New model for stability of Fannie Mae and Freddie Mac

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In 2007, the American housing boom ended, and there was heightened risk of a housing crisis. Private securitizers withdrew from purchasing high-risk mortgages, while government-sponsored enterprises, Fannie Mae and Freddie Mac, dramatically increased their acquisitions of risky mortgages. By 2008, the agencies reversed course, decreasing their high-risk acquisitions.

In a new article, an economist proposes a scenario in which large lenders temporarily boost high-risk activity at the end of a boom. According to her model, lenders with many outstanding mortgages have incentives to extend risky credit to prop up housing prices, which lessens the losses on their outstanding portfolio of mortgages. As the bust continues, lenders slowly wind down their mortgage exposure.

The article, by a researcher at Carnegie Mellon University (CMU), appears in *The Review of Financial Studies*, a journal of the Society for Financial Studies.

"As policymakers discuss whether to phase out Fannie Mae and Freddie Mac in the aftermath of the 2018 housing crisis, this model contributes to a deeper understanding of policies that ensure the stability of the financial system," suggests Deeksha Gupta, Assistant Professor of Finance at CMU's Tepper School of Business, the author of the article.

In her model, Gupta addresses how concentration in mortgage markets can affect both the quantity and quality of mortgage credit. Fannie Mae and Freddie Mac, currently in government conservatorship, accounted for 61 percent of all outstanding U.S. mortgage debt in February 2019.

The propping up effect can stabilize housing prices, but may also cause greater financial fragility by increasing housing defaults in later periods during a bust. Therefore, this dynamic is important to consider when deciding on the future of the enterprises, Gupta argues.

In the aftermath of the housing crisis, policymakers expressed interest in designing policies to curb high-risk lending. But the role concentration can play in creating incentives to extend risky mortgage credit has been largely overlooked, Gupta contends.

"While the model I propose focuses on the 2008 housing crisis, it can be applied more generally," Gupta says. "For example, the model can be used when considering housing policy since 2009, which aimed at stabilizing housing markets."

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More information: Deeksha Gupta, Too Much Skin-in-the-Game? The Effect of Mortgage Market Concentration on Credit and House Prices, *The Review of Financial Studies* (2021). DOI: 10.1093/rfs/hhab027

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