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Fannie Mae and Freddie Mac: How Can We Increase Their Support of the Mortgage Market?

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Report to the Kirwan Institute for the Study of Race and Ethnicity

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Fannie Mae and Freddie Mac:
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By Thomas H. Stanton

In September 2007 Fannie Mae and Freddie Mac failed and went into government hands. Since their failure a year ago, Fannie Mae and Freddie Mac have absorbed almost $ 100 billion of taxpayer funds to make up for losses at the two companies. The Treasury has committed up to another $ 300 billion to cover losses in the future.

The Obama Administration is reviewing a range of options for the future of the two insolvent companies. This report proposes using Fannie Mae and Freddie Mac as wholly owned government corporations, i.e., government agencies, to support the mortgage market for the next five years. That support might include (1) funding new mortgages with lower borrowing costs, including prudent affordable housing loans, (2) providing help for troubled mortgage borrowers, (3) improving consumer protection for borrowers, and (4) supporting other government housing programs and especially the Federal Housing Administration (FHA). At the end of five years, when the housing market has stabilized, policymakers can decide on the ultimate future of the two organizations.

The first section of this report discusses how Fannie Mae and Freddie Mac failed and the sometimes unmanageable tension between private profits and their public missions. The second section discusses the continuing tension between private profits and public purpose now that the companies are in government hands, but with shareholders still in possession of a minority of stock of each company. This section also introduces the government corporation as an organizational form. The third section presents advantages of the government corporation in providing multiple forms of support for the mortgage market in ways that reflect the substantial taxpayer investment in Fannie Mae and Freddie Mac. The report concludes with the judgment that potential benefits over the next five years could be enormous. After that, when the financial system and housing market have stabilized policymakers will have a better idea what form the two government corporations should take to provide the support that may be needed for the longer term.

I. The Failure of Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac committed serious misjudgments that helped to bring about their insolvency. The most serious misjudgments involved the companies' resistance to accepting more effective supervision and capital standards.

High Leverage

For years, starting with their successful efforts to weaken the legislation that established their safety-and-soundness regulator,[1] the two companies managed to fend off capital standards that

[1] Among the many reports documenting the successful efforts of Fannie Mae and Freddie Mac at weakening the regulator and their capital standards, see, e.g., Carol Matlack, Getting Their Way, *National Journal*, October 27,1990, pp. 2584-2588; Jill Zuckman, "Bills To Increase GSE Oversight Move Ahead in House, Senate," CQ Weekly, August 3, 1991; Stephen Labaton, "Power of the Mortgage Twins: Fannie and Freddie Guard Autonomy,"

would have reduced their excessive leverage and provided a cushion to absorb potential losses. They held about half of the capital that competing banks and thrift institutions would have needed to hold to support a similar book of business.

The companies fought for high leverage because this benefited their shareholders and managers, at least until the companies failed. Freddie Mac reported returns on equity of over 20 percent for most years since it became an investor-owned company in 1989, reaching highs of 47.2 percent in 2002 and 39.0 percent in 2000. Fannie Mae reported earnings of almost as much, reaching a high of 39.8 percent in 2001.[2] The two companies fought higher capital requirements because more capital would have diluted those returns to shareholders.

While high leverage was profitable for the owners and managers of the two companies, it also made them much more vulnerable to financial collapse in the event that the mortgage market became troubled.

Poor Business Decisions

The two companies compounded the problem of their self-inflicted structural vulnerabilities with a series of misjudgments that involved taking on excessive risk just at the point that housing prices were peaking. According to press reports, the chief executives of both Fannie Mae and Freddie Mac disregarded warnings from their risk officers and sought to catch up with the market by greatly increasing their purchases of risky loans.[3]

Freddie Mac reported that, "Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years ended December 31, 2007 and 2006, respectively."[4] Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in each of 2006 and 2005. Moreover, Alt-A mortgage loans "represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively."[5] Both companies also invested in highly rated private-label mortgage-related securities that were backed by Alt-A or subprime mortgage loans, amounting to total holdings by the two companies of over $ 200 billion in 2007.[6]

In short, Fannie Mae's and Freddie Mac's managers made unwise business decisions that they knew, or at least their risk officers knew, could inflict serious harm on the two companies.

