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Annual Privatization Report 2011: Federal Government Privatization

By Adam Summers and Anthony Randazzo
Edited by Leonard Gilroy and Harris Kenny

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Part 1

Government and Contractors Spar Over Which Functions Are "Inherently Governmental"

For years, the federal government, public employees unions and private contractors have been sparring over which governmental functions and activities should be deemed so critical or "inherently governmental" that they must be performed by government workers and which should be outsourced to private sector providers. The administration of Barack Obama has generally taken a more sour view of contracting and private sector involvement than the previous administration of George W. Bush. A two-and-a-half year battle over contracting guidelines culminated in the final policy letter issued by the Office of Federal Procurement Policy (OFPP) in September 2011, although the debate is sure to persist indefinitely.

The debate over government contracting guidelines began in earnest following the issuance of a March 4, 2009 White House memorandum. The memorandum instructed the director of the Office of Management and Budget (OMB), the Secretary of Defense, the administrator of the National Aeronautics and Space Administration (NASA), the administrator of General Services, the director of the Office of Personnel Management, and other agency heads to develop "Government-wide guidance to assist agencies in reviewing, and creating processes for ongoing review of, existing contracts in order to identify contracts that are wasteful, inefficient, or not otherwise likely to meet the agency's needs, and to formulate appropriate corrective action in a timely manner."[1] In the memorandum, President Obama argued,

> *Since 2001, spending on Government contracts has more than doubled, reaching over $500 billion in 2008. During this same period, there has been a significant increase in the dollars awarded without full and open competition and an increase in the dollars obligated through cost-reimbursement contracts. Between fiscal years 2000 and 2008, for example, dollars obligated under cost reimbursement contracts nearly doubled, from $71 billion in 2000 to $135 billion in 2008. Reversing these trends away from full and open competition and toward cost-reimbursement contracts could result in savings of billions of dollars each year for the American taxpayer.*[2]

In response to the presidential memorandum, OMB issued a draft policy letter in late March 2010 intended to improve guidance on federal contracting policies. During the ensuing three months, the administration received over 30,000 public comments on the proposed regulations. One particularly contentious provision concerned the introduction of a new category of government functions to be considered in contracting decisions. In addition to dividing government activities into those that are inherently governmental and those that are commercial in nature, as defined in the 1998 Federal Activities Inventory Reform (FAIR) Act, the draft letter proposed adding a category of functions "closely associated with the performance of inherently governmental functions." As Reason Foundation Director of Government Reform Leonard Gilroy cautioned in one of those 30,000 comments to OFPP,

> *The new class of "closely associated" functions would expand the definition of what work should be reserved for federal employees beyond that which has been previously authorized by Congress. Not only is this expansion unwarranted, but it also tries to artificially create a new category of functions that ostensibly exist in a grey area between "inherently governmental" and "commercial" functions, but which in practice would effectively be treated as "inherently governmental" functions. Indeed, most of the items in the illustrative list of functions "closely associated with the performance of inherently governmental functions" are commercial in nature, and it is reasonable to expect that new regulatory controls on these and other "closely associated" functions will have the impact of dramatically expanding the scope of work off-limits to private contractors, thereby creating the conditions for unchecked growth in the federal workforce.*

Others, such as public employees unions, argued that the "closely associated" functions should be treated like the "inherently governmental" functions, so that more work would be reserved for government employees, and still others offered specific recommendations to tweak the list of functions included in the "closely associated" definition.

In September 2011, OMB issued its final version of the contracting guidelines in the form of OFPP Policy Letter 11-01, Performance of Inherently Governmental and Critical Functions.[3] The policies described in the letter went into effect on October 12, 2011, and were added to the Federal Acquisition Regulation.

The final policies and regulations were substantially similar to those in the March 2010 draft letter. According to OFPP administrator Dan Gordon, the list of "inherently governmental" functions is about 90 percent to 95 percent the same as the previous one in the Federal Acquisition Regulations.[4] The definitions of several specific functions were clarified, such as security operations, which are not to be contracted out if they involve combat operations or the likelihood that contractors may become involved in combat.

The notion of functions "closely associated with the performance of inherently governmental functions" remained (see Table 1 for examples of functions falling into the "closely associated" category), although its consideration was downgraded somewhat, as OFPP felt that "the concept is more relevant to management practices, or internal control mechanisms, as opposed to serving as a stand-alone functional category."[5] Adding to the confusion, however, was the concept of "critical functions," originally used in the 2009 National Defense Authorization Act, in which an agency weighing the decision to contract out government functions must "determine if the agency is at risk of losing control of its ability to perform its mission and operations."[6]

Table 1: Examples of "Inherently Governmental" and "Closely Associated" Government Functions in the New OFPP Contracting Regulations

Function	Inherently Governmental	Closely Associated
Budget development	The determination of budget policy, guidance and strategy; federal program priorities or budget requests.	Support for budget preparation, such as workforce modeling, fact finding, efficiency studies, and shared-cost analysis.
Policy & regulatory development	Determination of the content and application of policies and regulations.	Support for policy development, such as drafting policy documents and performing analyses, feasibility studies, and strategy options.
Human resources management	The selection of individuals for federal government employment, including interviewing candidates and direction and control of federal employees.	Support for human resources management such as screening resumes in accordance with agency guidelines.
Acquisition planning, execution and management	Determining requirements; approval of contract strategy; independent determination of cost; awarding contracts; ordering changes; performance reviews; termination of contracts.	Conducting market research; developing inputs for cost estimates; drafting work statements; preparing technical evaluation; drafting price negotiation memos; assisting in performance evaluation; assessing contract claims; preparing settlement documents.

Source: Wyatt Kash, "When Is a Federal Job Function 'Inherently Governmental'? OFPP Memo Outlines New Terms," AOL Government, September 13, 2011, http://gov.aol.com/2011/09/13/when-is-a-federal-job-function-inherently-governmental-ofpp/ (retrieved November 22, 2011).

