

**SUPPLEMENTAL REMARKS TO THE HOUSE BANKING
COMMITTEE ON THE FUTURE OF FANNIE MAE AND
FREDDIE MAC, JUNE 21, 2000**

I head the Competitive Enterprise Institute, a pro-market public interest group that has long been active in financial regulatory issues. I'm pleased to be invited to testify today on the "moral hazard" problems created by Freddie Mac and Fannie Mae. While these firms might once have merited some special assistance as "infant industries," they have now clearly matured. The continuance of special privileges creates a serious hazard to the market, to taxpayers, to the economy, and, perhaps most of all, to the poor, whose real need—economic opportunity—is given lower priority by pushing middle- and upper- class housing mortgages to the front of the capital queue.

A monograph by Peter Wallison and Bert Ely documenting the risk posed by the projected rapid growth of Fannie and Freddie was recently published by the American Enterprise Institute. I have requested copies of this monograph and would ask that these be made available to the Committee. For balance, I've also appended to my remarks a recent paper by the Senior Economist of Freddie Mac, Robert Van Order, just published in the Cato Institute's *Regulation* magazine. "A Microeconomic Analysis of Fannie Mae and Freddie Mac" presents a lukewarm case for these entities. Finally, I add the delightful "Dear Abby" editorial that appeared earlier this week in *The Wall Street Journal*. That editorial illustrates well that, although there are complexities in this issue, the core issues can be readily communicated to the American public.

Let me now summarize my testimony. First, let me note that Fannie and Freddie are strange organizations, neither private-sector fish nor

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political-sector fowl. As a result, no one is quite clear how these entities should be evaluated or how they might be held accountable. They are largely immune to competitive market regulation—their access to low-cost money makes it impossible for truly private firms to compete. Yet, their charter grants them special subsidies and permits them to expose the taxpayer to unlimited risk without effective political scrutiny. As Mr. Nader noted last week, these GSEs [government-sponsored enterprises] operate under special rules: The management and shareholders keep any profits, but the taxpayer will bear the bailout burden if their policies go sour. This asymmetry is dangerous and evades the whole system of checks and balances that is the basis of the American political system.

Fannie and Freddie get subsidies, but no one ever votes for them. This is wrong. America fought a war to oppose “taxation without representation.” Yet, today, in this situation we have seemingly endorsed “subsidization without representation.” Did we really mean to define GSEs as government-subsidized enterprises?

The roots of this problem, as you’ve heard time and time again in these hearings, stem from Fannie’s and Freddie’s ability to obtain funds at a rate far lower than any private firm. Cheap money guarantees them high profits. Now, making a profit is normally a tough game, but when you’re allowed to play with Monopoly money and everyone else has to use the real thing, you can buy up all the houses and hotels (or, at least, their mortgages) from Baltic Avenue to Park Place without passing Go (and, of course, without running the risk of going to jail). Monopoly money makes it easy to become a monopolist. And, as these hearings

have indicated, Fannie and Freddie are well on their way to becoming the largest monopolists in history.

Fannie and Freddie, of course, argue that all this misses the point. As their ads have been telling us repeatedly for the last month or so, they simply want to help everyone realize the American Dream. Good rhetoric; not so good policy. First, note that some of the so-called housing subsidy is dissipated in higher housing costs. Just as subsidized student loans contributed to the rapid increase in college tuition costs, so also have the Fannie/Freddie subsidies made housing less affordable. I hope you will seek an estimate of the extent to which the problem of affordable housing may have been exacerbated by Fannie and Freddie. It would be especially important to examine this question for those lower-income groups not served by Fannie and Freddie.

Still, as their ads do point out, the interest rate, if not the cost of housing, is lower because of their involvement. Doesn't this make the American Dream more affordable—at least for those not priced out of the housing market? Perhaps, but there are many other American Dreams: getting a job, starting your own business, having a better school for your kids. And these dreams also require capital. Fannie and Freddie create no new capital—they simply move it around. For those pursuing other dreams, Fannie and Freddie may be more of a nightmare!

Some people—many of whom already share in the American Dream—gain a mortgage at somewhat lower rates. Others find themselves priced out of the housing market or, more frequently, find themselves unable to gain the funds needed to launch or expand their business or to expand their employment. Moreover, at least one-third of this taxpayer

subsidy goes to management and shareholders—people who have already achieved the American Dream.

At least in the game of Monopoly people can buy something besides real estate.

Fannie and Freddie claim their success reflects skill. Perhaps. Certainly, there are some smart people at these agencies—at the salaries they offer, there certainly should be—but the success of Fannie/Freddie has less to do with their smarts than their subsidies. Had they purchased livestock, race tracks, movie theaters, car dealerships, railroads, or even aluminum siding, they still would have made money.

If you can buy low and sell high by using low-cost taxpayer-backed money, you do well. Indeed, give anyone in this room the right to issue their very own personalized Treasury bills, and I predict that they, too, will become very rich in very short order.

