

Fannie, Freddie and an Outbreak of Amnesia

By Douglas Holtz-Eakin

A dangerous amnesia pervades the current discussion about the future of mortgage giants Fannie Mae and Freddie Mac. Recall that during the 2008 financial crisis these “government-sponsored enterprises,” hit hard by the subprime meltdown, were put into full-blown government conservatorship, with taxpayers footing the bill for a \$188 billion bailout. Many, myself included, thought reforming Fannie and Freddie would be an immediate postcrisis priority. Sadly, it never happened.

Now there’s a growing movement afoot to recapitalize Fannie and Freddie and release them from conservatorship. Even conservative groups such as the National Taxpayers Union and Americans for Prosperity are pushing for passage of the Housing Finance Restructuring Act of 2016, introduced in April by Sen. Mick Mulvaney (R., S.C.), which includes a recap-and-release scheme.

This is a bad idea that fails to address the fundamental flaws in Fannie and Freddie’s business model and could lead to another financial

collapse and taxpayer rescue.

Those who favor recap and release are buttressed by a lawsuit filed by investors in Fannie and Freddie equity. Initially, taxpayers were compensated for the bailout with a 10% annual dividend on their investment. In 2012, however, the Treasury Department began sweeping all

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quarterly profits from Fannie and Freddie into the general fund, nearly \$250 billion to date. Investors in the GSEs have sued the government, labeling the Treasury action an illegal “taking” that has prevented Fannie and Freddie from accumulating capital and meriting release from conservatorship.

Affordable-housing advocates, the mortgage industry, home builders and realtors are also in favor of recap and release. They argue that the Federal Housing Finance Agency,

the GSEs’ regulator, should reverse course. In other words, stop eliminating Fannie and Freddie’s portfolios of mortgage securities, stop transferring credit risk to the private sector, and—most important—stop the scheduled elimination of Fannie and Freddie capital by 2018.

Regardless of any group’s rationale, “recap and release” is rubbish. In an election cycle when private enterprise is often accused of crony capitalism and participating in a “rigged” system, it is forgotten that Fannie and Freddie were the very embodiment of crony capitalism. Granted charters by the federal government, they benefited from presidential appointments to their boards, lines of credit at the Treasury, exemptions from taxation and securities registration, and minimal capital requirements, even as they accumulated enormous, undiversified portfolios of mortgage assets. These special provisions permitted Fannie and Freddie to borrow cheaply while asserting (wink, nod) that they were absolutely independent of the federal government.

Investors benefited from highly leveraged returns on fees collected to

guarantee often risky mortgages. Housing advocates took advantage of off-budget slush funds that Fannie and Freddie were happy to dole out in pursuit of political influence. And the system was rigged to ensure that taxpayers picked up the tab when it all came tumbling down.

Recap and release does nothing to change the fundamental flaws in this business model. More important, Fannie and Freddie cannot compete as genuinely private enterprises. The FHFA is currently winding down their portfolios of mortgage assets. If it was a ripe profit opportunity to have a monoline-housing hedge fund, the private sector has been readily able to get into that business at any time. There is nothing special about Fannie and Freddie in that regard.

That leaves the business of collecting fees in exchange for mortgage guarantees. It may be that there is a private business model, with competitive rates of return on capital, for providing guarantees on new mortgages. But Fannie and Freddie together carry an existing stock of roughly \$5 trillion in mortgages, so they would have to charge much higher fees to accumulate

capital to back those guarantees successfully. Those fees would be easily undercut by, and the business lost to, any new competitor entering the guarantee business.

The only way Fannie and Freddie’s investors make money is to maintain the existing crony business model. But not even that gets the GSEs out of the woods if they are required to hold adequate capital. As the Journal’s John Carney explained in an April 4 column, at current rates of profit, Fannie and Freddie wouldn’t have enough capital to depart conservatorship for decades.

In the end, it isn’t about the details of the law or the policy objectives in low-income housing. The issue is a business model that is dangerous to taxpayers, cannot survive on its own capital, and should not be permitted to continue. Now is not the time for “recap and release.” It’s time to put Fannie and Freddie out of their—and taxpayers’—misery.

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