According to former OFPP Deputy Administrator Robert Burton, now advocating for small business clients as a partner at Venable LLP, this regulation will continue to cause "confusion and risk," as one agency will define "critical functions" differently from another and decisions will be made arbitrarily on an ad hoc basis.[7] In addition, Burton separately argued that, under the new policies, agencies can argue that any job is critical to meeting their missions and claimed, "What this policy letter does is institutionalize insourcing in the federal government."[8]

This could prove to be a dangerous precedent if the new regulations are used to reverse a long-standing federal policy of relying upon the private sector for products and services whenever it is possible and practicable to do so. Such a policy was outlined in 1955 in Bureau of the Budget Bulletin No. 55-4, and reaffirmed in Bureau of the Budget Circular A-76 in 1966 and OMB Circular A-76 in 2003.

There are compelling reasons to rely on the private sector as much as possible. In addition to preventing the government from competing with its own citizens to provide services, the private sector has much stronger incentives than do government agencies to provide the best quality goods and services at the lowest price. As Thomas Jefferson observed way back in 1808, “It is better for the public to procure at the market whatever the market can supply; because there it is by competition kept up in its quality, and reduced to its minimum price.” While private businesses must offer better quality and lower prices than their competitors to succeed, government agencies face no such threat of going out of business for providing wasteful or substandard service.

While the new federal contracting regulations may not be as bad as many contractors and advocates of free markets and limited government feared at the outset of the process, they do appear to grant the government more leeway to eschew contracting and maintain government work “in-house.” This could prove to be more costly, which is especially damaging in an era of exploding national debt. Although the ultimate impact of the new regulations is uncertain, clearly there will be much confusion and debate over their implementation as the battle over which functions of government can and should be contracted out to the private sector rages on.

Part 2

Roadblocks for Housing Finance Privatization

What a difference a year makes. When we reported in *Annual Privatization Report 2010*, all of the stars were aligning for the federal government to finally move on reforming the American housing finance system. After a year of delay, however, it appears that the perpetual conservatorship of Fannie Mae and Freddie Mac will not be addressed by the whole Congress until after the presidential election in 2012.

While some have argued it was foolhardy to hope for change in the first place, there were a number of developments that presented opportunities for privatization:

- In the fall of 2010, the Treasury Department hosted a summit specifically aimed at bringing together ideas for housing finance reform and solicited a host of ideas on what should be done to both prevent another catastrophic housing bubble as well as ensure a stable housing market for the future.
- Republicans in the House of Representatives, who spent most of 2010 pressing the leadership in the Financial Services Committee to address housing finance reform, were elected to the majority and promised to debate legislation on privatizing the housing finance system.[9]
- The White House released "Reforming America's Housing Finance Market: A Report to Congress" in early February 2011 that explicitly stated Fannie Mae and Freddie Mac were not necessary for the future stability of the American housing market.[10]
- Treasury Secretary Timothy Geithner testified before a Republican-led House Financial Services Committee in March 2011, "we hope to work together with you and your colleagues to pass comprehensive legislation within the next two years. Failing to act would exacerbate market uncertainty and risk leaving many of the flaws in the market that brought us to this point in the first place unaddressed."[11]
- And even Rep. Barney Frank (D-MA), long known for being a supporter of the government-sponsored enterprises (GSEs), stated for the record that the enterprise model for housing finance had failed and they should be dissolved in favor of an alternate system.[12]

However, very little of substance happened in 2011. After a few weeks of fanfare around the Administration's "Reforming America's Housing Finance Market" paper, Treasury Secretary Timothy Geithner acknowledged that the federal government's focus would be on managing the debt ceiling threat as its first priority. By the time an agreement was reached between Republicans and Democrats in August 2011, momentum on housing finance reform had long since stalled out.

In the spring of 2011, Republicans in the House introduced a number of pieces of legislation that would have limited the government role in housing, though few made it past the subcommittee level.[13] At least two plans were proposed with joint sponsorship from a Republican and Democrat, both of which would have kept the government subsidizing housing in some capacity, were dead on arrival. And at press time only a bill to create a covered bonds market and a bill to limit the pay of Fannie Mae and Freddie Mac executives had made it to the House floor. The Senate has only held a few hearings on housing-related matters but without discussing any specific proposed changes to the status quo.

Despite the role that the debt ceiling debate took in sidelining many other domestic policy subjects in the congressional agenda, government lacks enthusiasm for moving forward with privatization of the housing finance system. This is despite the seemingly bi-partisan agreement that Fannie Mae and Freddie Mac should be replaced or eliminated at some point.

Filtering through the noise that comes from the challenge of removing any decades-long program in Washington, D.C. in any political climate, there appear to be six leading barriers to the privatization of the American housing finance system.

A. Fear of the Unknown

First, many policymakers fear taking action of any kind in a highly uncertain climate. Rep. Shelley Moore Capito (R-WV) told an American Banker conference audience in October 2011 that she was uncomfortable changing anything in the housing finance system because of how fragile the housing market is, even though she ultimately favors reducing the role of GSEs in the housing finance system.

Critics of this position argue that *not* doing something is actually an action. In 2011, Fannie Mae, Freddie Mac and the Federal Housing Administration (FHA) combined to purchase or guarantee 95 percent of all new mortgages in America (and every one of those mortgages is backed by taxpayer guarantees). This is largely because the GSEs are able to price out competition, particularly since the maximum loan size Fannie and Freddie can purchase expanded from $417,000 in 2008 to as high as $729,750 in mid-2011, but only back down to $625,500 at the end of 2011. The critics argue that by taking this dominating position the mortgage market runs the risk of making the housing recovery take longer than if Congress did take action.

Fannie Mae and Freddie Mac have always undercharged, of course. That is the point of their existence. If they charged market rates to provide guarantees for mortgages, they would not provide any service not otherwise found in the private sector. The idea of Fannie and Freddie is that they increase the amount of investment in mortgages, making it easier to get a mortgage, by offering investors subsidized guarantees. They also buy a large number of mortgages from originators making it possible for smaller lenders to underwrite numerous mortgages within the conforming loan limits, turn around and sell them to the GSEs after pocketing fees, and go right back to lending out that money to more homebuyers.

