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Fannie-Freddie Fight Goes Beyond Politics

By: Nick Timiraos – July 23, 2013

As Congress begins considering how to replace Fannie Mae and Freddie Mac, the real clash over the look of the mortgage market will be fought by two competing interests: business and real-estate groups that want to preserve a federal backstop and antigovernment libertarians who want to eliminate it.

One part of the fight is now coming to a head as the House Financial Services Committee on Tuesday began voting on a bill to wind down the government-controlled mortgage-finance firms and create a mostly private market, with Republicans on the panel mostly lined up in favor and Democrats uniformly opposed.

Until recently, Republicans and Democrats have struggled to address how the country should revamp Fannie and Freddie, which were bailed out by the government nearly five years ago and together with federal agencies have been backing around nine in 10 new loans. The Obama administration hasn't put forward any detailed plans.

The bill in the House has strong backing from conservative academics who say the U.S. would be better off with a mostly private mortgage market. Republicans endorsed that approach when they reclaimed the House of Representatives in 2010, fueled by a surge of tea-party conservatives unhappy with the government's response to the financial crisis.

The House measure "gets government out of the way, helps increase competition, enhances transparency and gives consumers more freedom to choose the mortgage that's right for them," Rep. Jeb Hensarling (R., Texas), the chairman of the House finance panel, said on Tuesday.

The bill has attracted strong opposition from home builders and real-estate agents because steps to raise the cost of mortgage lending could hurt their ability to sell homes. Also, the measure has provoked concern within the financial-services industry because the elimination of Fannie and Freddie could degrade the deep, liquid credit markets that attracted an array of investors to fund U.S. mortgages, particularly 30-year, fixed-rate loans that banks don't like to hold on their books and which don't exist in many other countries.

This bond market, which also allows homeowners to lock in a mortgage rate weeks ahead of closing on a loan, has functioned over the past five years only because Fannie and Freddie have received nearly explicit backing from the federal government.

"The people promoting this bill seemingly either don't understand mortgage finance or they simply don't care. It's purely an ideological exercise," said Scott Simon, who retired in May as a managing director at bond giant Pacific Investment Management Co., or Pimco, a unit of Allianz SE.

Mr. Simon, a self-described "Reagan Republican," says that he wouldn't design from scratch the mortgage market that has taken root in the U.S. over the past 40 years. But he said the types of changes proposed would require home buyers to make significantly larger down payments for loans that would carry higher rates.

The bill would do far more damage to the economy than the Dodd-Frank financial-overhaul law, which has been frequently criticized by Republicans, he said. "Dodd-Frank is not even in the same area code of hurting things as this bill would be," he said.

Still, some analysts have said that the House effort could help steer whatever compromise ultimately emerges. "The stronger the House's position, the more they can pull the bill in their direction," said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute.

Mr. Calabria, who supports the bill, played down critics' worries that the 30-year, fixed-rate mortgage would disappear. "It's not a question of whether it goes away, but whether it goes from 70% of the market to 40% of the market," he said.

While the debate over the House bill has fallen largely along party lines, recent efforts in the Senate have bipartisan backing, giving them greater odds of success. Last month, eight senators—four Republicans and four Democrats—introduced a bill that would also wind down Fannie and Freddie over five years, replacing the companies with a new system that provides for guarantees of certain mortgage-backed securities.

It's unclear whether Republican leaders will have enough support to pass the bill through the House of Representatives, though aides have said that they hope to try later this fall. The bill isn't likely to move anywhere in the Senate, which is controlled by Democrats.

Economists have said that an additional challenge facing efforts to privatize most of the U.S. mortgage market is that it could further consolidate lending in larger institutions. That's because mortgage lending relies to some degree on building economies of scale. Fannie and Freddie helped provide smaller institutions with access to the nation's multitrillion-dollar mortgage-bond markets.

"This will in effect solidify and exacerbate 'too big to fail,' " said Frank Sorrentino, chief executive at the $1 billion-asset ConnectOne Bank in Englewood Cliffs, N.J.

Fannie and Freddie were rescued by the government in 2008 as rising mortgage defaults threatened to wipe out thin capital reserves, though their loans have performed far better than those securitized by Wall Street banks. At the peak of the financial crisis, Fannie and Freddie cost taxpayers around $150 billion. Recently, they have begun to report large profits, and financial analysts say the government could recoup the money invested in the firms as early as next year.