U.S. Housing Finance Reform: Why Fix What Isn't Broken?

February 14, 2018

by Libby Cantrill, Michael Cudzil, Daniel Hyman, Kent Smith of PIMCO

SUMMARY

- We believe reform of the government-sponsored enterprises (GSEs) should simply formalize the current state of affairs – namely, by making the government guarantee explicit and otherwise keeping Fannie Mae and Freddie Mac functioning as they largely are today.
- To ensure a viable alternative to the government balance sheet, policymakers must also focus on reviving the moribund private mortgage market by making commonsense changes that bring private capital back in a responsible manner.
- Specifically, we believe policymakers need to consider changes to the private-label securities market to protect investors, such as providing investors a private right of action to enforce against bad loans in securitization structures and preventing investors from being held accountable for the practices of originators.

The topic of housing finance reform has come in and out of focus on Capitol Hill since Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) were taken into conservatorship back in 2008. As one of the largest participants in the mortgage-backed securities (MBS) market, and given our fiduciary role as a steward of other people's assets, we at PIMCO are devoted to a liquid and stable mortgage market. Not surprisingly, we have taken a keen interest in the various reform proposals introduced over the past several years.

Housing finance reform need not be revolutionary

While we have refrained from commenting on specific plans, we believe housing finance reform must be comprehensive, above all else. And while we agree with a focus on shrinking the government's role in housing finance, we believe similar attention must be paid to a responsible and thoughtful rebuilding of the private mortgage market – the alternative to the government balance sheet.

When it comes to the GSEs, we think policymakers should take a "do no harm" approach to reform that contains several key elements:

- An explicit government guarantee for both future and legacy MBS
- A continuation of the national mortgage rate (e.g., a borrower in Spartanburg, SC, can access a similar mortgage rate to a borrower in San Francisco, CA)
- A guarantee fee that is counter-cyclical (versus a pro-cyclical, floating fee)
- A continuation of the GSEs' current credit risk transfer (CRT) program
- Loan limits transitioned thoughtfully to be based on income levels, not housing prices

What you do *not* hear PIMCO calling for is a wholesale change or even an end to the status quo for Fannie Mae and Freddie Mac. Indeed, from our perspective as a large market participant, the delivery of mortgage credit has never been so efficient or so fair, nor has the market for MBS ever been so deep, liquid and stable as it has been during the years that Fannie and Freddie have been under conservatorship. What's more, the Federal Housing Finance Agency (FHFA)'s heightened oversight has put an end to the pernicious activities that gave rise to the GSEs' conservatorship – namely, buying subprime private-label securities collateralized by poor-credit-quality loans and putting them on their balance sheets – thereby mitigating the threat they pose to taxpayers.

Conservatorship: not a dirty word

Although conservatorship may be unpopular, policymakers must stop treating it as a four-letter word if they truly want to protect and promote a consistent national mortgage rate, broad access to mortgage credit and a deep, liquid secondary mortgage market. Instead, we believe GSE "reform" should simply formalize the current state of affairs – namely, by making the government guarantee explicit and otherwise keeping Fannie and Freddie functioning as they largely are today.

© 2020 Advisor Perspectives, Inc. All rights reserved.

In other words, Congress should be honest about conservatorship: It has been and continues to be immensely successful, not to mention wildly profitable, and the current system works.

In our view, formally folding Fannie and Freddie into the U.S. government is the simplest, most elegant and least disruptive solution to achieve a national mortgage rate, access to mortgage credit and a deep, functioning market. It is also the most straightforward solution to deliver on sensible subsidized affordable housing goals. At the same time, policymakers should slowly reduce the government footprint by carefully and deliberately lowering loan limits and ultimately tying them to median incomes, rather than to housing prices (as they are today).

A private market renaissance

To ensure a viable alternative to the government balance sheet, policymakers must also focus on reviving the moribund private mortgage market by making commonsense changes that bring private capital back in a responsible manner. Specifically, we believe policymakers need to consider changes to the private-label securities market to protect investors, such as providing investors a private right of action to enforce against bad loans in securitization structures (something they cannot do now) and preventing investors from being held accountable for the practices of originators. Until such protections are in place, big fiduciaries, such as PIMCO, are not likely to return to these markets.

Reform could be simple – and eminently doable

While this may all sound quixotic, we think policymakers should ask themselves why they are so intent on fixing what is clearly not broken. Indeed, with a few tweaks, we believe policymakers could thoughtfully and slowly shrink the government balance sheet and revive the private mortgage market – all while ensuring they don't disrupt one of the most functional markets in the world.

DISCLOSURES

A word about risk: All investments contain risk and may lose value. Mortgage- and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee, there is no assurance that private guarantors will meet their obligations. Certain U.S. government securities are backed by the full faith of the government. Obligations of U.S. government agencies and authorities are supported by varying degrees but are generally not backed by the full faith of the U.S. government. Portfolios that invest in such securities are not guaranteed and will fluctuate in value. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice.

This material contains the opinions of the manager and such opinions are subject to change without notice. This material has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America L.P. in the United States and throughout the world.

©2018, PIMCO.