Prior to the 1990s, tighter conforming loan standards limited the role of Fannie and Freddie so they could not monopolize the housing market. Even after lending standards were weakened in the 1990s, there was so much demand for mortgage financing during the housing bubble that the GSE share of the market was kept to about 40 percent. It was only after the conforming loan standard went sky high and the housing bubble's collapse caused mortgage lending to tighten up that Fannie and Freddie, along with FHA, were able to take as much as 95 percent of the mortgage financing market.

Even with today's very weak housing market, GSEs use their unlimited access to taxpayer funds to subsidize risk premiums. Fannie Mae and Freddie Mac currently charge between 15 and 25 basis points (i.e. 0.25 percent) on mortgage-backed securities to guarantee payment to the investor in case a mortgage defaults. The Congressional Budget Office suggested in April 2011 that the GSEs should really be charging 440 basis points.[14] In dollar terms, that is the difference between collecting $12.5 billion and $220 billion for investor insurance on the GSE's $5 trillion in mortgage-backed securities.

A change of this magnitude would undoubtedly have reverberating effects in the housing market, legitimizing the concerns of policymakers weary of taking action in a fragile environment if something went wrong. On the other hand, as long as the guarantee fee charged by the GSEs is so low, along with a very high conforming loan limit, there will be little room for private sector investors willing to take on full credit risk to return to the mortgate market—something both the White House and congressional Republicans have advocated is critical for rebuilding the housing market.

If the GSE and FHA monopoly in the mortgage market is a barrier to stability in the housing industry, choosing to do nothing is, ironically, also an action that risks damaging an already fragile housing market.

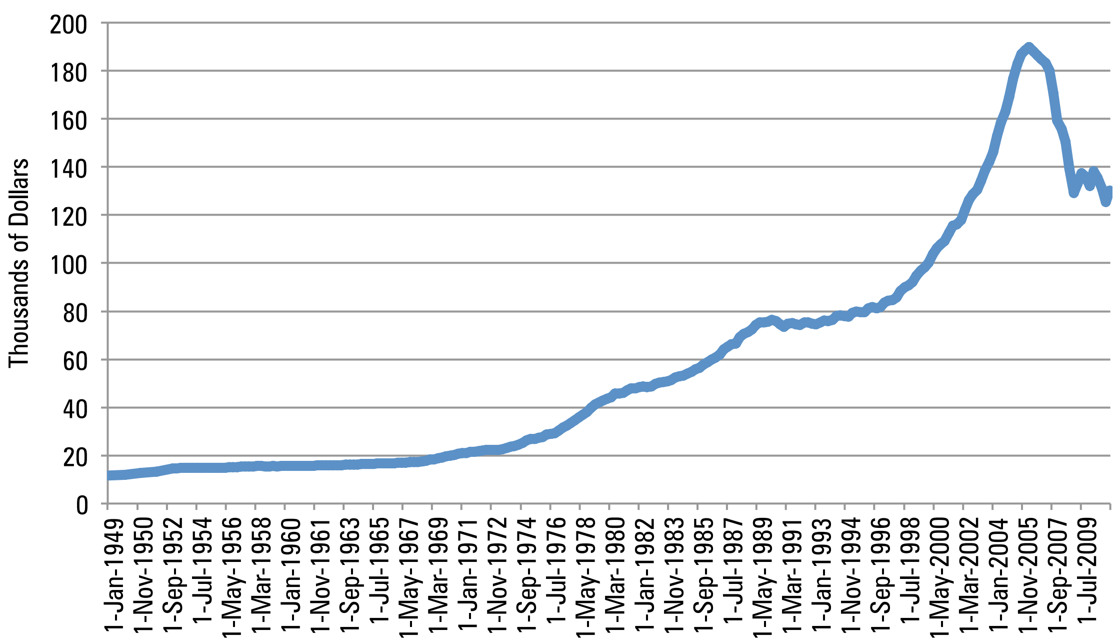
B. Housing Prices

Second, removing Fannie Mae and Freddie Mac's price supports for housing would likely cause home values to decline further than they have already. Policymakers understandably fear the political risks associated with falling housing prices, as well as sense the acute damage caused when households have to go through the foreclosure process on a home that is underwater and not qualified for refinancing or a modification. However, some academics argue that supporting housing prices is running counter to policies aiming at housing market recovery, noting that nationwide home values still need to fall in order to align with the pre-bubble price trend.

Over the past several decades, politicians in Washington, D.C. have considered increasing homeownership to be a civic duty, partly because of the pervasive belief that homeownership is a good investment every middle-class household should have. Data from the Case-Shiller Housing Price Index, however, suggests that housing is not the best investment for everyone. This reverses decades of the conventional wisdom and renders policymakers' desire to have high housing prices (while also wanting affordable housing) a complicating factor in pursuing privatization of the housing finance system.[15]

It is easy to see why policymakers have bought into the uncontested belief that homeownership is a good investment for everyone. Looking at the Case-Shiller HPI over time, prices grew steadily until the 1990s and then took off like a rocket until the bubble burst in 2006, as demonstrated in Figure 1 below.