New York Times, November 12,1991, p. D1; Kenneth H. Bacon, "Privileged Position: Fannie Mae Expected to Escape Attempt at Tighter Regulation," *Wall Street Journal*, June 19,1992, p. A1.

[2] These and other statistics on the two companies may be found in the historical data tables of each annual report of their regulator, the Federal Housing Finance Agency. The 2008 report is available at: http://www.fhfa.gov/webfiles/2335/FHFA_ReportToCongress2008508rev.pdf.

[3] David S. Hilzenrath, "Fannie's Perilous Pursuit of Subprime Loans: As It Tried to Increase Its Business, Company Gave Risks Short Shrift, Documents Show," *Washington Post*, August 19, 2008, p. D01; Charles Duhigg, "At Freddie Mac, Chief Discarded Warning Signs," *New York Times*, August 5, 2008; Charles Duhigg, "The Reckoning: Pressured To Take More Risk, Fannie Reached Tipping Point, *New York Times*, October 5, 2008.

[4] Freddie Mac, *Annual Report*, 2007, p. 13.

[5] *Ibid*, pp. 128-9.

[6] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.

Because they persisted in operating with high leverage and thin capitalization, neither company could withstand the resulting losses.

Fannie Mae and Freddie Mac were the largest companies in a group of organizations known as government-sponsored enterprises (GSEs).[7] In making their mistakes, Fannie Mae and Freddie Mac revealed the inherent vulnerabilities of the GSE as an organizational form. First, the GSE lives or dies according to its charter and other laws that determine the conditions under which it operates. That means that GSEs select their chief officers in good part for their political connections and savvy rather than their ability to manage two of the largest financial institutions in the world.

Second, the GSE combines private ownership with government backing in a way that creates a virtually unstoppable political force. Because of their government backing and low capital requirements in their charters, Fannie Mae and Freddie Mac gained immense market power. They doubled in size every five years or so until at the time of their failure the two companies funded over $ 5 trillion of mortgages, about 40 percent of the mortgage market.

Their market power gave them political power. Whenever someone would urge regulatory reform, such as higher capital standards to reduce the GSEs' dangerous leverage, huge numbers of constituents could be expected to flood Capitol Hill.[8] That political power in turn entrenched the GSEs' market power.

The GSE is characterized by an unusual combination of private ownership and public purpose. Under the law, the officers and directors of a privately owned corporation have a fiduciary responsibility to serve shareholders and the corporation. Other purposes are secondary. This principle applies to shareholder-owned GSEs as well. The Treasury Department reported many years ago on "the tension between profit and public purpose" inherent in the GSEs and noted that, "As a private company, the GSE will act to fulfill its fiduciary responsibilities by promoting and protecting the interests of its shareholders."[9]

It can become difficult if not impossible to the tension between the needs of private shareholders and those of stakeholders with differing views of the companies' public purposes. Former Fannie Mae CEO Daniel Mudd testified in December 2008 that the conflicting pressures are so unmanageable that the GSE should be ended as an organizational form:

> "I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder,

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[7] A government-sponsored enterprise is a government chartered, privately owned and privately controlled institution that, while lacking an express government guarantee, benefits from the perception that the government stands behind its financial obligations. See, Ronald C. Moe and Thomas H. Stanton, "Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," *Public Administration Review*. July/August 1989. This definition is consistent with the definition Congress enacted in amendments to the Congressional Budget Act of 1974, codified at 2 U.S.C. Section 622 (8).

[8] Observers have long noted this pattern. "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington." David A. Vise, "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, January 16, 1995, p. A14.

[9] U.S. Department of the Treasury, *Government Sponsorship of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation*, July 11, 1996, p. 81.

> bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs."[10]

Mr. Mudd speaks with the voice of someone who has struggled to manage the complexities of a government-sponsored enterprise. His recommendation to end the GSE as an organizational form is consistent with lessons from the public administration literature as well.[11]

II. Turning Fannie Mae and Freddie Mac into Wholly Owned Government Corporations

The question then becomes whether the mortgage markets continue to need governmental support. If not, privatization of the GSEs would be the answer. However, for the next five years government support is likely to be a high priority. In the second quarter of 2009 Fannie Mae and Freddie Mac, now in government hands, funded almost three quarters of newly originated home mortgages. Most of the remainder was funded with support from the Federal Housing Administration (FHA). In this context, privatization of the GSEs is out of the question. The continuing weak state of the economy means that the mortgage market is likely to require extensive government support for perhaps five years. After that, depending on the state of the mortgage market, one hopes that much less support would be needed.

Fannie Mae and Freddie Mac in Conservatorship

The government placed Fannie Mae and Freddie Mac into conservatorship rather than receivership. Unlike receivership, the voluntary acceptance of conservatorship by Fannie Mae or Freddie Mac was not subject to legal challenge, which could have further disturbed the financial markets.

Technically, conservatorship means that the government is working to restore the companies to financial health. As the head of the Federal Housing Finance Agency (FHFA), the federal agency

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[10] Daniel H. Mudd, Written Statement, Before the Committee on Oversight and Government Reform U.S. House of Representatives, December 9, 2008, available at http://oversight.house.gov/story.asp?ID=2252, accessed February 7, 2009. Similarly, in August 2008 the *Washington Post* reported the views of Freddie Mac's CEO at the time, Richard Syron:

> "Freddie Mac chief executive Richard F. Syron…said yesterday that conflicting demands on the government-chartered mortgage giant have made his job 'almost impossible.'
> "On the eve of Freddie Mac's quarterly earnings report, Syron said that the McLean company has been whipsawed by the dual tasks of creating profit for private investors and serving the public by boosting the housing market. 'What this organization is all about is balancing among the different missions,' Syron said in an interview. 'It makes the job almost impossible.'"[10]

[11] See, e.g., Harold Seidman, *Politics, Position, and Power: The Dynamics of Federal Organization,* Fifth Edition (New York: Oxford University Press, 1998), p. 213:

> "Intermingling of public and private purposes in a profit making corporation almost inevitably means subordination of public responsibilities to corporate goals. We run the danger of creating a system in which we privatize profits and socialize losses."

See also, Thomas H. Stanton, "Government-Sponsored Enterprises: Reality Catches up to Public Administration Theory," *Public Administration Review,* July/August, 2009.

that oversees the two companies, recently testified, "…FHFA's duties as conservator mean just that, conserving the Enterprises' assets."[12]

Consistent with this view, but inconsistent with the fact that the two companies are insolvent with a substantial negative net worth, the government has preserved private shareholders in the two companies and allowed their stock to trade freely. Until shareholders are removed, the officers and directors of the two companies will face conflict as to their fiduciary responsibilities. Do they price mortgage purchases low to support the market or do they price higher to replenish the companies' shareholder value? As the companies themselves pointed out in filings with the Securities and Exchange Commission, they face conflicts among multiple objectives that "create conflicts in strategic and day-to-day decision making that will likely lead to less than optimal outcomes for one or more, or possibly all, of these objectives."[13]

Conservatorship and the preservation of shareholders are largely inconsistent with the pressing need to use the two companies to support the mortgage market. With shareholders still in the equation, government cannot use the two companies as a source of strength for the rest of the mortgage market, except as this can be justified as a means of conserving Fannie Mae's and Freddie Mac's assets.

It is time to remove the shareholders from the insolvent companies and turn Fannie Mae and Freddie Mac into wholly owned government corporations. At that point policymakers can use the two companies to support the mortgage market in many ways that are not being done today.

