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Fannie, Freddie Mustn't Be Left Out Of Reform

By MARK A. CALABRIA
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All the debate of the last several weeks on changes to the financial regulatory system has omitted any discussion over reforming the entities at the center of the housing bubble and financial meltdown: Fannie Mae and Freddie Mac.

Total losses from the bailout of Fannie and Freddie are likely to exceed $250 billion — as much as the cost to the taxpayer of all bank failures in American history combined.

Fannie and Freddie infected capital markets and spread through every sector of the banking system. Before the bursting of the housing bubble, holdings of government-sponsored enterprise (GSE) securities — bonds and mortgage-backed securities as well as preferred stock — constituted more than 150% of core capital for insured banks.

It was not only the commercial banking system that was stuffed with toxic GSE holdings; it was also many of the investment banks. More than 50% of Maiden Lane One, the toxic assets that the Federal Reserve guaranteed in order to persuade JPMorgan to buy Bear Stearns, are GSE securities.

Additionally, more than 40% of money market mutual fund holdings were in the form of GSE securities.

The threats to the stability of the mutual fund industry were not simply a result of Lehman's failure. Had the government not bailed out Fannie and Freddie, many funds would have "broke the buck."

Save A Chinese Bank

Quite simply, Washington fostered an environment where if Fannie and Freddie caught a cold, the banking system would catch a fever.

Fannie and Freddie were the weak links in our domestic financial system. They were also the vehicles that carried excess world savings into America's housing market.

At the height of the bubble, almost 60% of newly issued GSE debt was purchased outside the U.S. One of the largest purchases of that debt was the Chinese Central Bank.

What did Fannie and Freddie do with their foreign borrowings? They invested in the subprime mortgage market.

At the height of the bubble, Fannie and Freddie purchased more than 40% of the private-label subprime mortgage-backed securities. Between the two of them, they were the largest single source of liquidity for the subprime market.

Interestingly enough, the very vintages of subprime loans that performed the worst — 2006 and 2007 — were the years in which Fannie and Freddie entered the market in force.

With their massive leverage, Fannie and Freddie were levered more than 100-to-1 — a disaster waiting to happen.

Why then were foreign investors so willing to trust their money to Fannie and Freddie? Quite simply, they were assured by U.S. Treasury officials that their losses would be covered.

Ultimately, Fannie and Freddie were not bailed out in order to save our housing market; they were bailed out in order to protect the Chinese Central Bank from taking losses. Without the implicit federal guarantee of Fannie and Freddie, trillions of dollars of global capital flow would not have been funneled into the U.S. subprime mortgage market.

Protect Taxpayers

Some might argue that the problem with Fannie and Freddie was fixed with last year's regulatory reform bill. That bill created a new regulator, one with increased supervisory powers, including the ability to wind down a GSE, and independence from the congressional appropriations process, letting the regulator raise additional funding.

Nothing could be further from the truth. As one of the drafters and negotiators for that bill while on the staff of the Senate Banking Committee, I can say that there was a shared awareness by all parties that the bill was insufficient to prevent the failure of Fannie and Freddie.

It was not the best bill that could be crafted. It was the best bill that could pass, given the continued strength of Fannie and Freddie apologists in Congress.

Nothing in the bill would have prevented the GSEs' massive accumulation of subprime mortgage-backed securities. Nor would the bill have deterred the GSEs from purchasing the many whole loans that have soured on them.

With their "strengthened" affordable-housing goals, the bill encourages GSEs to extend those purchases.

Had the reform bill that passed been signed into law years earlier, we would be in the same spot with Fannie and Freddie.

Most of the worst economic and financial crises in American history have involved real estate. Such is likely to be the case in the future. Reform of Fannie and Freddie is imperative so that American taxpayers will not be on the hook for hundreds of billions of dollars for the next real estate bubble.

• Calabria is director of financial regulation studies at the Cato Institute in Washington, D.C.