Figure 1: Nominal National Housing Prices, 1949–2011

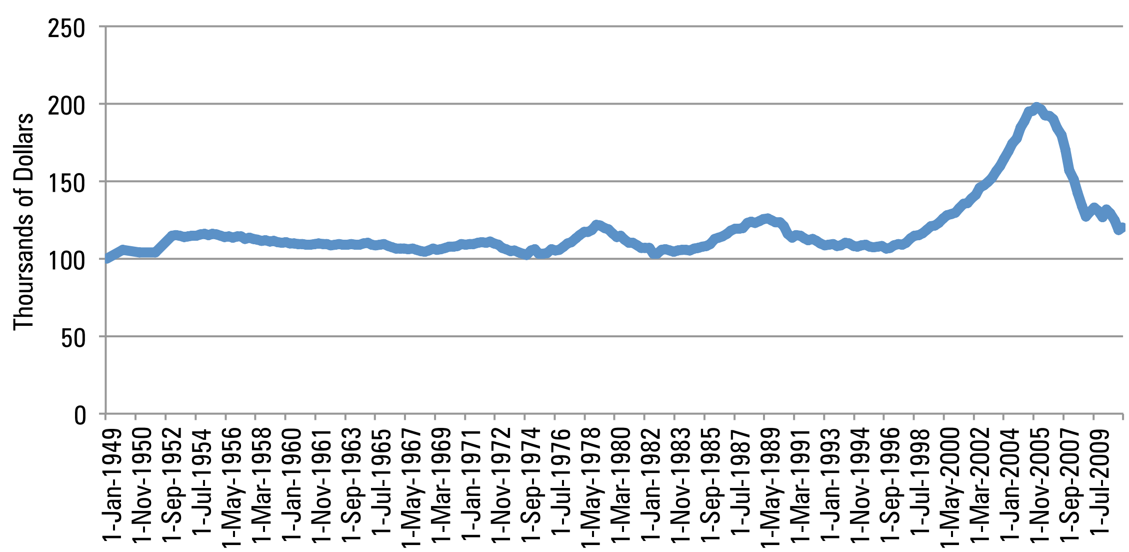


Source: Case-Shiller Housing Price Index

When looking at housing this way, the "ownership society" lauded by President Bush in the early 2000s sounds like a good idea, especially considering social values associated with homeownership, like neighborliness and having a stake in nurturing a community. However, owning a home is not always the great investment policymakers often believe it will be for their constituents, even without devastating housing bubbles.

When you adjust these numbers for inflation, housing prices stayed nearly flat from the end of World War II until the mid-1990s. Only once the so-called 1992 Government-Sponsored Enterprise (GSE) Safety and Soundness Act opened up the floodgates of federal subsidies, later to be caffeinated by the Federal Reserve's loose monetary policy in the early 2000s, did prices double nationally. Of course, that price jump was a bubble and prices have fallen nearly back to levels last seen in the 1990s, as demonstrated in Figure 2 below.

Figure 2: Inflation-Adjusted National Housing Prices, 1949–2011

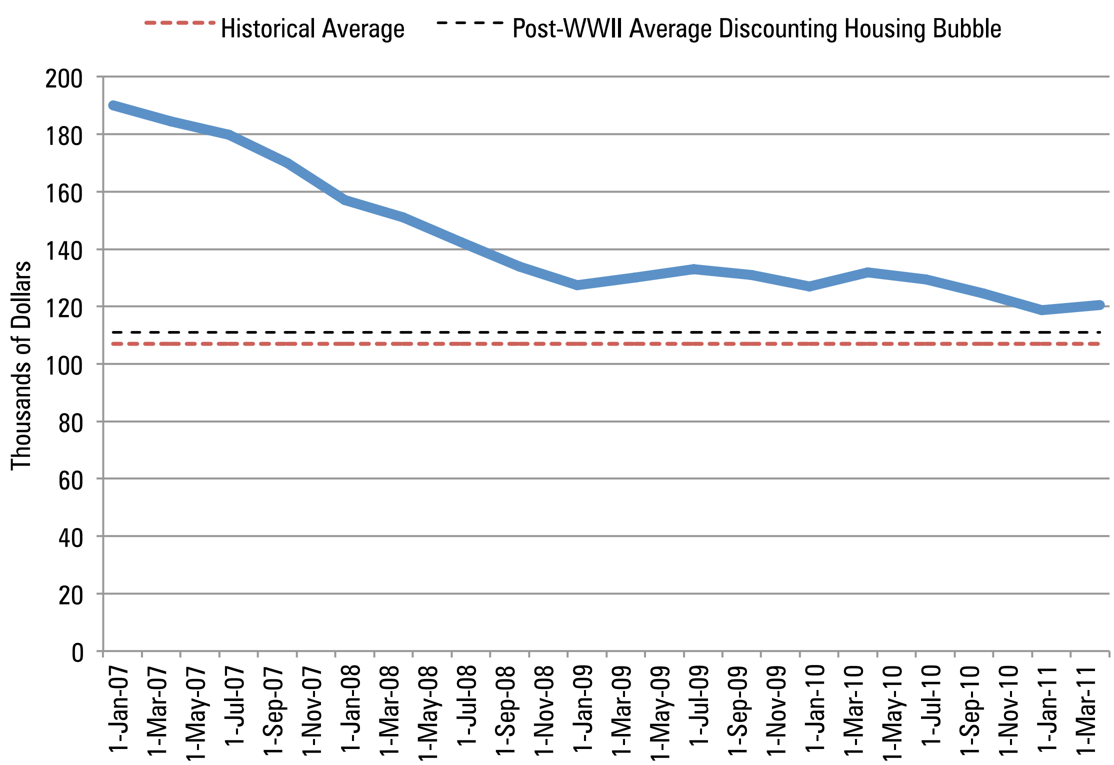


Source: Case- Shiller Real Housing Price Data

By this measure, there was very little national investment gain in housing until excessive subsidies created the housing bubble. This is not to say housing was a bad investment in the last century. In the 50 years following World War II, real housing prices grew 3.53 percent. But compared to other possible investments during this period, that is a very small growth rate. Consider that during the same period, the Dow Jones stock index grew more than 2700 percent. Similarly, the S&P 500 and NASDAQ—which started later in the century—have grown substantially larger than housing. Since 1970, the indexes have grown about 550 percent and 950 percent respectively.

Eventually real housing prices picked up, doubling from 1996 to 2006 on the back of the housing bubble. But in trying to boost investment values, policymakers and poorly incentivized bankers drove prices unsustainably high, and the peak of growth was short-lived as home values have steadily fallen back toward the pre-bubble trend line, as can be seen in Figure 3 below.

Figure 3: Inflation-Adjusted National Housing Prices, 1Q2007–2Q2011



Source: Case-Shiller Real Housing Price Data

These numbers suggest that housing prices will fall another 7 percent to 10 percent. Other economists have estimated prices will fall over the coming years at similar and sometimes larger rates of decline.[16] While economist Robert Shiller is correct when he says it is impossible for statisticians to perfectly forecast housing prices, it is highly likely that housing prices will fall *even with* Fannie Mae and Freddie Mac run as wards of the state.

