Published on *San Francisco Examiner* (http://www.sfexaminer.com)

By *Anonymous*
Created *Feb 22 2011 - 11:20pm*

Fannie, Freddie lose relevance

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. 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 non-owner-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 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 phase-out, 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.

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.

Arnold Kling is an adjunct scholar at the Cato Institute and a member of the Mercatus Center at George Mason University. This article was adapted from The Weekly Standard.

Op Eds Opinion Fannie Mae and Freddie Mac housing finance market

Source URL: http://www.sfexaminer.com/opinion/op-eds/2011/02/fannie-freddie-lose-relevance