The Wholly Owned Government Corporation

What form should government support now take? Mr. Mudd has it right: if government cannot make the GSEs fully private, then they should become fully public. That means turning Fannie Mae and Freddie Mac into wholly owned government corporations.

The wholly owned government corporation is a special type of government agency that is supposed to keep its accounts and manage its affairs on a businesslike basis.[14] To the extent that a government corporation is financially self-sustaining, it does not need annual appropriations and instead funds itself from revenues that it generates from its activities. The U.S. Postal Service sells mail delivery services, the Tennessee Valley Authority sells power, and Ginnie Mae charges a fee for guaranteeing mortgage-backed securities.

Wholly owned government corporations have provided support to housing and community development for many decades. Fannie Mae, established in 1938 as a secondary market

[12] Statement of Edward J. DeMarco, Acting Director Federal Housing Finance Agency before the U.S. Senate Committee on Banking, Housing and Urban Affairs "The Future of the Mortgage Market and the Housing Enterprises" October 8, 2009, p. 6.

[13] Fannie Mae Form 10Q filing for the quarterly period ended September 30, 2008, p. 7; Freddie Mac Form 10Q filing for the quarterly period ended September 30, 2008, p.5.

[14] See, e.g., Thomas H. Stanton and Ronald C. Moe, "Government Corporations and Government Sponsored Enterprises," Chapter 3 in *Tools of Government: A Guide to the New Governance*, Lester M. Salamon, Editor, Oxford University Press, 2002; Office of Management and Budget, *Memorandum on Government Corporations*, M-96-05, December 8, 1995; and U.S. Government Accountability Office, *Government Corporations: Profiles of Existing Government Corporations*, GGD-96-14, December 1995.

institution to help revitalize the housing sector, began as a wholly owned government corporation. Only in 1968 did the government separate the Federal National Mortgage Association (Fannie Mae) into two parts, (1) Ginnie Mae, which remains a wholly owned government corporation, and (2) Fannie Mae, which became a government-sponsored enterprise, owned and controlled by private shareholders. More recent examples of government corporations include the Resolution Trust Corporation, which helped to resolve the savings and loan debacle, and the Community Development Financial Institutions Fund. The Clinton Administration proposed transforming the FHA into a wholly owned government corporation as a way to increase its capacity, but the proposal did not become law.[15]

III. How Government Corporations Could Support the Mortgage Market

Once they become wholly owned government corporations, we can use Fannie Mae and Freddie Mac as agents of reform for the mortgage market. The benefits could be enormous:

- They could fund mortgages in a manner targeted to meet pressing public purposes, including providing affordable housing in a financially prudent manner.
- They could deliver government support for borrowers facing foreclosure and especially for the increasing number who default on their mortgages because they lose their jobs.
- They could provide essential consumer protections for borrowers, such as Alex Pollock's one-page mortgage disclosure form, borrower counseling, and increased pre-foreclosure loss mitigation services.[16]
- They could adapt their Automated Underwriting Systems and other systems and capabilities for use by other federal agencies and programs, starting with the FHA.

In short, the government could turn the insolvency of Fannie Mae and Freddie Mac into an opportunity to begin to upgrade the quality of federal support for delivery of credit by federal agencies. Consider each of these advantages in turn.

Funding new mortgages with lower borrowing costs, including prudent affordable housing loans

Because they are in conservatorship, with private shareholders as well as government ownership, Fannie Mae and Freddie Mac do not operate with the lowest possible borrowing costs. The markets charge somewhat more to the two failed companies because they operate with government backing that is somewhat less than a full-fledged government guarantee, known as a "full-faith-and-credit" guarantee of the federal government. Turning Fannie Mae and Freddie Mac into wholly owned government corporations would allow them to borrow with a full government guarantee. Because they merely need to make a surplus, and not additional profits for shareholders, the government corporations could lower mortgage rates more than is possible for a GSE.