If housing prices cease to be viewed as an investment, and instead are thought of more like a savings account, then the reasons to fear housing prices falling back to their pre-bubble trend are reduced. There remains the problem of underwater homes and the fact that most negative equity will likely get worked out in short sales and foreclosures. The policy decision, though, is less about housing prices and more about whether it is appropriate public policy to force modification of those loans or to let the foreclosures work themselves out of the system.

If the housing finance system had been privatized in 2008 and prices allowed to fall to their natural level quicker, 2011 probably would have returned stability to the housing market. However, the stalled process of housing finance reform has led to a slower decline in housing prices that does not appear to be fully worked out and left policymakers with a difficult decision of allowing homeowners to take losses on their mortgages along with investors on the other side, or to concentrate the losses in the financial industry itself, which benefited from taxpayer support to grow as large as it has in the first place.

C. The Love of 30-Year Fixed-Rate Mortgages

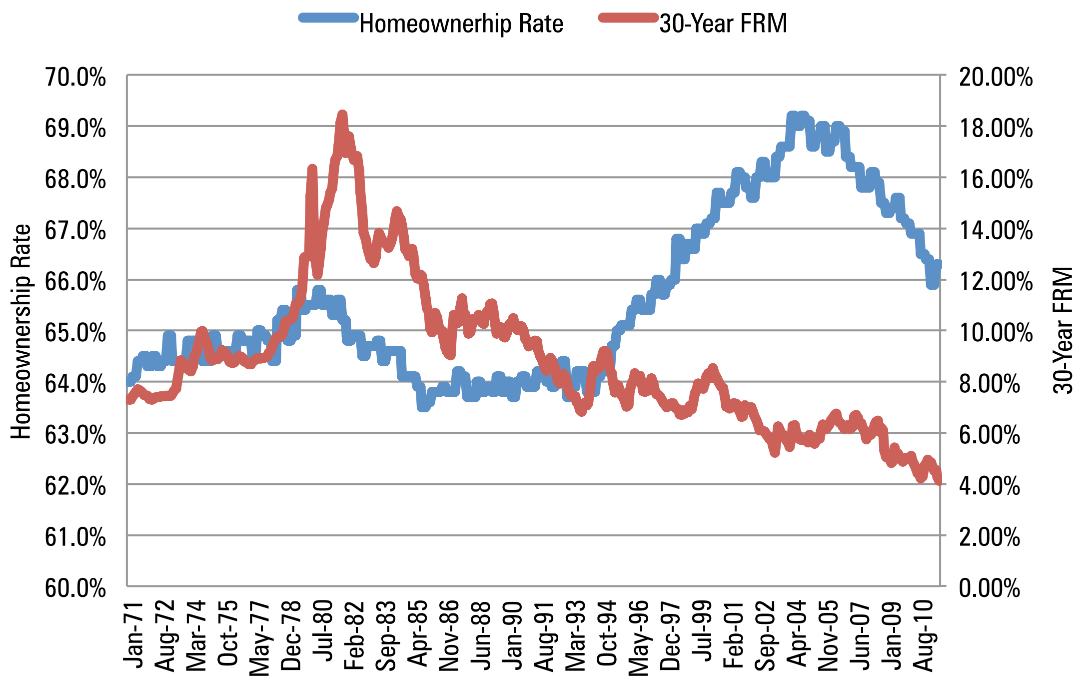
Third, there is deep-rooted attachment to the 30-year fixed rate mortgage (FRM) in the United States. Many believe FRMs would disappear without government involvement in housing finance, but there are a host of housing experts who argue it is unclear whether 30-year FRMs would become more expensive without Fannie Mae and Freddie Mac subsidizing the risk. In either case, though, the source of the debate is whether policymakers should consider low-priced 30-year FRMs to be a necessary component of the American housing finance system or not.

People like 30-year FRMs because they are predictable and put the risk of interest rates rising on the mortgagee. If interest rates fall, a homeowner can refinance at the lower rate, but if interest rates rise, then the bank will make less from the mortgage. Banks and other mortgage originators are able to afford this by securitizing many 30-year FRMs and transferring the risk to those who buy the securities. All of this makes 30-year FRMs cost much less for homebuyers than adjustable-rate mortgages, or shorter-term mortgages.

Of course, there are many things that people would prefer to be inexpensive. Policymakers presumably single out the fixed-rate mortgages because they want to promote homeownership. Put another way, the fear is that without 30-year FRMs the number of Americans who own a home would fall because they couldn't get access to affordable mortgages.

The price of a 30-year FRM has varied over the past several decades, as has the homeownership rate. If the fear of policymakers is valid, then theoretically, homeownership rates should historically have fallen when 30-year FRM rates rose. However, the data do not appear to support this thesis:

Figure 4: Homeownership Rates Compared with 30-Year Fixed Rate Mortgages (FRM), 1971–2011



Source: U.S. Census Bureau and Freddie Mac

As Figure 4 shows, there is little consistent correlation between the 30-year FRM and homeownership.[17] Both rates rose in the 1970s. Then in the early 80s homeownership began to decline while mortgage rates rose, as you might expect if there was causation. However, by the end of the 80s mortgage rates dropped back down to about where they started the decade, but the homeownership rate continued to fall.

More recently, it is clear that mortgage rates on the 30-year fixed have been falling somewhat steadily since the mid-90s, starting at a 9 percent average down to today's roughly 4 percent rate. However, the homeownership level shot up from 64 percent in 1995 to 69 percent in 2004 only to fall back down again to just 65.9 percent as of July 2011 (the most recent data available at press time).

There is little doubt that mortgage rates influence homeownership rates at some level. The more expensive mortgages are, the fewer homes are bought, and the less homeownership rises. However, just because 30-year FRMs specifically are more expensive does not mean that homebuyers can't get other mortgages that are within their price range. The data would suggest this is what homebuyers have done in the past, which is why there is no clear causation or correlation between homeownership and the rates on 30-year FRMs.

