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Weekly Standard: Breaking Up With Fannie Mae

by ARNOLD KLING

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Obama's 2012 budget proposal included a plan to phase out Fannie Mae and Freddie Mac, tw o giant housing agencies.

February 25, 2011 text size A A A

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On Feb. 11, the day that Hosni Mubarak resigned as president of Egypt, the Obama administration released its report to Congress on reforming America's housing finance market. The report most notably proposes phasing out Fannie Mae and Freddie Mac, the two large government-sponsored enterprises (GSEs). Like Mubarak, the GSEs have seen their once formidable political position reduced to one of helpless isolation, abandoned by all former supporters. However, as in Egypt, deposing former leaders does not by itself ensure a happy outcome. American housing policy is afflicted with deep political pathologies, and unless these can be confronted and overcome, a future without Fannie and Freddie could turn out to be worse than the status quo.

Over the past several decades, a diverse coalition of special interests has used "affordable housing" as a rallying cry to lobby for government support of mortgage lending on lenient, generous terms. As is well described by Bethany McLean and Joe Nocera in their book *All the Devils Are Here*, the participants in this favor-seeking effort have run the gamut from self-styled "community groups" all the way up to top-tier Wall Street firms.

As the "affordable housing" juggernaut gathered momentum, the mortgage market became laced with the booze of dubious lending practices. Loans to nonowner-occupied borrowers increased from less than 5 percent of the mortgage market to more than 15 percent. Down payments of less than 10 percent became the norm rather than the exception. Where home ownership used to promote thrift as households paid down mortgage principal and banked the increase in the value of their homes, some of the newer mortgages had "negative amortization," and equity was dissipated with second mortgages and cash-out refinancing.

As they loaded up on this booze, mortgage market participants reveled in privatized gains and socialized risks. The GSEs epitomized this, of course, but everyone from overly aggressive home buyers to Wall Street investment banks took advantage of the good times while they lasted. The emergency government handouts afterward meant that all taxpayers got stuck with the hangover.

The big question going forward is whether Washington will be able to get off the sauce and stay off. If so, then any housing finance reform is very likely to succeed. If not, then failure is inevitable.

Currently, something like 90 percent of all new mortgages in this country are funded by the Federal Housing Administration (FHA) or by the GSEs. The administration's report advocates a gradual reduction in the presence of government in the mortgage market, leaving room for the private sector to step in. This is an objective that should be welcome across the political spectrum. Surely even progressives must doubt the wisdom of government subsidies that accrue primarily to the upper half of the income distribution.

To achieve this gradual phaseout, the provision of government mortgage support will need to be rationed in some way. It can be rationed by price, with the agencies raising their fees until private firms are able to compete. It can be rationed by quantity, with limits imposed on the market share of the agencies. And it can be rationed by market segment, with the agencies prevented from purchasing certain types of mortgages.

The administration report includes suggestions for all three types of rationing. It recommends increasing the fees charged by the GSEs and the FHA. It suggests a goal of reducing the FHA's market share from the 30 percent it has reached in recent months to 10-15 percent going forward. It suggests taking the GSEs and FHA out of the high end of the housing market by reducing the size of the loans that they can purchase. And it suggests getting the government out of the extremely risky segments of the subprime and low-down-payment mortgage market, by tightening underwriting standards.

I wish that the report's recommendations for rationing by market segment had been stronger. It would be best to have the GSEs go off the booze right away. By that I mean immediately prohibiting them from guaranteeing second mortgages, cash-out refinances, loans for nonowner-occupied homes, and loans with down payments of less than 10 percent. Furthermore, private mortgage insurance should be required on loans with down payments of less than 20 percent. Certainly the government should not provide backing for loans with negative amortization, and in fact I would go even further and limit guarantees to 15-year and 30-year fixed-rate loans. Adjustable-rate loans should by no means be banned from the market, but there is no reason for government to provide backing for them.

One of the recommendations of the report — to prevent Freddie Mac and Fannie Mae from holding mortgage securities in portfolio — has nothing to do with scaling back their role in mortgage lending. Instead, it bears the signature of lobbying by Wall Street, which wants to keep the lucrative business of mortgage securities trading all to itself. Say what you will about Freddie and Fannie, Wall Street's designs on the mortgage market are even more rapacious, and its influence on policy potentially even more pernicious — especially if, as the report proposes, there is to be any sort of government "backstop" for the mortgage market.

This proposed backstop would simply be a new way of socializing risk, a Freddie Mac or Fannie Mae under a different name. The description of this backstop in the report is shockingly brief and sketchy. It appears, however, to be based on a paper entitled "The Economics of Housing Finance Reform: Privatizing, Regulating and Backstopping Mortgage Markets," by David Scharfstein and Adi Sunderam, a professor and graduate student, respectively, at Harvard's business school and economics department.

Even as described more fully in their paper, the backstop mechanism is not well thought through. The authors suggest setting up a nonprofit institution backed by the government that would operate in the mortgage insurance business.

The advantage of the nonprofit structure is that it presumably would not be motivated to expand. There is no guarantee, however, that what starts out as a nonprofit enterprise will always remain so. Freddie Mac was formed in 1970 as a government agency, but when the opportunity presented itself in the late 1980s, Freddie became a shareholder-owned corporation. Its executives were hardly passive bystanders in the transition process.

Scharfstein and Sunderam envision this backstop agency expanding during a crisis. However, the same goal could be achieved by injecting capital into mortgage insurance companies in such an event. Meanwhile, an inexperienced entrant into the mortgage insurance industry would expose taxpayers to significant losses from mistakes or misjudgment.

In addition to these proposals, the administration's report contains a number of laudable features. For instance, it raises the issue of reining in the Federal Home Loan Banks, often-forgotten enterprises that pose significant risks to taxpayers. Like your appendix or your tonsils, the FHLBs are not needed in the body politic, but they could potentially cause considerable pain and discomfort if they are not removed in timely fashion.

Like the revolution in Egypt, the administration's report begins a new era of promise and peril. Congress should set about to achieve the promise and avoid the peril.

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