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THE PATHS TO MORTGAGE FINANCE REFORM AND THEIR BUDGETARY IMPLICATIONS

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Executive Summary

The passage of the Housing and Economic Recovery Act in July of 2008 expanded the federal government's authority to place Fannie Mae and Freddie Mac into conservatorship. As exercised, under the conservatorship the government secured the right to stock warrants worth 79.9% of the company as well as a ten percent dividend on its gross investment. The existing shareholders kept the other 20.1%.

However, the terms of the conservatorship were repeatedly amended. As the two GSEs returned to profitability, the government amended the conservatorship to lay claim to the entire net worth of the two government-sponsored enterprises, which it swept into Treasury's coffers each quarter. This move effectively froze out the non-government shareholders from any residual profits.

It also allowed the federal government to report sharply lower deficits than would have otherwise been the case. As of 2014 the government had recouped its core \$187.5 billion investment in the two and Congress is now contemplating major reforms of the mortgage finance sector.

The current reform plan that has garnered bipartisan support, the one proposed by Senators Tim Johnson and Mike Crapo, would wind down Fannie and Freddie and replace them with new entities. In doing so it would also largely codify the Treasury's zeroing out of Fannie and Freddie's private shareholders.

In order to allow the new entities to begin with a fresh balance sheet, the legislation would have the federal government explicitly guarantee the \$5.2 trillion of debt of Fannie Mae and Freddie Mac. While a booming economy could gradually reduce that figure with few untoward

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consequences for the government, if the housing market were to have another swoon, the government would undoubtedly find itself having to cover some portion of this debt.

Explicitly guaranteeing the debt incurred by Fannie Mae and Freddy Mac represents an unprecedented step for the government, and something the Treasury previously went to some lengths to avoid. Such an explicit guarantee is also contrary to long existing statute, which even today denies creditors any right to taxpayer backing. Neither the public assumption of all GSE debt nor the effective confiscation of the private shareholders' GSE stock send an affirming signal to private investment.

Reform of the U.S. housing market is past due: if we hope to rebuild our mortgage finance system on a foundation of private capital, then property and contractual rights must be respected.

Introduction

In 2008 president Bush signed the Housing and Economic Recovery Act, or HERA, which created a new regulator for Fannie Mae and Freddie Mac, with expanded conservatorship and receivership authorities. Only months after the law's passage, both GSEs were placed into conservatorship. The government chose conservatorship because it wanted to protect the investors in their bonds, the ranks of which included many foreign governments as well as U.S. banks with an already tenuous grip on solvency. Conservatorship also allowed the Treasury to avoid the question of whether the trillions of dollars of GSE debt could be kept off of the government's balance sheet.

When the Treasury took the two entities over it assigned itself ownership of just under 80% of the two, along with annual dividends worth ten percent of its investment. In the intervening years it has injected a total of \$187.5 billion into the two.

In 2012 the Treasury amended its arrangement by assigning itself the right to "sweep" the entire net wealth of Fannie and Freddie into its coffers. The arrangement effectively meant that the

other shareholders were shut out of any residual profits earned by the two. The effective zeroing out of Fannie Mae's and Freddie Mac's shareholders stands in stark contrast to the other financial companies the government bailed out--outside of the avenue of bankruptcy--during the 2008 financial crisis. Citibank and AIG's shareholders retained ownership of a portion of the company, and even Countrywide, National City, and Bear Sterns' shareholders---all insolvent when taken over at the government's behest by a rival company—received something for their stock in the mergers engineered by Treasury. Obviously none of these companies enjoyed a congressional charter, leaving any comparison informative but incomplete.

What is of particular importance today is that the Treasury will soon report that the federal government has recouped its core investment.

While the economy has slowly returned to some semblance of normalcy, the housing market's recovery appears fragile and far from complete. Housing prices have appreciated from their post-recession depths but remain below pre-recession prices in most markets, with 13 percent of all mortgaged homes displaying negative equity in the third quarter of 2013.²

The government is now contemplating a major reform of the government's role in housing finance, with legislation proposed in both the Senate Banking Committee as well as the House Financial Services committee. There is also a major private sector plan proposed by one of the major GSE shareholders. Each offers certain improvements but the one getting bipartisan support—the Johnson-Crapo bill—would place the approximately \$5 trillion of outstanding GSE debt on the government's balance sheet, an unprecedented move and one that the government went to great lengths to avoid in 2008.