Even if the price on 30-year FRMs were to jump 50, 100, or 250 basis points on today's 4 percent mortgage rates, we'd still be well below historical averages, which (as Figure 4 shows) got as high as 18 percent in the 1980s and didn't fall consistently below 8 percent until the late 1990s.

This does not clarify whether or not the 30-year fixed rate mortgage would disappear in a fully private housing finance system. However, it does suggest that the negative consequences of that becoming a reality are limited. Given that this runs against the conventional wisdom, however, the fears of policymakers about the negative consequences have remained.

D. Fear of No More Mortgage Investors

Fourth, there are a host of questions surrounding what is necessary to get private sector financiers to return to mortgage investing. Even if Fannie Mae and Freddie Mac were wound out of the system, there remain challenges for navigating legal challenges and necessary due diligence for responsible mortgage investing. Some have argued that it would be impossible to fully untangle the government from the housing finance system, while others argue all of the challenges have private sector solutions.

One reason private investors are hesitant to return to mortgage financing is because there are many questions surrounding the viability of securitization. Most mortgage-backed securities investors did not know the quality of the mortgages they were purchasing and did not take the time to look at the characteristics of each mortgage. The due diligence necessary to ensure quality in a mortgage-backed security is very time consuming. And since the main ratings agencies are paid by those selling the mortgages and have government-assigned credibility, they are widely untrustworthy. One idea, proposed by Reason Foundation, is to establish an industry group similar to the Financial Accounting Standards Board that would rate mortgages, providing clarity about the underwriting characteristics of any particular loan, enabling streamlined buybacks of poorly underwritten loans, and enforcing sanctions against issuers that misrepresent the quality of their mortgages. This could conceivably shorten the due diligence process and reduce the costs, re-energizing private sector investors' confidence in the market.

Another challenge for private sector investors is the confidence in rule of law governing contracts. There has been a significant push for the government to forcibly modify mortgages that have high negative equity—either by the mortgage owners themselves through "modifications" or through a "cramdown" by a judge. The idea is that eliminating some of the principal makes it more likely the borrower could afford to stay in their home, while putting the losses on the financial industry or taxpayers as a whole. Whether or not this is good policy, it does provide a disincentive for future mortgage-backed security investors who may fear that judges or regulators will break their contracts and force modifications without consent.

Possible policy solutions proposed to solve this problem include adjusting the terms of securities to allow more flexibility by the trustee of the security in ensuring maximum return, as well as clarifying the law to ensure the rights of first lien holders are upheld. While these conflicts are not new, market participants did not recognize them as a roadblock prior to 2007 since there were few defaults to be concerned about. Now that heavy losses in collateralized pools of mortgages have proven to be a real possibility, "tranche warfare"—i.e. the fight among various classes of investors as to who shoulders these losses—has become bitter and brutal. This conflict has highlighted defects in the incentive structures of many deals.[18]

It is generally held that mortgage-backed security investors should not have to struggle to determine the restitution to which they would be entitled in case of default. Most industry experts also agree that streamlining the adjudication of disagreements between investors and issuers over representations and warranties would make mortgage investing much more attractive in the future.

The Dodd-Frank Act (DFA), passed in July 2010, creates another set of concerns that the return of private capital to mortgage financing may not be very robust if the government steps out of the way. The DFA sought to respond to the financial crisis and fix perceived problems in the regulatory system. Its sweeping scope addressed nearly every corner of the financial industry, including mortgage finance (though, ironically without addressing Fannie Mae and Freddie Mac). One section of the DFA directs regulators to create a qualified mortgage (QM) definition that requires lenders to confirm a borrower's ability to pay a mortgage. The law says that if a borrower is later determined to have not been able to afford the mortgage, limitations will be placed on the lender's ability to foreclose. This creates significant risks for both mortgage investors and securitizers.

Another section of the DFA is known as the Volcker Rule. Lawmakers directed regulators to separate most investment activities from banking activities within financial institutions that conduct both investment banking and commercial banking. While regulators have not approved a final rule (one is expected in the spring of 2012), some fear that the final rule will not include a safe harbor provision for bank-affiliated securitizers to hedge against their transactions.

Finally, the DFA also directs regulators to define a very safe "qualified residential mortgage" (QRM) and then requires securtizers to retain 5 percent of the value of any securities they sell. The terms of the QRM are hotly debated, and the first proposed rule was widely criticized by nearly all sides as either too harsh (it requires 20 percent down payments among other things) or too favoring of the government (it exempts Fannie Mae, Freddie Mac and FHA from the retention requirement). If the final QRM definition does exempt federal agencies from the retention rules, many worry it will make securitizing mortgages to sell to the government a much more lucrative practice and could hurt the private sector's competitiveness. Others are also concerned that if the QRM definition is very strict, the 5 percent retention rule will be impossible for community banks to comply with because big balance sheets are likely to be required to securitize non-QRM mortgages.

Collectively, the QM, Volcker Rule and QRM provisions of Dodd-Frank create disincentives for private activity in the mortgage market, and could make the return of private capital very limited even if mortgage financing was fully privatized.

E. Desires for Funding Low-Income Family Mortgages

Fifth, particular interest groups want to help low-income families who have good credit, but are denied credit by housing financiers, have the ability to purchase a home and then pass that asset along to their children. These families may be denied credit because they do not fit traditional standards for what makes a good borrower, or they may live in markets that have not been penetrated or saturated by the banking community. In theory this requires government to provide incentives, funded by taxpayers, to financial institutions to provide mortgages to these kinds of families.

However, even if policymakers wanted to subsidize the cost of homeownership for a particular demographic in society, it would be much better to set up direct-to-the-borrower subsidy programs than to continue with the GSE model that largely subsidizes the risks of mortgage investors with taxpayer-funded guarantees. Such subsidies should be transparent, on budget and subject to appropriation, narrowly targeted so as not to compete with what services the private sector is offering, built on sustainable underwriting standards, and governed by responsible accounting standards. Technically speaking, if Congress were to redesign housing policy programs along these lines, there would be no need for Fannie Mae or Freddie Mac to accomplish the goals.

