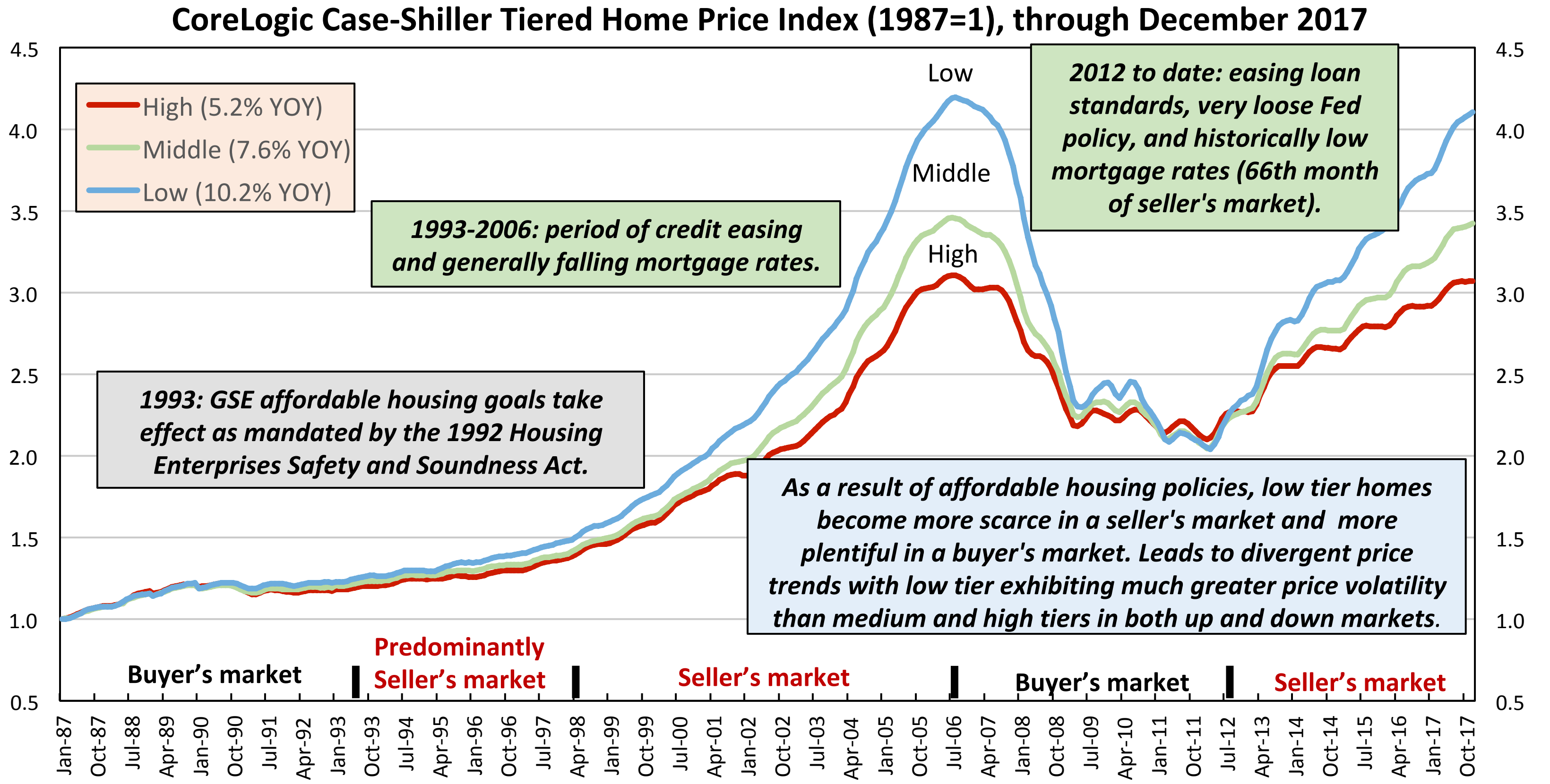
* Calculated as FHFA's all-transaction house price index until 1987, then Case-Shiller U.S. National Home Price Index (SA) divided by BEA's price index for personal consumption expenditures.

Note: National Association of Realtors (NAR) defines a seller's market as inventory that is less than or equal to 6 months of sales. NAR data pertain to existing homes; not available before June 1982. Data from the Census Bureau for new home inventories used before June 1982.

Source: AEI Center on Housing Markets and Finance, www.HousingRisk.org, Prof. Malpezzi, S&P CoreLogic Case-Shiller Home Price Index, FHFA, BEA, Census Bureau, and the NAR.

Greater House Price Volatility at the Lower End

The current seller's market is 66 months old. Prior to the Great Recession a seller's market lasted for 99 months. Since the advent of expanded "affordable housing" efforts, these trends have become stronger at the lower end of the market, as indicated by higher peaks and lower troughs. Increasing leverage fuels unsustainable house price trends. Low Price Tier is up 10.2% y-o-y and 100% since 2012 trough, while High Price Tier is up 5.2% y-o-y and 45% since 2012 trough. We expect price growth to accelerate in 2018, particularly at the Low Price Tier.



