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Fannie Mae and Freddie Mac Still Endanger U.S. Economy

How the Government-Sponsored Enterprises Got Us Here and What We Can Do about It

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Nearly a decade since the housing bust of 2008 sent the U.S. economy into a tailspin, much legislation has been enacted and regulation promulgated in the name of "financial reform"—to little effect. Many of the problems that precipitated the financial crisis continue to threaten the American financial system.

Chief among these is the continued—and increased—dominance of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac over the nation's residential mortgage market. The implosion of Fannie and Freddie, which resulted in a direct government takeover, was the first of several cascading events in September 2008 that transformed the mortgage bust into a full-blown financial crisis. The twin collapse of Lehman Brothers and American International Group would follow days later. By the end of the month, Congress had created the Troubled Asset Relief Program (TARP) to provide $700 billion in bailouts to U.S. financial institutions.

When other financial institutions that received TARP funds paid back what they owed to the U.S. Treasury in full, the government relinquished its ownership stake in these firms.[1] However, Fannie and Freddie have paid back to the government about 50 percent more than the government lent them—a $270 billion payment for a $187.5 billion cash infusion—with no end to government ownership in sight.[2] And there will be no end in sight, as long as Fannie and Freddie continue to operate as they do. In an era when politicians from all sides say they want to reform financial institutions that are too big to fail, Fannie and Freddie's footprint in the housing market must be sharply reduced.

On September 6, 2008, James Lockhart, then-director of the Federal Housing Finance Agency (FHFA), the GSEs' regulator, announced that Fannie and Freddie were severely undercapitalized and he was putting them under conservatorship. Under federal law, the FHFA has the option to put the GSEs into receivership, where they would be dissolved in a process similar to bankruptcy, or conservatorship, under which the GSEs would ultimately be returned to the private sector after their capital holdings were strengthened. The government chose the latter option, which gave the GSEs' shareholders the reasonable expectation that their ownership would continue, at least until Congress acted to restructure the agency.

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The "Third Amendment," a provision which the Obama administration quietly pushed onto the terms of the GSE bailout and takeover, requires the GSEs to remit profits to the government in perpetuity.[3] "Amendment" refers to changes in the agreement between GSE shareholders and the U.S. government that commenced upon the takeover. The First and Second Amendments were largely technical.

Today, the GSEs' role in the housing market is greater than ever, with Fannie and Freddie and other government backing nearly 90 percent of U.S. mortgages, compared to just under 50 percent in the years before the crisis.[4] Measured as private companies, Fannie and Freddie's combined size far exceeds that of any other private financial institution in the United States. With more than $3 billion in assets, Fannie ranks 20th on the Fortune 500 list of largest U.S. companies, higher than any other U.S. financial institution. With more than $2 billion in assets, Freddie ranks 39th.[5]

How We Got Here. Very few people can remember a time when the government was not heavily involved in housing. Yet such a time did exist, before the first government-sponsored housing enterprise was created 80 years ago. Nonsubsidized private lenders financed the majority of both urban and rural home purchases in the late 19th and early 20th centuries.

National and many state-chartered banks were forbidden by their regulators to make mortgages until 1916, so it fell to life insurance companies, startup banks in Western territories, and individual entrepreneurs to develop the mortgage market. Often these mortgages were for a duration of about five years at a given interest rate, but they were frequently renewed.[6] As Kenneth Snowden, professor of economics at University of North Carolina-Greensboro, has written:

> From 1870 to 1940, the mortgage banking industry in the United States was a dynamic and entrepreneurial sector that took on different shapes and developed a variety of different mechanisms to originate, service and fund mortgage loans.[7]

When the Great Depression hit in the 1930s, private mortgages failed, as did many private loans. But politicians then, as now, treated homeownership as special and deserving of government support. In 1938, the Roosevelt administration created the Federal National Mortgage Agency to provide liquidity for housing by buying mortgages from banks.[8] The agency soon became known colloquially as Fannie Mae, which would later become its official name. Banks quickly took advantage of this indirect subsidy from the federal government. Many banks explicitly tailored their mortgages to Fannie's specifications, a practice that continues to this day, giving the GSEs much power over the design of the mortgage market.

Some 30 years later, in an effort to get the expense of Fannie off the official government books, Fannie was made quasi-private, with mostly implicit government support. In 1968, Congress gave Fannie a special federal charter and allowed it to sell shares to the public. Congress also furnished Fannie a line of credit for $2 billion from the Treasury Department.[9] In 1970, Congress created another GSE, a "little brother" to compete with

Fannie called Freddie Mac. Freddie also had a $2 billion line of credit with the Treasury Department.[10]

