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Fannie and Freddie: What Congress Should Do

Since September 7, 2008 when the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac (the “twins”) into conservatorship, there has yet to be any serious public debate regarding the government’s next steps. In the meantime, the mortgage market remains at a standstill as these two 800-pound gorillas nurse their handicaps and taxpayers find themselves on the hook for at least \$5 trillion in potential obligations. This article lays out both our preference and expectations for where these two entities will end up.

Preference: A Free Market Approach

Financial history will reveal this latest chapter regarding the twins is but a repeat of the old axiom: There is no free lunch.

Fannie and Freddie are government-sponsored enterprises (GSEs), which is to say they are private, shareholder-owned corporations with government charters. The charters require the companies to increase liquidity in the residential mortgage finance market, promote access to mortgage credit and provide assistance to the secondary market for residential mortgages. Their shareholders, of course, demand an appropriate risk-adjusted level of return.

Many have argued that today’s mortgage-related issues were exacerbated by the twins’ relaxed underwriting standards in response to congressional leaders’ desire to promote homeownership, even to those who could not afford to make the mortgage payments. While promoting broad homeownership is certainly a noble cause, the financial

markets have developed greatly since these two entities were originally created. Today, we have national banking networks and even non-bank mortgage originators, who when properly funded are more than happy to promote homeownership. In addition, the secondary market for mortgages remains one of the most liquid markets in the world, even under today’s dire circumstances. In other words, the twins compete with private enterprises — albeit with the backing of the taxpayer.

Restructuring is in Order...

Ideally, Congress should eventually dismantle or at least severely downsize these entities so that the free markets can operate without government interference. This would allow risk pricing to readjust to the appropriate level set by the “invisible hand” defined by Adam Smith. Shouldn’t the owners of capital determine which credit risks are acceptable or not without the added advantage of a “government guarantee?” Why give the investors in the twins a free lunch?

If not fully closed, the best way to shrink these agencies would be to phase out their investment and funding operations so that they simply sell a “government guarantee” that a mortgage originator can purchase given the underwriting standards fit the type of homeownership the government wishes to promote. We already have this model in the form of Ginnie Mae, the twins’ largely ignored cousin who has survived the current market downturn without a scratch.

...But Expect More of the Same

You may be wondering how a company can serve two masters — one in the form of shareholders looking to maximize returns and another in the form of the U.S. government looking to broaden homeownership. But, the twins figured out long ago that Congress along with the rest of Washington are their only true constituents.

Together, Fannie and Freddie over the last decade have contributed over \$200 million in lobbying and campaign contributions. In addition, they have run highly sophisticated lobbying operations tapping high powered Washington influencers such as John McCain's presidential campaign manager Rick Davis and President Barack Obama's original vice president vetter Jim Johnson.

Following the money, the data seem to indicate they've been politically agnostic over the years. After all, Fannie gave 53 percent of its political donations to republicans in 2006 who controlled Congress at that time, but during the most recent cycle gave 56 percent of their donations to democrats. As their donations swung to favor those in power at seemingly each turn, it's fair to surmise the goal was not to support any single ideology or agenda, but to curry favor with whoever was in power.

Because these entities are federally chartered, it is up to Congress to determine their fate. If we have an open debate on this issue, it will surely last at least six months with several late night sessions viewable in home districts on C-Span. There are many issues up for debate, including whether they should remain publicly owned, whether they should directly invest in mortgages and whether they should obtain the "full faith and credit of the United States." These are important questions deserving of solid debate among our leaders with thoughtful input from industry experts.

Unfortunately, we are much more cynical of Washington and fear that these decisions will arrive in backrooms and quickly — too quickly to allow for avoiding potentially obvious pitfalls some years from now.

Our suspicion is that Fannie and Freddie may emerge from this crisis in a similar structure as when the crisis began. Certainly, their efforts to reach for the marginal home-buyer will be curtailed for now, but in some distant Congressional session when times are better, a movement could occur that would push the twins to promote home ownership for all potential buyers — not simply those who can afford it. Congress must seize this opportunity to help the twins mature, otherwise the cycle will repeat.

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