Governmental responses to the housing bust, at the both the federal and local levels, have been characterized by a repeated disregard for the interest and claims of investors.³ Bank settlements have often been paid indirectly by investors. The ability to foreclose, one of the inherent rights

² CoreLogic, Equity Report, Q3 2013. <http://www.corelogic.com/about-us/researchtrends/equity-report.aspx#>

³ See Mark Calabria, Questions and Thoughts on the Mortgage Settlement, Cato@Liberty. <http://www.cato.org/blog/questions-thoughts-mortgage-settlement>

under a mortgage, has been regularly denied.⁴ In all likelihood political risks in the mortgage market rival both credit and interest rate risk. Perhaps worse is that such political risk is far more difficult to calculate and price, leaving the mortgage market in a state of disarray. A stasis that leaves Fannie Mae and Freddie Mac in limbo as wards of the state, owned in full by the Treasury, forecloses any substantive changes that could heal the mortgage market, cure most of what ails the housing market, and help the U.S. economy return to a normal post-recovery level of economic growth.

A Brief History of Fannie Mae and Freddie Mac

The Roosevelt Administration created Fannie Mae, originally known as the Federal National Mortgage Association, in 1938 in order to facilitate bank acceptance of Federal Housing Administration (FHA) loans. In 1968 The Johnson Administration split Fannie Mae in two, creating both a privately-owned corporation and a government-owned corporation that became Ginnie Mae. Ginnie Mae kept the FHA and VA loans while Fannie Mae began purchasing private mortgages. Freddie Mac came along in 1970, originally created to buy mortgages from savings and loans.

The two entities led a tranquil existence until the real estate boom in the early 2000s. In response to the bursting of the dot-com bubble and the terrorist attacks on 9/11, the Federal Reserve aggressively reduced the Federal Funds rate until it fell below one percent. Mortgage rates declined in tandem, with the 30 year fixed rate mortgage averaging just 5.8 percent in 2003, spurring the housing market. Fannie and Freddie's profits ballooned.

Once the fed started tightening the money supply in 2004, mortgage rates rose, and the refinancing surge that drove Fannie and Freddie's profit growth dropped markedly, with refinancing volumes dropping over 40 percent. Most participants in the mortgage market, including Fannie and Freddie, derive a substantial part of their income not from the slow, steady

⁴ See Mark Calabria, Are Courts Dragging out the Housing Crisis, Cato@Liberty. <http://www.cato.org/blog/are-courts-dragging-out-housing-crisis>

accumulation of mortgage payments from borrowers, but from fee income or gains realized upon the sale of a mortgage or mortgage backed security.

The concomitant flattening of the yield curve also put pressure on GSE profits. When the spread is wide, the GSEs profit from floating short-term debt and buying back their own mortgage-backed securities, which are tied to long term rates. After 2004 this spread began to narrow, reducing the arbitrage profits from the GSEs' portfolio trading activities. Declining fee income and reduced interest rate spreads put pressure on all mortgage market participants to find income elsewhere. Many, including Fannie and Freddie, made up that income by reducing the credit quality of their loans.

When housing prices began to fall, the market value of securities linked to housing, especially those connected to subprime mortgages, declined in tandem. Since at least the mid-1990s, Fannie and Freddie had been purchasing private-label, subprime mortgage-backed securities. As their value declined, accounting rules required the GSEs to recognize this "impairment" in their income statement. From 2008 and 2010, the total value of this impairment totaled almost \$50 billion, making them both insolvent.

In a belated attempt to fix the GSEs, Congress passed Housing and Economic Recovery Act of 2008, establishing a new regulator for the GSEs, the Federal Housing Finance Agency (FHFA) as well as a resolution regime that mirrored that for commercial banks. It also allowed the Treasury to provide temporary support to the agency debt market.

In order to avoid the GSEs falling into receivership, which would have imposed losses on creditors and could have resulted in the government placing the GSE debt onto its books,⁵ the new regulator placed them under conservatorship. Treasury's primary objective at the time—besides keeping a lid on its liabilities --was to protect GSE creditors, particularly since a number of foreign central banks were heavily invested in GSE debt.

Ultimately, Fannie and Freddie received a total of \$187.5 billion in support from the U.S.

⁵ John Carney: Fannie and Freddie Fight: Hedge Funds vs. Treasury. [NetNet](#), CNBC, 9 July 2013.

Treasury—i.e. U.S. taxpayers. The Treasury entered into a Senior Preferred Stock Purchase Agreement with each GSE that⁶ required the GSEs to pay a 10 percent dividend payment to the Treasury on any shares that they purchase.

