Backgrounder

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Time to Reform Fannie Mae and Freddie Mac

Ronald D. Utt, Ph.D.

In late 2004, the leadership of the Federal National Mortgage Association (FNMA or Fannie Mae) was accused of having engaged in a series of questionable accounting practices that led to an overstatement of its earnings and an understatement of its risk. Although Fannie Mae's top officers denied the accusations, a careful review by the U.S. Securities and Exchange Commission confirmed the allegations. Within a few weeks, Fannie Mae conceded the charges and its top officers were forced to resign. Any doubts about the seriousness of the company's shaky finances were laid to rest on January 19, 2005, when Fannie Mae cut its dividend in half to bolster its cash reserves.

Since then, Congress has held a series of hearings on Fannie Mae's predicament and how to reform it. In the last week of May 2005, the House Committee on Financial Services proposed a series of regulatory changes that it claims would rectify the problem. However, critics of the FNMA, many of its private-sector competitors, and White House officials contend that these proposals are too timid and that the new regulatory environment would sustain the powerful co-monopolistic position that it shares with the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), which suffered its own accounting and ethical lapses in 2003.

A better and more effective alternative is to phase out their generous federal credit privileges, allowing these financial giants time to adjust to a more competitive environment. To implement this orderly withdrawal of federal support, Congress should:

Talking Points

- Fannie Mae and Freddie Mac have abused their generous federal privileges to the point that they now control as much as half of the nation's residential mortgage market.
- Their commanding presence exposes U.S. financial markets to excessive risk and instability.
- Despite their immense financial resources, Fannie Mae's and Freddie Mac's impact on homebuilding and homeownership has been inconsequential.
- The "reform" legislation now before the House of Representatives could enhance their influence and market penetration.
- Congress should instead revoke their federal privileges—their $2.25 billion lines of credit with the U.S. Treasury and the Federal Reserve's authority to buy their debt—thereby forcing them to compete with other financial institutions on a level playing field.

This paper, in its entirety, can be found at:
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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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- **Phase out** Fannie Mae's and Freddie Mac's lines of credit with the U.S. Treasury over five years in annual increments of $500 million for each government-sponsored enterprise (GSE),
- **Eliminate** immediately the Federal Reserve's authority to buy their debt, and
- **Eliminate** the GSEs' exemption from state and local income taxes.

As the phaseout proceeds, Fannie Mae and Freddie Mac should:

- **Conduct** an orderly reduction in their holdings of residential mortgages (the profits from these investments depend largely on their ability to borrow at subsidized rates) and
- **Concentrate** their skilled workforces on securitizing residential mortgages in fair and open competition with the private sector.

These legislative changes would greatly reduce the risk to financial markets and taxpayer exposure. They would also restore competition in residential mortgage markets while leaving the housing industry and homeownership opportunities unaffected.

Making the Most of the Opportunity

While Members of the 109th Congress are to be commended for taking on these two political powerhouses, the legislative package reported out by the House Committee on Financial Services in late May 2005 (H.R. 1461) falls short of what is needed. It will do little to address the fundamental problems associated with these federally supported financial monopolies that provide limited benefit to the housing finance market or homeownership opportunities.

Notwithstanding press reports that the new legislation would "create a new more powerful regulator for financial services giants Fannie Mae and Freddie Mac,"[1] some GSE reform advocates and Bush Administration officials view it as too weak and contend that the new regulatory system is less restrictive than the current one.[2] In addition, the new proposal would require Fannie Mae and Freddie Mac to use 5 percent of their profits to fund "affordable" housing programs. This is a clumsy and costly effort to contrive a public purpose for these enterprises, which have long outlived any justification for the valuable privileges that they receive from the federal government.

The failure of Congress to address these broader issues stems from a flawed reform process that focused on Fannie Mae's Enron-like behavior instead of the statutory privileges that have allowed it to amass enormous market power. Together, these two GSEs control half of the residential mortgage market, deterring competition and forcing the housing and housing finance markets to rely on two financially unstable co-monopolists. With such market power concentrated in the hands of only two companies, the stability of U.S. financial markets could be undermined by financial problems in just one of them. Of course, if a bailout ever becomes necessary, the taxpayers could end up paying the bill.

In recent years, there have been a number of proposals to reform these GSEs. Some involve more regulation, others urge the creation of more GSEs to foster competition among government-subsidized entities, and still others would eliminate the statutory privileges that tie the GSEs to the taxpayer.