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[15] U.S. Department of Housing and Urban Development, *HUD Reinvention: From Blueprint to Action*, March 1995, pp. 49-72.
[16] Alex Pollock's one page mortgage form can be found at http://www.aei.org/scholars/scholarID.88/scholar.asp.

As government corporations, Fannie Mae and Freddie Mac could do even more to support affordable housing. With shareholders out of the picture, the two companies could set aside a small fraction of their incomes each year for a form of the Affordable Housing Trust Fund. That kind of fund, which had been intended for the two companies as government-sponsored enterprises, would be a practical program for two wholly owned government corporations to implement. Money from the trust fund could be used to reduce borrowing costs for qualified affordable housing applicants, to provide counseling and other costly but necessary services, support innovative programs such as those of NeighborWorks, and other purposes that policymakers might authorize.

As government corporations, Fannie Mae and Freddie Mac also could experiment with eligibility criteria for nontraditional borrowers. It has long been understood that credit scores, now ubiquitous in determining the eligibility of middle class loan applicants, may not apply as well to low income or other nontraditional types of borrowers.[17] Because they do not need to subordinate their public purposes to the interests of shareholders, the two government corporations could experiment with flexibility in credit and mortgage scores. Pilot programs could test various parameters to see whether substitutes might be available that make nontraditional borrowers creditworthy even though they do not meet the standard criteria. Especially given lessons from today's troubled mortgage market, these pilot programs could be important means of adjusting credit scores to inform the difficult judgment how much credit to offer what types of borrowers to support homeownership without extending credit that a borrower would be unlikely to repay.

The corporations also could experiment with allocations of subsidy amounts from available Affordable Housing Trust Fund monies to try to determine how much and what kinds of financial or counseling or other support are most effective with what types of nontraditional borrowers. By publishing results from these experiments the corporations could help to influence constructive actions of private lenders and inform policymakers of the most cost-effective policies that might be considered to carry out affordable housing and community reinvestment and other such purposes.

By limiting the experiments to pilot programs, the government corporations could limit their financial risk (and also the potential financial harm to participating nontraditional borrowers). If a pilot program proved successful, then the government corporations could expand their overall lending criteria in a prudent manner to take account of the results.

Providing help for troubled mortgage borrowers

The number of foreclosures continues to rise. Millions of people are defaulting on their mortgages and being forced from their homes. Defaults are coming in three waves: (1) the borrowers who took out mortgages (subprime, Alt-A, option-adjusted ARMs, etc.) that they never should have had; (2) borrowers who took out mortgages with teaser rates that are resetting to levels that the borrower cannot afford to repay; and (3) an increasing number of people who had been current on their mortgages until losing their jobs in the recession.

[17] See, e.g., Thomas H. Stanton, *Credit Scoring and Loan Scoring: Tools for Improved Management of Federal Credit Programs*, PwC Endowment for the Business of Government, July 1999, available at http://www.businessofgovernment.org/pdfs/credit.pdf

The Administration has tried to prompt Fannie Mae, Freddie Mac, and lenders with government assistance to offer loss mitigation programs. FHA is also available to help borrowers to refinance. However, none of these programs serve the wave of people who default on their mortgages when they lose their jobs.[18] Moreover, there is indication that some lender reluctance to modify loans has a practical basis: many unmodified delinquent loans cure themselves and many modified loans default.[19] In between are millions of mortgage loans that are likely to default and lead to foreclosure.

One result will be an increasing number of families who are traumatized by being put out on the street. Another result will be the collapse of property values and community vitality in neighborhoods affected by multiple foreclosures. The possibility of blight is serious. Evidence from one major lender shows that foreclosed properties lose almost two-thirds of their value in liquidation sales.[20]

What should be done? The Administration and private lenders fear that supporting people who are foreclosed upon could create incentives for millions of other people, and especially those whose mortgages exceed the value of their homes, to default. Practical answers are available; the country has faced this problem before.[21]

Perhaps policymakers should take the view that many people suffered from a huge real estate bubble that cannot be sustained. While we may not be able to keep everyone in their home, we at least should mitigate the hardship and let them down easy. That appears to be a good part of the logic behind the massive government support for banks and auto companies.