Privatized Profits, Socialized Losses. In many ways, this quasi-private, quasi-government structure for Fannie and Freddie was the worst of all possible worlds. It "privatized" the profits to shareholders and "socialized" losses to taxpayers.[11] The federal Treasury's line of credit was interpreted by many investors to be an explicit government guarantee for all of the GSEs' operations. In effect, it sent out the signal that if the companies fell upon hard times, taxpayers would be on the hook for investors' losses. Testifying before the House Financial Services Committee in 2000, Competitive Enterprise Institute Founder Fred L. Smith, Jr. warned that though the line of credit with the Treasury Department "is only $2 billion today. It could be $200 billion tomorrow" if the GSEs were to implode.[12]

As a result of pressure from politicians and the desire for profits (with the assumption that taxpayers would likely absorb any big losses), the GSEs began to loosen their lending standards in the mid-1990s. In effect, the GSEs were pressured to "roll the dice," in the words of Rep. Barney Frank (D-Mass.), with "affordable housing" goals and looser standards for mortgages. Frank pushed this agenda during his time as ranking minority member, and later chairman, of the House Financial Services Committee.

As American Enterprise Institute scholars Peter Wallison and Edward Pinto have documented, Fannie and Freddie began classifying as "prime" many loans earlier classified as "subprime," because the borrowers had FICO credit scores of less than 660. They contend that these looser standards spread across the mortgage market, leading private banks to make loans of even lower quality, paving the way for the financial crisis.[13]

Then in September 2008—70 years after Fannie was created and 40 years after it was made quasi-private—the government took over Fannie and Freddie to prevent their insolvency in the wake of the financial crisis.[14] Though he was accused of wildly exaggerating the GSEs' future price tag to taxpayers at the time, it turned out Smith had estimated their liability to taxpayers about right, as the federal government spent nearly $200 billion of taxpayer funds to prop them up.[15]

By 2012, Fannie and Freddie had begun to turn a profit and would pay the government back.[16] But in a cruel irony, the GSE shareholders who thought they were making an ultra-safe investment—backed by the full faith and credit of the U.S. government—saw none of the new profits even after the government was paid back. In 2012, the Obama administration promulgated the Third Amendment, which gave the Treasury Department the right to siphon off 100 percent of the GSEs' profits in perpetuity. The only explanation given was that it would make for a more efficient method of collecting the money owed to the Treasury.[17]

GSEs More Dangerous than Ever. Nine years later, the GSEs are still government-owned and pose a liability to taxpayers should anything go wrong. Not only did the government rip off GSE shareholders via the Third Amendment, it also picked taxpayers' pockets, as none of the profits are even going to the GSEs to maintain capital reserves. Instead, they are remitted directly to the Treasury, added to the pool of funds from appropriations, and

immediately spent on government operations. Already, stress tests conducted by the Federal Housing Finance Agency show that Fannie and Freddie may need up to $100 billion in new bailout money if there are changes in interest rates or economic volatility.[18]

GSE shareholders have launched several lawsuits to repeal the Third Amendment. In July 2013, the hedge fund Perry Capital filed a lawsuit against the U.S. Treasury Department on the grounds that the Third Amendment exceeds the Housing and Economic Recovery statute that governs GSE conservatorship and is "arbitrary and capricious" under the Administrative Procedures Act.[19] The Fairholme group of mutual funds is suing the U.S. government for breach of the Takings Clause of the U.S. Constitution, which states that "private property" shall not be taken for "public use" without "just compensation."[20]

Conclusion. Fannie Mae and Freddie Mac should be wound down, and should not be replaced. The housing market once functioned well without them, and can do so again. A free market, where lenders have to compete for individuals' business, made housing affordable to millions of Americans in the 50 years before Fannie's creation, just as it has done for other big ticket items, like cars and computers. (When Freddie was created in 1970, the very idea of a computer in the home seemed incredible.)

Congress and the Trump administration need to take two other steps for a fully private mortgage market to function. First, the government should respect the property rights of GSE shareholders and offer them some form of compensation. There are moral and practical reasons for compensating GSE shareholders. If government abrogates contracts in this case, why would investors make substantial investments in mortgage securities in the future? If investors see any market as prone to arbitrary government takeovers, they will be very reluctant to invest in this sector. Investors will not buy into a transitional privatization scheme, if they think the government can abrogate their property rights at the first sign of things going south. In its GSE phase-out legislation, Congress should set up a commission to determine the value of GSE shares, and once the commission makes its determination, the government should compensate GSE shareholders accordingly.

Regulations encumbering the mortgage market that have little to do with safety and soundness—and in fact may hinder safety and soundness as well as efficiency—must go. These include the Dodd-Frank financial law's "qualified mortgage" and "qualified residential mortgage" provisions, which make it more difficult for smaller banks to keep a mortgage on its books. Because one of the major factors in the crisis, coupled with unwise government policies, was banks selling mortgages into securities, public policy should encourage banks to hold on to the loans they make. Instead, the rules are prodding banks to sell off their mortgages or even exit the mortgage business altogether.[21]

A consumer-driven marketplace where mortgages are neither subsidized nor heavily regulated is the only option for a vibrant and stable housing market that makes housing widespread and affordable.

Notes

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