In August of 2012, a third amendment to the purchase agreements ended the payment of dividends and instead instituted a sweep of profits. Unlike the initial purchase agreements, which were executed between the Treasury and the Boards of Fannie Mae and Freddie Mac, the third amendment was agreed to by Treasury and FHFA, acting on behalf of the GSEs in its role as conservator. The third amendment eliminates the GSEs' ability to retain earnings, build capital or distribute dividends.

The Budgetary Treatment of GSEs

Despite the extraordinary financial investment and control exercised over Fannie Mae and Freddie Mac by the federal government, the budgetary treatment of these entities is the subject of much disagreement, particularly between the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB), the chief budget estimators for the Legislative and Executive branches. Since 1968, Fannie Mae has been excluded from the federal budget, and Freddie Mac has been excluded since its inception in 1970. However, after the federal government took control of the GSEs, disagreement arose and has since persisted regarding how the financial flows of the GSEs should be reflected in the federal budget.

CBO considers those operations as being on-budget, concluding that “the institutions had effectively become government entities whose operations should be included in the federal budget.”⁷ For this reason, when CBO constructs its budget baselines it treats the GSEs in a manner similar to other credit programs operated by the federal government, something that the Federal Credit Reform Act of 1990 (FCRA) requires. Under FCRA, CBO records credit programs as subsidy costs, with the net present value of future cash flows associated with loan

⁶ These agreement, and amendments to such, can be found at: <http://www.fhfa.gov/Default.aspx?Page=364>

⁷ <http://www.cbo.gov/publication/41887>

commitments made in a given year *appearing on the budget*.

A key element of estimating net present values is the interest rate used to discount cash flows in future years. FCRA stipulates that the interest rates on Treasury securities be used to discount future cash flows, which leaves out risk or the opportunity cost of capital. The CBO's treatment of the GSEs in the federal budget departs from FCRA by incorporating market risk in its discounting of future associated cash-flows. The law that created the Troubled Asset Relief Program (TARP) required similar discounting.

In its latest version of the *Budget and Economic Outlook*, CBO estimates that the GSEs' operations will cost the federal government approximately \$19 billion over the next decade. For 2014 only, CBO records payments between the GSE's and the Treasury on a cash and extra-governmental basis, while it merely records subsidy costs for 2015-2024, in order to reconcile current-year deficit figures between CBO and those reported by OMB/Treasury. CBO estimates that net payments from those entities to the Treasury will amount to \$81 billion in 2014. OMB, on the other hand, has resisted placing the GSEs on budget and instead records any transactions between the Treasury and the GSE's on a cash rather than accrual basis (i.e., as outlays and/or offsetting receipts).

The government amended the terms for these payments in August of 2012 (the so-called Third Amendment). Under those terms the GSEs are to pay a dividend with an amount equivalent to the GSEs positive net worth above a capital reserve amount, \$185.2 billion in dividends had been paid as of December 31, 2013, with an additional \$181.5 billion in payments projected from January 1, 2014 through 2024.

Neither CBO nor OMB incorporates debt or mortgage-backed-securities issued by the GSEs in their estimates of federal debt. There has been a great of attention paid to the magnitude of the balance sheets of the GSEs and the degree to which the taxpayer would be exposed to the liabilities of those entities. These estimates typically focus on the GSEs' gross liabilities, which amounted to a combined \$5.2 trillion by the end of 2013 by OM's estimation. Under CBO's treatment, assets as of the end of 2008 were effectively written down, with subsidy costs for

mortgage loan cohorts in 2009 and future years being incorporated into the budgetary baseline. This write-down was reflected as a one-time \$291 billion expense in 2009, reflecting the taxpayer exposure of the GSEs' book of business at the time. Future loan guarantees and other operations amount to an estimated \$19 billion over the next ten years, according to CBO.⁸

In contrast, OMB projects cash transactions between the Treasury and the GSEs and expects to collect dividends in excess of the total amount ultimately invested. This methodology is only indirectly related to the overall magnitude of the GSEs' book of business, to the extent that GSE operations remain profitable and can afford the dividends claimed by the Treasury.

The Budgetary Implications of GSE Reform

Any change to the current status of Fannie Mae and Freddie would impact the federal budget, although how the federal budget authorities score those changes varies substantially.

There are two different budgetary impacts worth considering: The first is the "official" score from CBO or OMB, based on the assumptions of steady economic growth and a stable housing market. The second would be the budget impact in the event that the assumptions of a quiescent economy and housing market no longer held.