But all this weakens the stability of the American financial system. That's what "moral hazard" is all about. And it is those unintended consequences of helping one American Dream at the expense of all the other American Dreams. Those consequences should concern this Committee and this Congress.

And these risks threaten to get worse. The hearing last week illustrated that threat very well. Groups seeking more funds for lower-income housing were critical of Fannie and Freddie. However, they sought not the reform of these agencies, but more resources for lower-income housing. Such moves would do little to help the poor (luring families into debt does them no favor—as witnessed by concerns over "predatory

lending”) nor would it do much to address the affordable housing issue (a problem linked to anti-growth initiatives and other government regulations). Yet, it might well increase the likelihood of a Fannie/Freddie default and, thus, a taxpayer bailout.

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In effect, Fannie and Freddie are being urged to increase their riskier lending without incurring any additional risk! Not much chance of that happening in the real world but, as long as the taxpayer is forced to cover that additional risk, I suspect that Fannie/Freddie will soon move to do exactly that.

What can be done about this? Not much if we’re not willing to rein them in. Political regulation has a very poor track record. Market discipline is far better at ensuring rational lending policies. If Fannie and Freddie are as necessary and as well-managed as they claim, then let them meet a market test rather than spend fortunes on newspaper advertisements.

The problem remains that in any real political calculus, Fannie and Freddie are already Too Big to Fail. Their stock is held in too-large blocks by too many important groups. Today, if a crisis were to occur, it is highly unlikely that anyone responsible would actually get a “haircut.” The sad reality is that (when the smoke clears) we’d be more likely find that Freddie and Fannie had been given a perm.

Tinkering at the edges isn’t likely to resolve the Fannie/Freddie instability. Rather, we should take advantage of the current good times to defuse this time bomb while we can. I recommend that this process begin by enacting the provisions of your bill. Specifically:

- Phase out the ability of regulated financial institutions to hold Fannie/Freddie stock as “Treasury Bill” equivalents;
- End the visible line-of-credit subsidy;
- End their exemption from state and local taxes (as a citizen of the District of Columbia, I was surprised that former D.C. Representative Walter Fauntroy neglected to recommend that reform last week);
- Eliminate their ability to use taxpayer-backed money to enter other sectors of the credit economy;
- Require increased capital reserves; and
- Create a liquidation plan that would plausibly avoid a bailout if and when the next economic crisis occurs.

Some have suggested we proceed carefully and I fully agree, but that does not mean delaying further action. The unintended consequences of past inaction are already very serious and the growth projections of Fannie and Freddie suggest that there is much worse in store. Delay is always the easiest course in the short term. Recall the prayer of the youthful Saint Augustine: “Oh God, make me chaste—but not yet!”

Still, even if you move expeditiously, I suspect it will not be enough. Fannie and Freddie have no real-world existence. They exist as artifacts of the special privileges they possess. Masquerading as market entities, they are better viewed as a costly and complex way of transferring capital from small businesses, consumer credit, high-tech startups, state and local governments, and schools to middle- and upper-income home purchasers. This is not wise. If America wants to nationalize its credit sector, wouldn’t it be better to do it directly, rather than by using the ruse of GSEs?

Thus, as noted in my written testimony, I suggest that the Department of Justice be urged to develop a divestiture/breakup plan for Fannie/Freddie. They should be converted from Too Big to Fail institutions into normal market firms. I've noted that Fannie Mae's Ms. Gorelick comes from Justice and might well assist in the breakup. If government is willing to shatter a well-run truly private firm because it wasn't willing to bend a knee to Joel Klein and Judge Penfield Jackson, then it should certainly be willing to disassemble the artificial creations of Fannie and Freddie. Were these entities broken into four or so national firms, each assigned a diversified share of the holdings of the current monopolies, the privatization effort would be much less traumatic and far less risky politically.

Chairman, members of this Committee, these hearings cannot be very pleasant for you. You are finding that Fannie and Freddie have outlived their usefulness, have engaged in mission creep to a level never seen by any agency in history, have weakened the private housing finance markets, and now reject reform. Unfortunately, Freddie and Fannie are no paper tigers. They have massive resources and seem willing to use them without limit for lobbying, propaganda, political contributions, and attacking any opponents (including yourselves). Moreover, most people will see only the ads claiming disaster if Fannie and Freddie are ever reformed.

Yet, America has survived to date because we are a representative government; you were elected to represent the good of the American people, not the privileges of the powerful. Moreover, you have a bully pulpit to educate the American people on this issue. And it's not really very hard, as *The Wall Street Journal* editorial makes clear. Indeed, the

Labor of Love: A Fred Smith Story

Freddie and Fannie get-rich-quick scheme would be laughed off the stage of any high school civics class in America. These hearings begin the educational process necessary for reform and I would like to commend you, Chairman Baker, and all those on this Committee for your willingness to explore how best to defuse this time bomb. I look forward to working with you toward advancing this most important work.