Commentary

The Mysterious Ways Of Fannie And Freddie

Johan Norberg 01.15.10, 5:10 PM ET

The Financial Crisis Inquiry Commission has started its work with a highly publicized two-day hearing in Washington, D.C. The Commission is supposed to find out what caused the financial crisis, but it seems like they are trying to enact *Hamlet* without the Prince of Denmark. Among all the bankers and regulators on stage during the hearings, there was not a single representative of the government-sponsored mortgage giants, Fannie Mae and Freddie Mac, which were major causes of the housing bubble.

The reason for the omission is disturbingly obvious. When Congress created the Commission they wanted a crisis narrative of greedy bankers and passive regulators. In other words, they wanted to put the blame somewhere else. Fannie Mae and Freddie Mac are creatures of Congress and it was Congress that pushed them to undermine underwriting standards and increase lending to low-income households while stalling reform.

Fannie and Freddie regularly let members of Congress announce large housing developments for low-income earners in exchange for political and financial support; over the past decade the two GSEs spent almost $200 million on lobbying and contributions to both parties, but most of all to Democrats, the present majority. Politicians wanted scapegoats on stage--Fannie and Freddie representatives would have functioned as a mirror.

Fannie and Freddie had an implicit government guarantee that made it possible for them to borrow cheaper than other financial institutions, and with those thousands of billions of dollars they bought mortgages from primary lenders, so that these got their money back and could lend even more to other prospective homebuyers.

In 2004, almost at the peak of the bubble, the Bush administration increased the ambitious targets for GSE lending of the Clinton Administration. It said that within four years, 56% of Fannie's and Freddie's mortgages should go to low-income households and 28% of the mortgages to those with a "very-low income." In plain English this means households that could not afford that mortgage the moment the interest rate returned to a more realistic level. The only thing we ever heard from Congress were demands to increase lending even more aggressively.

Fannie Mae and Freddie Mac pioneered securitization of mortgages, whereby they re-packaged loans and sold them to investors. Increased political pressure to serve low-income households meant that they soon began to buy mortgage-backed securities on an enormous scale themselves. After 2004 the market could make almost any kind of loans, knowing that the government-sponsored enterprises would buy them. About 40% of the loans were junk. "We didn't really know what we were buying," admits a former director at Fannie Mae.

Investment bankers have been publicly scolded by the Commission for taking on so much risk, with leverage ratios around 30 to 1. Shouldn't they ask how Fannie Mae and Freddie Mac ended up with a leverage ratio closer to 60 to 1?

As a result of their losses, Fannie and Freddie blew up in September 2008 and were in effect nationalized. The Treasury Department implemented $200 billion caps on government aid to each company, which have just been removed. The worst consequence of removing caps is not potential cost of hundreds of billions to taxpayer, but the effect on the rest of the market. The GSEs showed Wall Street that subprime lending was encouraged by the government; they made it profitable for lenders to make bad loans to sell them; and they pushed up house prices by opening up the market for owning homes to people who had previously rented.

The Financial Crisis Inquiry Commission couldn't care less. Granted, government-sponsored enterprises are mentioned in the 21st of 22 areas of inquiry for the Commission, but even there it is an afterthought: "financial institutions" in general is the object of study in No 21. And, as previously mentioned, no representative from Fannie or Freddie was invited to the hearing.

Today, former executives at the two GSEs say that the firms made so many bad loans because Congress constantly leaned on them to buy more mortgages from low-income borrowers. It is no surprise that Congress does not want anyone to hear that message. But it makes a mockery of their pretention to examine all possible causes of the crisis in an even-handed and objective way.

A former GSE employee recently said, self-critically: "It didn't take a lot of sophistication to notice what was happening to the quality of the loans. Anybody could have seen it. But nobody on the outside was even questioning us about it."

Apparently the outside world still isn't.

Johan Norberg is a senior fellow at the Cato Institute and author of Financial Fiasco: How America's Infatuation with Home Ownership and Easy Money Created the Economic Crisis.

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