There are three major reform proposals currently getting attention: one is a bipartisan bill produced by members of the Senate Banking Committee, another is a Republican-only effort led by members of the House Financial Services Committee, and a third comes from one of the major private shareholders of the GSEs, Fairholme investment. Each would end Fannie Mae and Freddie Mac and lessens the role of the federal government in home ownership financing, but none fully extricates the government.

The PATH act and the Fairholme plan would raise modest amounts of revenue for the government while ostensibly limiting its exposure in the event of another market downturn. The bipartisan senate bills—Corker-Warner and Johnson-Crapo—that have garnered support from

⁸ <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/108xx/doc10878/01-13-fanniefreddie.pdf>

the White House would also generate revenue from a CBO/OMB perspective, but leave the government vulnerable to trillions of dollars of costs in the event of another market collapse by explicitly assuming the liabilities for all existing mortgage-backed securities issued by the GSEs.

PATH Act, H.R. 2767

H.R. 2767 would repeal the federal charters of Fannie Mae and Freddie Mac and end the operations of those firms five years after enactment of the bill. The Act would remove the GSEs' charters, place many of their assets into receivership, and replace the GSEs' role in the mortgage market with a National Mortgage Market Utility. The Utility would facilitate the secondary mortgage market, but do so without a federal guarantee. According to the CBO, this proposal would reduce the deficit by \$5.7 billion over the next decade.⁹ This largely reflects the elimination of the subsidy costs assumed in CBO's baseline that would arise from winding down the GSEs. OMB has not estimated the effects of the PATH Act, but presumably the budgetary treatment of this proposal would reflect the net effect of the liquidation of the GSEs' assets and the value of forgone dividends. Going forward, OMB would score a sale relative to its projection of \$182 billion in future dividend payments – proceeds in excess would score as deficit reduction relative to OMB's baseline.

Corker-Warner, S. 1217

S. 1217 would wind down Fannie Mae and Freddie Mac and end their operations over five years. Outstanding debt obligations and mortgages would be transferred from the GSEs to a holding company, *and the federal government would guarantee repayment of those obligations*. Corker-Warner would create the Federal Mortgage Insurance Corporation (FMIC) to replace the GSEs in the mortgage market. Unlike the replaced entity envisioned in the PATH Act, the FMIC would provide an explicit federal guarantee on the mortgage-backed securities it insured.

⁹ <http://www.cbo.gov/sites/default/files/cbofiles/attachments/hr2767.pdf>

CBO has yet to score Corker-Warner: How it would do so depends on the degree to which it perceived that the bill would change the existing subsidy costs assumed in the baseline. It would likely result in a reduction in subsidy costs to the extent that the bill would reduce the federal role in providing mortgage loan guarantees and securitization, and thus would score as deficit reduction. However, that the new entity would also be providing *explicit federal guarantees on new mortgages* as well, lessening the reduction in the estimated subsidy costs resulting from the wind-down of the GSEs.

The assumption of the current debt of the GSEs leaves the government on the hook once again should another housing price decline occur in the near future. While it may be a low-probability event it is also a high cost event to the government, and made higher by the new guarantee.

OMB has not estimated the effects of Corker-Warner either, but as with the PATH Act, the budgetary effects observed by OMB would reflect extra-governmental transactions – the magnitude of which would reflect the net payments from the holding company and forgone dividends. To the extent any new proceeds exceed the projected dividend payments assumed in the baseline, the bill would be deemed as raising revenue. Just as with CBO, that score assumes a relatively quiescent economy and housing market, since another recession or real estate downturn would leave the government on the hook for any defaults on government-backed mortgages.

Johnson-Crapo

The Senate Banking Committee Chairman and Ranking Member released a reform proposal plan that hews closely to the Corker-Warner plan. Like Corker-Warner it would wind down the existing GSEs, place their accumulated \$5.2 trillion debt onto the government's balance sheet, and start fresh with new GSEs, a new regulator, and an explicit guarantee on mortgage debt it issued. The legislation also adopts the Corker-Warner language that would enshrine the Third

Amendment.¹⁰

Johnson-Crapo establishes a Mortgage Insurance Fund (MIF), which pays insurance claims on the principal and interest of FMIC-backed securities if losses exceed the private market first loss positions, as in Corker-Warner. The MIF would be funded initially by assessments on Fannie Mae and Freddie Mac and sustained in the future by fees on FMIC-backed securities. Securities guaranteed under Johnson-Crapo would be exempt from registration with the Securities and Exchange Commission, as well as several provisions of the Dodd-Frank Act, giving such securities a considerable advantage over purely private alternatives.