What kind of government support could Fannie Mae and Freddie Mac provide as wholly owned government corporations? One answer might be a program of government rental assistance that would allow a family to remain in its home for up to three years after foreclosure. If the lender was able to sell the property in that time, the voucher would become portable to allow the family to rent elsewhere. Because it could be more difficult to sell an occupied home, the government might provide funds for an increased commission for selling a foreclosed home when the family still occupies it.

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[18] For a cogent explanation why middle class families have become increasingly vulnerable to defaulting on their mortgages, see, Elizabeth Warren and Amelia Warren Tayagi, *The Two-Income Trap: Why Middle-Class Parents are Going Broke*, Basic Books, 2003.

[19] Manuel Adelino, Kristopher Gerardi, and Paul S. Willen, "Why Don't Lenders Renegotiate More Home Mortgages? Redefaults, Self-Cures, and Securitization," Public Policy Discussion Paper, Federal Reserve Bank of Boston, July 6, 2009.

[20] Gretchen Morgenson, "So Many Foreclosures, So Little Logic," *New York Times*, Sunday Business, July 5, 2009, p. 1

[21] Thus, the Emergency Housing Act of 1975 offered support to homeowners to try to prevent foreclosure but specified rules to prevent homeowners from arbitrarily defaulting on their loans; a current program with similar rules which is intended to prevent foreclosures is the Pennsylvania state Homeowners' Emergency Mortgage Assistance Program (HEMAP). A list of those protective measures, found at https://www.hemap.org/hemap/secure/help.aspx?HelpID=HEMAPQualifications, could be adapted for the rent support program suggested here.

The value of using a government corporation to reduce dislocation of households and communities is that the corporation could monitor success of the program and, according to the amount of discretion that the enabling legislation allows, adapt the program to meet local conditions in various markets, within specified parameters. In contrast to a GSE, a government corporation merely needs to cover its costs, not make a profit. Because a government corporation is a part of government, it can administer subsidized programs as well, so long as appropriations are available. The wholly owned government corporation is an organizational form well suited to providing such support to the housing market.

Improving consumer protection for borrowers

At this writing, the Congress continues to deliberate whether to create a Consumer Financial Protection Agency and the extent that such an agency will receive the legal authority and organizational capacity to do its job. The record of other consumer protection agencies is not completely encouraging in this regard. If the agency actually comes into being, it is likely that the same stakeholders that now seek to kill the agency would continue to exert pressure over coming years.[22]

The value of a government corporation is that it is active in the market. In contrast to a consumer protection agency that must regulate and enforce its decisions, a government corporation can set conditions as a requirement of doing business. In 1971, when Fannie Mae still had much of the culture of a government corporation and when Freddie Mac was just starting business, the two companies joined to standardize mortgage forms. The result was a great increase in the efficiency of the mortgage market as mortgage terms, with appropriate variations, were standardized across the country.[23]

In the same way the government corporations could set requirements that would enhance market efficiency in current circumstances. One clear need is for improved consumer disclosure. Alex Pollock of the American Enterprise Institute has proposed a one-page mortgage disclosure form. It would require a lender, for example, to disclose the highest monthly payments that are possible under the mortgage, thereby putting the borrower on notice about “teaser rates” and other variable rates that have turned mortgages into impossible burdens for so many households.

The government corporations also could place requirements for streamlined loss mitigation procedures into their seller-servicer guides, require counseling for affordable housing buyers, and otherwise ensure consumer protections that enhance the efficiency of the markets. It bears emphasis that the current market, in which millions of people are losing their homes and major

[22] The Consumer Product Safety Commission (CPSC), to give but one example, suffered continuing erosion of its staffing authority from 900 people in 1977, shortly after it began operations, to less than half that number thirty years later. Recent concern over imports of dangerous consumer products led to new legislation in 2008 that, among other measures, streamlined the agency’s cumbersome rulemaking procedures and required an increase in the agency’s staffing. See, Bruce Mulock, “Consumer Product Safety Commission: Current Issues,” Congressional Research Service, June 17, 2008; and Margaret Mikyung Lee, “Consumer Product Safety Commission Improvement Act 2008, P.L. 110-314,” Congressional Research Service, September 22, 2008.

