FEE FOUNDATION *for* ECONOMIC EDUCATION

We Don't Need Fannie and Freddie; We Need Freedom

Daniel J. Mitchell

December 20, 2016

Remember the financial crisis and market meltdown from late last decade? That wasn't a fun time, and we're still dealing with some of the fallout.

Let's specifically look at Fannie Mae and Freddie Mac, the two privately owned but government-created housing finance institutions (also known as government-sponsored enterprises, or GSEs). Fannie and Freddie received giant bailouts during the crisis, but they weren't shut down. Instead, they have continued to operate, continued to benefit from implicit government subsidies, and continued to dominate housing finance because of their government-protected status.

Under the conditions of the bailouts, however, the excess cash generated by this government-subsidized duopoly have gone to the Treasury rather than to shareholders (incidentally, I wrote "excess cash" rather than "profit" because I think of the latter as money that isfairly earned in a competitive marketplace, whereas the earnings of the GSE's are the result of an artificial, subsidized, and protected system).

In any event, the bailout will have been repaid at some point in the near future, so the government has to decide the next step. Should Fannie and Freddie be allowed to simply go back to their old model?

As you might expect, Cato's expert on the issue, Mark Calabria, has a lot to say about the issue. In a column co-authored with Alex Pollock of the American Enterprise Institute, he proposes a set of reforms.

> Nobody wants the old Fannie and Freddie back; nobody wants them to stay on indefinitely in conservatorship. What is required are practical steps forward.

Mark and Alex identify specific requirements that should be met before allowing Fannie and Freddie off the leash, starting with basic capital requirements and other reforms so the GSEs are less likely to create instability and excessive risk.

> Take away Fannie and Freddie's capital arbitrage and set their equity capital requirements in line with other financial institutions of similar size. Equity of at least 5 percent of total assets should be their required leverage capital ratio. …Given their undiversified business, something more might be prudent. In any case, the hyper-leverage which allowed Fannie and Freddie to put the whole financial system at risk needs to be permanently ended. …Designate them as the

> Systemically Important Financial Institutions (SIFIs) they indubitably are. Fannie and Freddie…have conclusively demonstrated their ability to generate huge systemic risk.

They also say Fannie and Freddie should no longer have special privileges. If these GSEs want to act like private companies, the should be subjected to all the laws and rules that apply to private companies.

> End all their securities law exemptions. …End all their preferences in banking law and regulation. …End their exemption from state and local income taxes. …End all their exemptions from consumer protection rules. …Open up their charters to competition just like banking charters.

In a column for the *Wall Street Journal*, the former heads of the FDIC and Wells Fargo, William Isaac and Richard Kovacevich, point out that President-Elect Trump wants to do the right thing and shrink the risky role of government.

> …the president-elect want[s] to privatize the home-mortgage market and "will get it done reasonably fast." That's good news for American homeowners, the economy and taxpayers who were forced to foot the bill after the 2008 subprime mortgage meltdown. …this is not a radical proposal. The private sector provides mortgages in most major countries, and there is little difference in the share of homeownership between the U.S. and other developed countries. No other country has the equivalent of the private-public model of Fannie Mae and Freddie Mac—crony capitalism at its best.

Isaac and Kovacevich explain why the old approach is unacceptable.

> …many politicians and industry participants believe that housing cannot prosper without government support. We disagree. The U.S. cannot afford to go through another financial crisis, which started with subprime mortgages and would never have been so large if the residential mortgage industry had been market-based. Subprime mortgages have existed for decades. But they were a small percentage of the mortgage market until Fannie and Freddie reduced credit standards to increase their market share and meet low-income homeownership targets mandated by Congress. By 2007 nearly 50% of mortgages originated in the U.S. were subprime and "alt-A" types with government agencies guaranteeing about 70% of those… Without these government guarantees, the subprime bubble and financial crisis would have never happened. Bank regulators and industry experts warned Congress for decades about Fannie and Freddie and their increasingly large and risky portfolios, but Congress failed to act.

They then point out how we can move to a system based instead on market, and that any subsidies and handouts should be limited and transparent.

> The solution is straightforward: The public-private hybrid of Fannie and Freddie—"government-sponsored entities"—should be abolished, their existing business sold or liquidated, and the mortgage market privatized. …The current $686,000 cap on new mortgages guaranteed by Fannie and Freddie should be reduced by $100,000 a year. This would put the companies out of originating new mortgages within seven years. …if the government still wants to subsidize mortgages for low-income families and minorities, the cost should be on budget and transparent. The Federal Housing Administration already does this.

By the way, a private system wouldn't mean an end to conventional mortgages.

> Others speculate that, without Fannie and Freddie, mortgage rates would skyrocket and the 30-year, fixed-rate mortgage would vanish. We disagree. Nonconventional or "jumbo" 30-year mortgages not guaranteed by Fannie and Freddie have existed for decades. In the decade preceding the financial crisis, the interest rate on these jumbo mortgages averaged only about 0.25% higher than similar guaranteed mortgages, a difference of a little over $40 a month on a $200,000 mortgage. Shouldn't Americans, like homeowners throughout the world, pay a tax-deductible $40 extra a month so taxpayers aren't on the hook for hundreds of billions to bail out Fannie and Freddie?

Amen. Fannie and Freddie never should have been created in the first place.

And today, with the memory of their disastrous impact still fresh in our minds, we should do everything possible to shut down these corrupt GSEs. I've argued for this position over and over and over again.

Sadly (but not surprisingly), there are many people who want to move policy in the wrong direction. The Obama Administration has pushed for more risky housing handouts, often aided and abetted by Republicans who care more about pleasing lobbyists than protecting taxpayers.

And it goes without saying that Fannie and Freddie are proposing more handouts in order to create a bigger constituency that will advocate for their preservation.

Kevin Williamson of National Review looks at a crazy idea to create more risk from Fannie Mae.

> …government-sponsored mortgage giant Fannie Mae roll[ed] out a daft new mortgage proposal that would allow borrowers without enough income to qualify for a mortgage to count income that isn't theirs on their mortgage application. …Claiming that the money you are using for a down payment is yours when it has been lent to you by a family member or a friend was a crime… Fannie Mae, the organized-crime syndicate masquerading as a quasi-governmental entity, has other ideas. Under its new and cynically misnamed "HomeReady" program, borrowers with subprime credit don't need to show that they have enough income to qualify for the mortgage they're after — they simply have to show that all the people residing in their household put together have enough income to qualify for that mortgage. We're not talking just about husbands and wives here, but any group of people who happen to share a roof and a mailing address. …That would be one thing if all these people were applying for a mortgage together, and were jointly on the hook for the mortgage payments. But that isn't the case. HomeReady will permit borrowers to claim other people's income for the purpose for qualifying for a mortgage, but will not give mortgage lenders any actual claim against that additional income. This is madness.

Madness is certainly an accurate description. If you want to be more circumspect, economic illiteracy is another option.

The bottom line is that government-subsidized risk is not a good idea.

And also keep in mind that shutting down Fannie and Freddie is just part of the solution. So long as deposit insurance exists, we're going to have some instability in the financial system. And so long as government wants to subsidize housing for people with poor credit, taxpayers will be on the hook for losses. And so long as there are biases in the tax code for debt over equity and residential real estate over business investment, the economy won't grow as fast.

Daniel J. Mitchell is a senior fellow at the Cato Institute who specializes in fiscal policy, particularly tax reform, international tax competition, and the economic burden of government spending. He also serves on the editorial board of the Cayman Financial Review.