Like Corker-Warner, Johnson-Crapo establishes a new regulator to oversee the insurance fund, as well as regulate the Federal Home Loan Banks. The new regulator would also have extensive new regulatory powers over both mortgage insurance companies and mortgage servicers. Prior to the recent financial crisis these were regulatory areas predominately occupied by the States. Like both the PATH Act and Corker-Warner, Johnson-Crapo would establish a full explicit guarantee of existing GSE debt obligations.

Michael Stegman, a senior Treasury official, recently stated that the administration would insist upon an explicit guarantee of this debt in order to support any reform.¹¹ Although how much leverage the White House has in this debate is an open question. Johnson-Crapo is likely to be introduced as a “Chairman’s mark” of Corker-Warner, S. 1217. Under traditional committee procedures the Banking Committee would move to vote on S. 1217 but amend such by striking all bill text and replacing with the Chairman’s mark. If Johnson-Crapo is voted out of the Banking Committee, in all likelihood, it will adopt the bill number for Corker-Warner, S. 1217.

The legislative proposals currently under serious consideration share a number of commonalities. All maintain an extensive government involvement in the mortgage market and leave the

¹⁰ Housing Finance Reform Text, Senate Banking Committee, 16 March, 2014: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=512757b1-e595-4b85-8321-30d91e368849

¹¹ Remarks of Counselor to the Treasury Secretary for Housing Finance Michael Stegman at the J.P. Morgan Securitized Products Research Conference, March 6, 2014. <http://www.treasury.gov/press-center/press-releases/Pages/jl2312.aspx>

taxpayer at considerable risk. The GSEs' current implied guarantees are made explicit, as each proposal brings the current outstanding GSE debt officially onto the books of the federal government. The three main bills also wind-down Fannie Mae and Freddie Mac, while leaving largely untouched the Federal Housing Administration and the Federal Home Loan Banks. Senate efforts, in the current political environment, are likely to continue to include an explicit government guarantee of mortgage credit risk.

IPO Scenario

An additional policy option widely discussed in the media would involve federal government selling its nearly 80 percent ownership stake in the GSEs.¹² While CBO would likely view this proposal as a reduction in subsidy costs relative to its baseline similar to the PATH Act, it is not clear how CBO would contemplate the disposition of warrants on common stock relative to the current baseline. To the extent that the CBO baseline does not contemplate an equity sale of Treasury's stake in the GSEs, that sale would score as deficit reduction. This would be highly dependent on valuation, but one estimate suggests a net deficit reduction of \$118 billion.¹³ OMB would observe this approach by taking the cash windfall from the sale realized through the exercise of Treasury's warrants on 79.9 percent of common stock in the GSE's netted against future dividends assumed in the budget. Estimates for the Treasury's gain are subject to considerable uncertainty, but could range from \$145 billion to \$250 billion. Of course such an estimate does not include the costs of any potential federal rescue of a re-privatized Fannie Mae and Freddie Mac.

The Housing and Economic Recovery Act of 2008 vests Treasury with the unilateral ability to dispose of its assistance to Fannie Mae and Freddie Mac, without the need for Congressional approval. While the current political environment makes that outcome extremely unlikely, the political environment is certain to shift in the years ahead. HERA, however, does not allow either Treasury or FHFA to extinguish the charters of the GSEs without an act of Congress.

¹² This section specifically references the Fairholme plan, which can be found at https://clients.fairholme.net/GSEProposal_11_11_13.pdf

¹³ Authors' calculations based on the numbers from the *May 2012 Budget Update* by CBO.

Can we end Too Big to Fail for the GSEs?

What separated Fannie and Freddie from most other financial institutions was the perception that their creditors would be protected from loss in the event of insolvency. While the aftermath of the 2008 financial crisis left the market with the distinct impression that there are other large, complex financial institutions that are too big to fail (which is manifested in credit spreads), none enjoyed this advantage to the degree of Fannie and Freddie, both of which could borrow capital at virtually the same rate as the federal government.

A crucial caveat is that the notion of too big to fail depends crucially upon market perceptions, since that guarantee remains “implicit”: Even today there is no statutory guarantee of Fannie and Freddie debt. Given that Congress’ explicit prohibition of any bailouts proved insufficient to prevent one from occurring, can the government ever credibly commit to ending such implied guarantees, and if not, what does such imply for reform of Fannie and Freddie?