Tiers price breakouts are calculated by breaking up all sales for each period, so that there are the same number of sales, after accounting for exclusions, in each of the three tiers. These 16 metro areas are used to derive the Tiered HPI: : Boston, NYC, DC, Chicago, Denver, Las Vegas, Los Angeles, San Diego, San Francisco, Miami, Atlanta, Minneapolis, Phoenix, Portland, Seattle, and Tampa. Only 8 metro areas included at beginning of series. This number grows until 1993, when 16 metro areas are consistently reported.

* A seller's market: an economic situation in which goods are scarce and sellers can keep prices high. (Google.com)

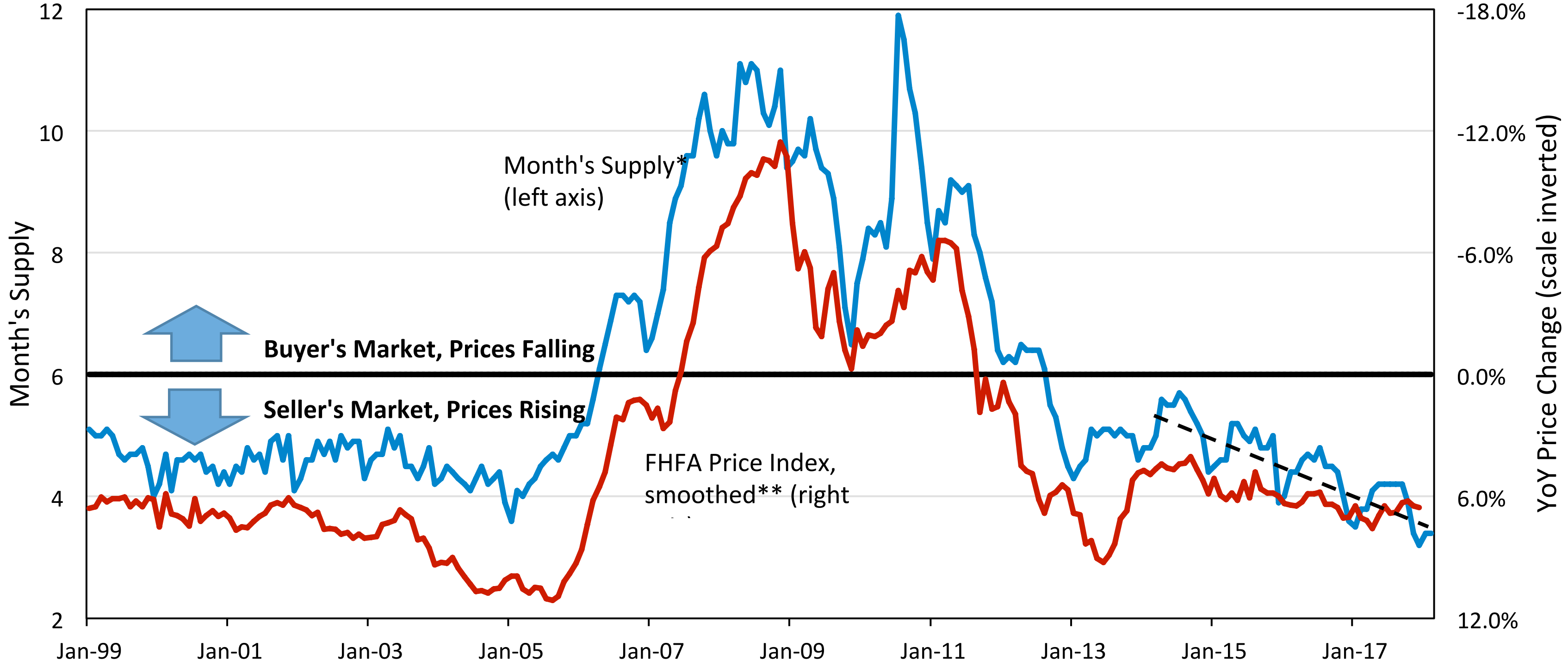
**A buyer's market: an economic situation in which goods are plentiful and buyers can keep prices down. (Google.com)

Source: CoreLogic Case-Shiller (Data: Dec-17, Pub: Feb-18), compiled by John Burns Consulting and AEI Center on Housing Markets and Finance (www.HousingRisk.org)

Supply-Demand Imbalance in the Market Driving Prices Up

Today's housing market has too much highly leveraged demand chasing too little supply. Historically, there is a strong relationship between the level of supply and price movements. According to the NAR, month inventory for December was at its lowest level (3.2) since they began tracking in 1999. Given the trend over the past 4 years, we expect year-over-year month's inventory to continue to trend lower.

National Month's Inventory & Changes in Nominal House Prices*



*Month's supply updated through February 2018; FHFA House Price Index updated through December 2017.

** The NAR defines a seller's market to exist when the inventory of existing homes for sale would be exhausted in six months or less at the current sales pace. Conversely, a buyer's market exists when the inventory of existing homes for sale exceeds six months at the current sales pace. (http://www.realtor.org/news-releases/2013/04/march-existing-home-sales-slip-due-to-limited-inventory-prices-maintain-uptrend).

*** FHFA Monthly Purchase-Only Seasonally Adjusted house price index. The series is a 6 month trailing average.

Source: National Association of Realtors, FHFA