F. The Deep Pockets of the Housing Industry

Last, but by far not least, is the inescapable truth that a fully private housing finance system would cut off hundreds of millions in taxpayer subsidies to the housing industry. The Mortgage Bankers Association, National Association of Realtors and Homebuilders Association are leading opponents of privatization of housing finance for that very reason. The more capital in general flowing to the housing industry, the more the constituent groups of these organizations benefit. As a result, they have a very understandable, but not always transparent, interest in encouraging as much government support for their industry as possible.

The housing industry is well known in Washington, D.C. to be a powerful lobbying group. Its members typically focus on conveying a message that without government support for the housing industry, the capacity for households around the country to achieve the American Dream would be damaged. To the degree that there would probably be fewer homes built without the government guaranteeing mortgage investors, they are not wrong about the threat to some shrinkage in their industry.

Critics seek to clarify, though, that there is no objective measure for how big the housing industry should be. There would not be as many construction workers today as there would have been without the housing bubble, for instance. And there would not have been a housing bubble without all the capital that flowed into mortgage investment. Given that the housing bubble has now shrunk and there is less of a demand for mortgage investment, it is natural that the housing industry would shrink as well. And with a fully private housing finance system, there would be fewer government distortions driving capital toward mortgage investment.

All of this spells the need for fewer homebuilders than in 2005, lower priced homes for realtors to sell than in 2006, and less business for mortgage bankers than in 2007. As a result, the housing lobby in Washington, D.C. has fought with intensity every effort to move toward restricting the role of Fannie Mae and Freddie Mac, as well as limitations on FHA. At the Mortgage Bankers Association annual meeting last year, the organization chairman vowed to fight any future attempts on reducing the federally supported guarantee for mortgage investors. This will erect a significant barrier to the privatization of the housing finance system moving forward.

G. Conclusion

In summary, the road blocks in Washington, D.C. to privatization of the housing finance system are primarily fears about housing prices declining, an unwillingness to face the risks of the unknown and substantively make changes to the status quo, and disincentives created by the Dodd-Frank Act. These fears have split the Republican Party into several factions that cannot agree on how to move legislation. And they have frozen the White House in any action beyond marginal attempts to fix the housing market. A desire exists to preserve the 30-year fixed-rate mortgage and funding for low-income households, and this has inspired several proposed ideas for replacing Fannie Mae and Freddie Mac with some other form of government support for housing. But with the fear that private investors will not return to the housing market, the power of the housing lobby, and an unknown political landscape after the 2012 election, the movement toward a privatized housing finance system appears to face a very steep, uphill battle in the coming years.

Part 3

Federal Government Divesting Unneeded Property

The federal government is moving ahead with a plan to reduce its inventory of unneeded buildings and other real estate property. As the government has grown, so too has its real property inventory. Many buildings go unused or underutilized, however, and there has been a concerted effort to try to identify those properties that could be consolidated or sold off. A March 2011 *Government Executive* article describes the magnitude of the problem, noting that there are "14,000 vacant government buildings and 55,000 other facilities considered underutilized. The facilities are run by 24 agencies, costing a combined $1.8 billion to operate and maintain."[19]

On June 10, 2010, President Obama issued a presidential memorandum to the heads of executive departments and agencies directing them to divest unneeded properties and better manage energy usage and efficiency at remaining facilities. According to the memorandum,

> *For decades, the Federal Government, the largest property owner and energy user in the United States, has managed more real estate than necessary to effectively support its programs and missions. Both taxpayer dollars and energy resources are being wasted to maintain these excess assets. In addition, many of the properties necessary for the Government's work are not operated efficiently, resulting in wasted funds and excessive greenhouse gas pollution. For example, over the past decade, the private sector reduced its data center footprint by capitalizing on innovative technologies to increase efficiencies. However, during that same period, the Federal Government experienced a substantial increase in the number of data centers, leading to increased energy consumption, real property expenditures, and operations and maintenance costs. …*
>
> *To eliminate wasteful spending of taxpayer dollars, save energy and water, and further reduce greenhouse gas pollution, I hereby direct executive departments and agencies to accelerate efforts to identify and eliminate excess properties.*[20]

The memorandum directed agencies to generate at least $3 billion in cost savings from these efforts by the end of fiscal year 2012. This figure does not include an additional $9.8 billion in expected savings from the Department of Defense's Base Realignment and Closure (BRAC) efforts from FY 2010 to FY 2012, an estimated $5 billion of which is to be saved from reduced operating and maintenance costs due to property sales or consolidations.[21] President Obama reiterated his goal to eliminate excess federal government properties during his 2011 State of the Union Address, when he proclaimed, "We're selling acres of federal office space that hasn't been used in years, and we'll cut through red tape to get rid of more."[22]

Politicians have long spoken of the need to reduce government waste, including the federal government's real estate assets. Most of these efforts have been stymied by bureaucratic red tape or a lack of commitment, however. As the president's memorandum noted, "Past attempts at reducing the Federal Government's civilian real estate property assets produced small savings and had a minor impact on the condition and performance of mission-critical properties. These efforts were not sufficiently comprehensive in disposing of excess real estate and did not emphasize making more efficient use of existing assets."[23] According to Jeffrey Zients, chief performance officer and deputy director for management of the Office of Management and Budget (OMB), political and bureaucratic hurdles have "created a culture of inertia."[24] One example of this red tape is a 1988 law that requires federal agencies to consider converting unused properties to homeless shelters.[25]

This time around, both the Obama administration and members of Congress have expressed a serious commitment to reducing surplus federal properties. President Obama has offered a proposal modeled after BRAC that would allow agencies to retain up to 40 percent of the proceeds from disposed properties. "The same longstanding barriers to selling off unneeded property that give some parties cause for skepticism are precisely the barriers the president is committed to tearing down," said OMB spokesman Moira Mack. "We are already making strong progress. … If Congress passes the president's proposal to cut through the red tape and politics that have long delayed the sale of excess property, we are confident we can deliver even more savings for the American people."[26]