[23] See, Committee on Banking, Housing, and Urban Affairs, United States Senate, “Federal National Mortgage Association Public Meeting on Conventional Mortgage Forms, Sponsored by the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation,” April 5 and 6, 1971, 92nd Congress, 1st Session, Document No. 92-21.

mortgage lenders have blown themselves up, requires increased consumer protection not only because this is fair, but also to promote market efficiency.

Supporting other government housing programs and especially the Federal Housing Administration (FHA)

Then-HUD Secretary Steve Preston pointed out in November 2008 that the volume of FHA mortgage insurance trebled over the prior year. He was candid in his assessment that FHA is not strong enough, either in statutory authority or administratively, to carry the load of a substantial increase in volume without causing significant potential losses to taxpayers. Secretary Preston objected to Congress' refusal to allow FHA to implement modest risk-based pricing for the agency's mortgage insurance program. He also pointed to problems with FHA's patchwork of IT systems, noting that FHA's core loan processing system is still written in COBOL.[24]

The HUD Inspector General and other housing experts also worry that fraud may overtake the FHA program as subprime lenders and others move their loan production to FHA. Kenneth M. Donahue, HUD's Inspector General, has warned that "It looks like an incoming tsunami." FHA lacks the capacity to monitor and respond quickly to fraud. Moreover, the agency's protracted procedures do not allow for prompt removal of fraudulent or abusive lenders from the program.[25]

Fannie Mae and Freddie Mac possess the needed systems and facilities to support FHA and ensure capable implementation of the FHA's single-family and multifamily mortgage insurance programs. As government corporations they could either provide technical assistance to FHA to upgrade its loan processing platforms and systems and models or, because of the continuing growth of FHA's workload, might themselves process FHA loans, at least until FHA's own capacity can be enhanced. Taxpayers have paid dearly for Fannie Mae and Freddie Mac and their systems, and may as well benefit from that investment by strengthening the FHA so that it does not collapse under the weight of its new responsibilities.[26]

IV. Conclusion: After Five Years

It is clear that government will need to provide extensive support of the mortgage market until it recovers from the current boom-and-bust, perhaps in five years. Until that time, because of the disruption that reorganization could cause, it is probably wise to maintain Fannie Mae and Freddie Mac as distinct corporations. In five years policymakers will have a better idea both of the needs of the mortgage market at that time and also of the consequences of the economic losses the nation has suffered from the debacle.

Then, depending on the needs that policymakers perceive at that time and the resources available to address those needs, it may be time to turn Fannie Mae and Freddie Mac into a single government corporation with a clear mandate to serve the most pressing housing needs. Those

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[24] HUD Secretary Steve Preston, Prepared Remarks at the National Press Club, November 19, 2008, available at http://www.hud.gov/news/speeches/2008-11-19.cfm, accessed October 16, 2009.

[25] Barry Meier, "As FHA's Role Grows, So Does the Risk of Fraud," *New York Times*, December 10, 2008.

[26] The two government corporations might also provide support for other federal housing programs including the direct loan program for homeowners (part of the disaster loan program) of the Small Business Administration. The needs of FHA are especially pressing and deserve to be a priority.

needs might include service to first-time homebuyers in the single-family market and support of the multifamily market, for example. The relationship of the new government corporation to FHA and Ginnie Mae would need to be determined by, among other factors, the financial and operational state of FHA at that point.

Whatever happens in five years, the bottom line today is clear: (1) the mortgage market needs much greater government support right now, and (2) that support could come from Fannie Mae and Freddie Mac as government corporations in a manner and to the extent that no other organization could provide.

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