

# Fannie Mae and Freddie Mac – Re-Loaded

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**ECONOMIC POLICIES FOR THE 21ST CENTURY**

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Fannie Mae and Freddie Mac meaningfully and substantially contributed to the magnitude and duration of the Great Recession that began just 10 years ago. At the time, Fannie and Freddie, both Government Sponsored Enterprises, were publicly traded firms that intermediated mortgage-backed securities that had an implicit guarantee by the federal government. Preceding the crisis, it was well known and documented that Fannie and Freddie had too little capital and too much leverage in their balance sheets; duration mis-match problems in their portfolios; involvement in accounting scandals; and generously and questionably funded and lobbied political candidates on both sides of the aisle.

In turn, Fannie and Freddie turned their government sponsored advantages – including the implicit guarantee of their securities and an allowance for lower capital standards than their competitors in the mortgage-backed securities market – into strong profits for their shareholders. As a *quid-pro-quo* for their special status, however, they faced an enormous political burden from both sides of the aisle. Pressure built when Fannie and Freddie enabled more families to be able to qualify for home loans by lowering their underwriting standards for a purchaser's down payment terms, credit and employment history backgrounds, etc. In short, as a price for their government-sponsored privilege, Fannie Mae and Freddie Mac securitized lower quality loans than they otherwise would have done in the assets that they sold.

It was a seemingly well-functioning, dysfunctional arraignment – until it wasn't.

Ten years later and Fannie and Freddie are reloaded: that is, they remain in a disproportionately large preferential market position called “conservatorship,” and they earn unchallenged profits. The latter should not be surprising since economic theory is clear that monopoly power is often associated with profits. The former should not be too puzzling either, given the latter, since Fannie and Freddie's monopoly profits now flow directly into the Treasury's coffers, and the federal government very much likes these current “naïve” tax cash flows. The term “naïve” suggests that the cash flows don't incorporate the underlying risks that were taken in the past to secure the cash flows, the time value of money, or the risks that lie ahead.

Yet again, we find ourselves in a seemingly well-functioning, dysfunctional arrangement – until we don't. And we should not wait until the shoe drops. Again.

Independently of how we arrived at this current situation, there are three reasons why the current system of conservatorship is flawed. First, we know that monopolies typically misallocate resources, which means that part of the profits coming to Fannie and Freddie would be better served as more favorable mortgage terms to families, or in more wisely priced risk that they are taking on. These inefficiencies can and will have real consequences.

Second, the monopoly profits of Fannie and Freddie are current tax revenue for the government, and it is not at all clear why taxing mortgages on housing (the commodity the federal government seems to want to subsidize through mortgage interest and property tax deductions) is the right kind of tax we should be levying, as compared to a tax on labor income, capital gains, gasoline, cigarettes, or cannabis. Indeed, if we were to incorporate the risk the federal government is taking on to get these tax dollars, it seems even less likely that this tax revenue is holistically a good idea.

Third, one does not need to be a pure cynic to recognize that governments have different aims and goals than the desires of households and private businesses. In fact, given its reliance on its newfound tax revenue, the federal government may wish to limit future innovation in housing finance to protect its new stream of revenue. The government may even wish to institutionalize its co-dependency with Fannie and Freddie, maintaining their status as Too Big to Fail, which keeps the public on the hook for losses that Fannie and Freddie will face in the future.

So, what would a fix to the current status for Fannie and Freddie look like? Bipartisan legislation proposed in September by retiring Congressman Jeb Hensarling (R-TX), and co-sponsored by Congressmen John Delaney (D-MD) and Jim Himes (D-CT), may provide some insight. In brief, their proposal wholeheartedly surrenders to the practical notion that we cannot return to a world where the federal government is not involved in guaranteeing mortgages that have been securitized.<sup>2</sup> It does, however, eliminate Fannie and Freddie's

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<sup>2</sup> See Jeb Hensarling, "Fannie and Freddie, Make Way for Ginnie Mae," September 5, 2018. <https://www.wsj.com/articles/fannie-and-freddie-make-way-for-ginnie-mae-1536189030>

charters, permanently ending their monopoly positions. In their place, Ginnie Mae would guarantee qualified mortgages that are securitized by regulated, well capitalized institutions. “Private credit enhancement” insurance would be paid by issuers for their loans to be eligible to be included in these securities. These private credit enhancements would also help to fund a sufficient “rainy day” capital to support the system in periods of stress. These overlapping, diversified pools of funds and insurance would, to the authors’ minds, provide sufficient protections to avoid future government bailouts.

There are fault lines within this proposal, given its slight efforts to widen home ownership to individuals and families with lower-income, less collateral, or with weaker credit backgrounds. Alternatively, subsidies to improve housing ownership for riskier buyers could be directly subsidized by the government, should they choose to do so, through the government’s FHA insurance system on loans, rather than through a more convoluted market process to be priced and sorted out by private intermediaries. The simple reason is that private intermediaries are going to want to charge a higher price for riskier borrowers – or not loan to them at all, which is at odds with expanding home ownership to these same groups.

The good news is that the current bipartisan proposal removes the privileged position of Fannie Mae and Freddie Mac, and crowds more capital into the system to lessen the chance that government bailouts will be needed. It is certainly not a dream proposal; it still places the government’s full faith and credit at the center of housing finance, which is a market feature not imitated by other countries. However, given the U.S.’s attachment to the 30-year fixed rate mortgage (with no pre-payment penalty), our default laws, and our on-again off-again desire to raise home ownership rates, it may be the best policy reform we can even hope for.