Unlike explicit guarantees such as deposit insurance, implied guarantees are best thought of as probabilities. Since the current Congress cannot bind the hand of future Congresses, and regulators are also face time inconsistency issues, ending implied guarantees and foreclosing their return is effectively impossible.

Part of the policy debate has been and will continue to be about efforts to transform financial markets so as to lessen the likelihood of future bailouts, as well as the market’s perception that a bailout can occur. Debates about breaking up banks are motivated by a desire to make those institutions small enough so that one or more could fail while posing no more than a minimal risk to the rest of the financial system.

Similar issues arise with Fannie and Freddie: The existence of a multitude of GSEs, such as those found in the Federal Home Loan Bank System, could make the rescue of any one less necessary. Restraining the ability of the executive branch and that of independent regulators to rescue failing firms without the explicit act of Congress could be another avenue, but it too amounts to a promise that future congresses would have no compelling reason to keep.

The receivership provisions for Fannie and Freddie, which Congress passed in 2008, were also viewed as an avenue for ending the implied guarantees, as it created a mechanism for imposing losses on creditors rather than the taxpayer. Of course such a mechanism must be credible, and at the time of the rescue of Fannie and Freddie their regulator possessed sufficient authority to protect the taxpayer from any loss. Their regulator, the FHFA, ultimately chose not to use that authority. Accordingly, the extent of any implied guarantee depends upon the expected behavior of regulators and the range of allowable activities facing regulators. Having the tools in place to avoid bailouts is no guarantee that they will, in fact, be avoided. Although it is likely impossible to completely end implied guarantees, a number of policy changes can be made to reduce the likelihood of it occurring again.

Conclusion

This is typically the part of the paper where the authors declare the equivalent of Q.E.D. and offer the way out of the current morass. While we feel that we have successfully prosecuted the brief that the status quo for the GSEs is untenable and that the current reform proposals have severe flaws, we do not have a single way to fix the problem to offer. Instead, we offer a few rules to guide any future reform dialogue, should an honest one ever develop.

Protect the Taxpayer the government has a duty to ensure that the taxpayers' money is prudently protected. The Treasury has recouped its core investments in Fannie Mae and Freddie Mac, and the reform plans currently being discussed would generate more revenue from the GSEs.

However, some reform plans—most notably Johnson-Crapo—would place the debt held by Fannie and Freddie on the balance sheet of the federal government, opening up the taxpayer to significant losses should the economy and housing market fail to expand as forecast. It also represents a precedent that could have unforeseen impacts in the future. For instance, what would the federal government do should a state like Illinois find itself unable to pay its pensioners and other creditors in a decade or two? While the state's current bondholders clearly don't have as

strong an expectation of the federal government bailing out the state as did the holders of bonds issued by Fannie Mae, a guarantee extended to owners of GSE debt opens the door to the possibility that the federal government may provide assistance in this area as well.

Respect the Rule of Law During the financial crisis, short-term exigencies overrode longer-term policy considerations. Bailouts were ad hoc in nature, often with arbitrary terms. For instance, the differing treatments of Bear Stearns and Lehman Brothers have never been consistently and clearly articulated. Instead, federal policymakers offer varying and contradictory explanations that often lack a basis in either fact or law. Similarly, the priority of claims was violated in the auto bailouts, favoring some creditors over others in a manner that appeared to be driven largely by politics. Such actions sowed uncertainty and likely reduced investment, slowing the pace of the recovery. In order to promote economic growth and financial stability, mortgage finance reform should establish a system based upon rules and not the arbitrary discretion of politicians.

The treatment of private equity holders in the GSEs has also been marred by uncertainty. It is true that those shareholders who kept their stock in the GSEs--or those who purchased it after the two went into conservatorship--were promised nothing, as befits a residual claimant, other than a share of what was left over after the other creditors were satisfied. But to preemptorily take away the privileges being a residual claimant shortly after it became clear that the position might be worth something is not good policy. While private equity holders have no property interest in the Congressional charters, a wind-down or resolution of the GSEs should provide for any excess value, where assets exceed liabilities, to flow to all equity holders.

The American system of mortgage finance has long been characterized by extensive government distortions and political meddling. The roots of the recent crisis can be found, along with monetary policy, in our current system of mortgage finance. To maintain the current system would be reckless, but it is crucial that any replacement actually be an improvement and not simply rearrange the deck-chairs on a proverbial Titanic.

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