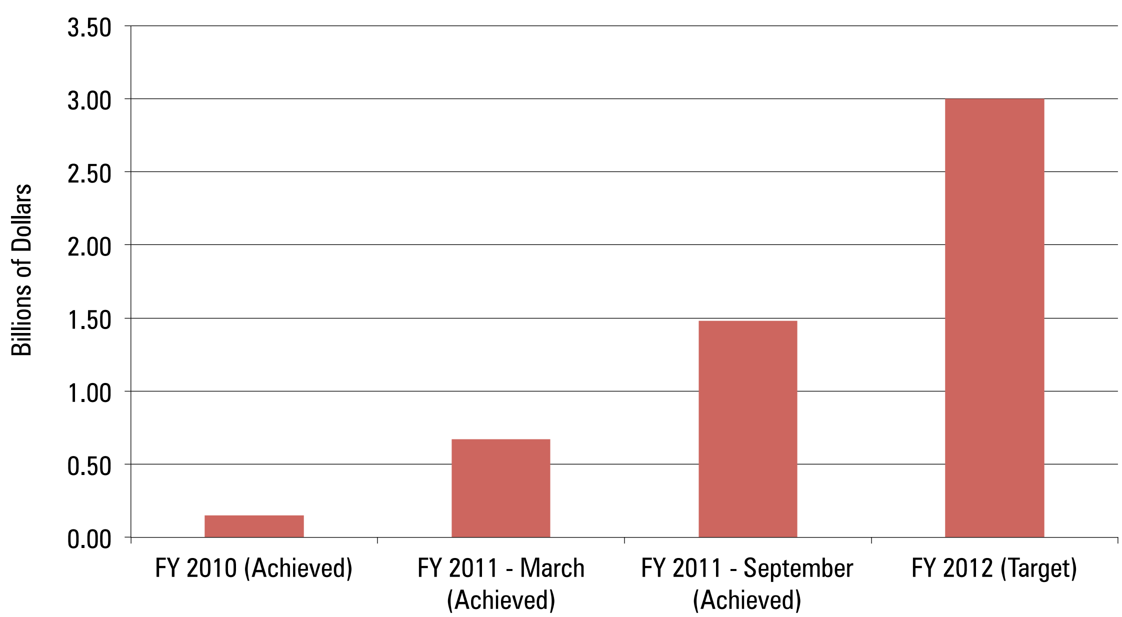
The proposal has been introduced in Congress in the form of the Civilian Property Realignment Act. Senator Scott Brown (R-MA) introduced the bill, S. 1503, in the Senate. Rep. Jeff Denham introduced his version, H.R. 1734, in the House of Representatives. The bill would establish a BRAC-like process for the civilian federal real property inventory by creating an independent civilian commission to make property recommendations to Congress that may only be voted on in their entirety (so there is no cherry picking of recommended properties). The OMB estimates that the measure would save $15 billion in the long run. "I believe the potential to save billions of dollars is real, and H.R. 1734 creates a process that can help us realize those savings," said Denham in a statement. "There are vacant or underused buildings across the country that will result in taxpayer savings and efficiencies immediately." Added Denham, "There has been inaction for too long—my bill will increase transparency and cut through the bureaucratic red tape to literally shrink the size of government and maximize utilization rates."[27]

There are several other proposals circulating in Congress to address the issue as well. Rep. Mike Quigley (D-IL) and Sen. Mark Pryor (D-AR) introduced the Federal Real Property Disposal Enhancement Act of 2011, H.R. 1205/S. 479, to introduce a new process for identifying, evaluating and disposing of federal real property, and to require the head of the General Services

Administration to "establish and maintain a single, comprehensive, and descriptive database of all Federal real property." Rep. Jason Chaffetz introduced two bills to address excess federal real property. The Excess Federal Building and Property Disposal Act of 2011, H.R. 665, directs the head of the Office of Management and Budget to dispose of at least $19 billion worth of excess property over the next 10 years, with 80 percent of the proceeds going to the Treasury and the remaining 20 percent going to the agency responsible for the property sold. Chaffetz's Disposal of Excess Federal Lands Act of 2011, H.R. 1126, would direct the Secretary of the Interior to sell certain federal lands in Arizona, Colorado, Idaho, Montana, Nebraska, Nevada, New Mexico, Oregon, Utah and Wyoming.

Progress on the current property disposal initiative has been mixed. According to the government's Performance.gov website, agencies have identified unneeded buildings that they value at $3.366 billion, which would exceed the president's $3 billion savings goal by the end of FY 2012, but so far the actual execution has been lagging, with only about $1.5 billion in proceeds realized over the past three years (see Figure 5).[28] To date, the greatest savings realized have come from the Department of Agriculture ($279 million), Department of Defense ($260 million), and Department of State ($153 million).[29] With 1.2 million properties that cost $20 billion a year to maintain,[30] the federal government has plenty of opportunities for savings.

Figure 5: Cumulative Federal Real Property Savings, FY 2010–FY 2012 (projected)



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17 The correlation coefficient between the two data sets is -0.547, which is a moderately negative correlation from 1971 to 2010. However, the correlation effects are inconsistent from decade to decade: 1971 to 1980 and 1981 to 1990 were strongly positively correlated at 0.896 and 0.889, but 1991 to 2000 was moderately negatively correlated at -0.447 and 2001 to 2010 was weakly positively correlated at 0.399.

18 For example, if an investor who owns a junior tranche of a security (meaning he takes losses earlier than senior levels of a security, but in exchange gets a higher yield on the investment) is affiliated with the company that services the underlying mortgages, the portfolio may be managed in a way that harms senior investors. Specifically, a servicer/subordinate bondholder could manipulate the outcomes of certain collateral tests, which, when triggered, force an accelerated payout to senior investors. While these tests are designed to protect senior investors from deterioration in the quality of the mortgage collateral, a servicer can manage the results of these tests, preventing them from triggering.

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