Freddie, Fannie May Be Finished, But What Comes Next?

By DAVID HOGBERG, INVESTOR'S BUSINESS DAILY Posted 02/09/2011 07:36 PM ET

A message adorns the front door of a foreclosed home in Salt Lake City on Sept. 8, 2008. The Obama administration is expected to announce its... View Enlarged Image

Fannie Mae and Freddie Mac's days are numbered, if reports about the Obama administration's plans for the money-losing mortgage finance giants are any indication. Republicans agree on that point. But what, if anything, might replace them will surely be a major controversy.

The administration is expected to announce its intention to phase out the government-sponsored enterprises. But it is leaving the door open for a federal role. It will reportedly give Congress three options: Get the government entirely out of guaranteeing loans, offer a limited guarantee, or offer a full guarantee.

Even some on the political left are leaning toward a much smaller role for the GSEs.

"Everyone across the ideological spectrum, all experts, agree that we need to reduce the current levels of 90% or so of govern ment-backed mortgage finance," said David Min, associate director for financial markets policy at the liberal Center for American Progress. "That needs to come down to historical levels if not lower."

However, there's a "but."

"But in the midst of a fragile economy we don't want to step it down too quickly," Min added.

How 'Confined'?

The American Bankers Association on Wednesday sent a letter to the administration stating "the role of the government in housing finance should be dramatically reduced from its current level."

The ABA is saying Fannie and Freddie should be: "strictly confined to a well-defined and regulated secondary market role and should not be allowed to compete with the private, primary market."

It's unclear what ABA would view as "strictly confined."

Prior to 2008, Freddie and Fannie securitized and guaranteed massive amounts of risky mortgages, helping to finance the housing bubble. They swelled in size and leveraged heavily, borrowing cheaply because of the implicit guarantee that the government would bail them out.

When homebuyers began defaulting en masse, investors were left holding toxic assets. With the GSEs hemorrhaging losses, the federal government took them into conservatorship in 2008.

It is estimated that taxpayers are currently on the hook for $142 billion to $259 billion in bad GSE loans.

But the still-sickly housing market is more reliant on Fannie and Freddie than ever. They back or own 95% of new home loans as private firms have fled.

John Berlau, director of the Center for Investors and Entrepreneurs at the free-market Competitive Enterprise Institute, sees no middle road for government.

"Unless there is a phase out plan, Fannie and Freddie will always find an excuse to get bigger and block private sector innovation," he said.

The government's future mortgage role was a major topic at a House Financial Services Committee subpanel hearing on Wednesday.

Chairman Scott Garrett, R-N.J., argued the focus needs to be on how "to protect the taxpayers, end the bailout, get private capital off the sidelines, and reduce the government's exposure to the housing market."

But Rep. Maxine Waters, D-Calif., urged that any plan ensure "access to sustainable homeownership, at affordable rates, for the American middle class."

In what is likely to become a talking point for those interested in maintaining the GSEs, she suggested that such a plan "preserve the 30-year, fixed-rate mortgage."

Several witnesses suggested immediate steps Congress could take toward a complete wind-down of the GSEs. Alex Pollock, resident fellow at the conservative American Enterprise Institute, called for ending the GSEs' charters in five years and bringing their capital and leverage requirements up to the same level as national banks.

Anthony Randazzo of the Reason Foundation and Mark Calabria of the Cato Institute — both libertarian think tanks — called for reducing the GSEs' loan limit, so private capital would begin moving back into the market.

Today Fannie and Freddie can back a mortgage up to $729,750; that will come down to $625,500 this September. Randazzo called for lowering it to $583,000. Calabria went further, calling for a limit of $500,000 that would be reduced $50,000 annually as Fannie and Freddie are phased out.

Calabria also suggested moving Fannie and Freddie from conservatorship to receivership, shifting losses from taxpayers to the GSEs' creditors.

But Sarah Wartell, executive vice president of the liberal Center for American Progress Action Fund, warned against "radical privatization." She claimed that without a government role, "mortgage finance would be sharply reduced, with many more middle-income households shut out of homeownership."

If Congress and the White House fail to agree on reform, the status quo, which nearly everyone says can't go on, could well continue.