The New Fannie And Freddie: Flim And Flam

Jagadeesh Gokhale

Jagadeesh Gokhale, a senior fellow at the Cato Institute, calls the U.S. to abolish the failed government-sponsored business model.

As the economy remains stalled, and the election draws closer, the Obama administration seems increasingly willing to consider proposals that will further distort the housing market and seem to have the ultimate goal of preserving a major role for Fannie Mae and Freddie Mac — the two giant government sponsored enterprises at the core of the housing finance debacle that caused the Great Recession.

This is not really surprising considering we're at the start of another election season when politicians are scrambling for goodies to sell for votes. Under the slogan of preserving the American Dream, the Obama election campaign is promising to resurrect the old policy of extending implicit government backing to Fannie and Freddie — if the President is re-elected.

The Obama Administration has outlined major policy initiatives to preserve a role for the same mortgage-lending giants that have had to be bailed out repeatedly since 2008 at taxpayer cost of $130 billion to date. The latest proposal would allow homeowners with underwater mortgages backed by Fannie and Freddie to refinance. This would be expected to transfer money from taxpayers to homeowners and, by increasing expected taxpayer burdens, is likely to delay economic recovery in consumer spending.

It is worth noting that the Administration's recent report on housing policy begins by blaming the private sector for initiating riskier lending practices: To wit:

Initially, Fannie Mae and Freddie Mac were largely on the sidelines while private markets generated increasingly risky mortgages. Between 2001 and 2005, private-label securitizations of Alt-A and subprime mortgages grew fivefold, yet Fannie Mae and Freddie Mac continued to primarily guarantee fully documented, high-quality mortgages.

This reveals a fundamental misunderstanding of how private markets work — one that needs to be exorcised before we can move to better policies. The Administration's statement assumes that private lenders' business decisions and risk-taking activities occur in a vacuum. On the contrary, the very existence of Fannie and Freddie to subsidize and support home lending probably triggered private risk taking at the margin in that sector.

The long-standing and profitable operation of housing GSEs — their purchases of home-loans financed out of bond sales to the public at cheap rates because of the implicit government backing they enjoyed — generated a long-sustained upward spiral in home prices, reduced aggregate risk perceptions in home finance among private lenders, and attracted capital including foreign savings. That made Fannie and Freddie a part of the constellation of government policies that promoted a steep home price bubble — that eventually burst to deliver the Great Recession.

The correct policy prescription under a buoyant housing market would have been to withdraw the GSEs from the market, and transition to a self sustaining home finance sector. Such a policy, had it commenced during the early 2000s, could have injected caution and countered the growing perception of a risk-free bonanza in home lending that fed the housing price bubble. Instead, Fannie and Freddie's appetite to preserve market share and profits was only whetted — as the historical record of their massive portfolio expansion by purchasing subprime loans clearly shows.

The Administration is now proposing to "wind down Fannie and Freddie on a responsible timeline," (that is, remove the old names), to "address fundamental flaws in the mortgage market to protect borrowers, help ensure transparency for investors, and increase the role of private capital," (that is, increase lending regulations that *stifle* the private market), and "target the government's vital support for affordable housing in a more effective and transparent manner" (that is, create new government sponsored home-lending institutions and *increase* its role in home-finance).

Instead of admitting that the lesson of the housing debacle is that some segments of the population do not deserve and cannot sustain home purchases financed through government subsidized mortgages, the Obama administration's proposals, including this latest one, seek to "serve the needs of families, lenders, and investors" (but not taxpayers, of course) to "makes us all better off" (again, taxpayers excluded).

Sometimes, when a company fails for reasons unconnected to its business model, its operators attempt to preserve it via cosmetic changes — a new name, new location, or different front-office personnel. Accenture, the business consulting firm — formerly a part of Arthur Andersen that was tainted in the Enron scandal — is now thriving. So is "Sunshine Financial," the formerly failed "People's First" home lending business in Florida. Look for something similar to happen to Fannie and Freddie — even though that "business model" has clearly failed.

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