New regulations have attracted the most support, but this could turn out to be a useless and counterproductive approach. If the GSEs provide little or no benefit to society—beyond enriching their leaders and the various contractors who serve them—there is little point in trying to limit their risk with regulations and expose the taxpayers to a costly bailout. The co-monopolists would likely

1. Annys Shin, "House Panel Approves New Fannie Regulator," *The Washington Post*, May 26, 2005, p. E1.
2. A number of provisions in H.R. 1461 are of concern to advocates of GSE reform. These include the one-year gap before the new regulator is created, emphasis on cost efficiencies, and an increase in the size of conforming loans, which will give the GSEs access to a greater share of the residential mortgage market. For more detail on the bill's deficiencies, see Thomas H. Stanton and Peter J. Wallison, "H.R. 1461: A GSE 'Reform' That Is Worse than Current Law," The American Enterprise Institute, June 17, 2005, at *www.aei.org/publications/pubID.22705.filter.all/pub_detail.asp* (June 20, 2005).

survive and thrive under a regulatory solution that would preserve the unhealthy concentration of risk, privilege, and power in the two companies.

Both Fannie Mae and Freddie Mac have proven exceptionally adept at lobbying Congress to preserve and enhance their privileges. Any effort that relies on new regulations will likely perpetuate the risk to the financial market and preserve their dominant influence. Indeed, if Armando Falcon, director of the Office of Federal Housing Enterprise Oversight (OFHEO), had not courageously persisted in exposing Fannie Mae's suspect operations, often in the face of congressional hostility, former Fannie Mae President Franklin Raines would still have his job and Fannie Mae's shaky finances and fabricated earnings would still be hidden.

Instead of adopting compromise regulations, the government should begin an orderly process of severing all ties with the GSEs. Their most valuable federal privileges are their $2.25 billion lines of credit (for a total of $4.5 billion) with the U.S. Treasury and the Federal Reserve's authority to buy their debt as part of its open market operations. These privileges allow Fannie Mae and Freddie Mac to claim an implicit federal guarantee of their outstanding obligations, which in turn makes them a popular investment for many major institutions, pension funds, and even foreign central banks. By lowering their borrowing costs and giving them access to subsidized credit, this implicit guarantee has allowed them to outcompete their private-sector rivals and establish a monopoly presence in the financial markets.

Losing Their Sense of Purpose

Fannie Mae was created in 1936 during the Great Depression to provide a secondary market to encourage greater use of the innovative long-term, fixed-rate, level-payment, fully amortized mortgages that the newly created Federal Housing Administration (FHA) was insuring against loss of principal and interest. The exercise was a success, and this type of innovative mortgage became the standard means of financing the postwar housing boom that raised the homeownership rate from 44 percent in 1940 to 69 percent by 2004.[3]

By the 1970s, the basic purpose of the GSEs had shifted to the role of adding more funds to the housing market by connecting prospective homebuyers with major capital markets. To accomplish this goal, the GSEs use their preferred credit rating to borrow in major financial markets and use the funds raised to acquire residential mortgages from brokers and other mortgage originators, earning profits and covering expenses on the difference in the interest rates earned and paid. The GSEs also package mortgages acquired from originators into "pass through" securities that are collateralized with qualified residential mortgages. Payments of principal and interest made by the homeowners are then "passed through" to the investors holding the securities.

Over much of this period, Fannie Mae and the federal government were minor players in the process. By 1965, the homeownership rate had risen to 63 percent, but Fannie Mae and the other sources of federal mortgage credit support accounted for only 6 percent of outstanding residential mortgages.[4] Savings and loan associations, savings and commercial banks, and life insurance companies accounted for most of the rest.[5]

Fannie Mae was restructured as a federally chartered corporation in 1968, and its shares were sold to the public a year later. Initially, Fannie Mae was limited to investing in residential mortgages insured by the FHA or guaranteed by the Veterans Administration so as to maintain its public purpose of assisting entry-level homebuyers.

3. Prior to creation of the FHA, most residential housing in the U.S. was financed with short-term, interest-only, "balloon" mortgages that were technically payable in full at the end of five years but were usually rolled over for another short period of time. However, when depository institutions faced a loss of deposits in the early days of the Great Depression, these loans were not extended, home owners defaulted, and both the housing and mortgage markets collapsed.

4. "Residential mortgages" refers to the standard industry definition of mortgages for homes for one to four families.

5. Council of Economic Advisers, *Economic Report of the President* (Washington, D.C.: U.S. Government Printing Office, 2003), pp. 366–367, Tables B-75 and B-76.

A few years after Fannie Mae's "privatization," Congress authorized the creation of another government-sponsored mortgage credit facility, Freddie Mac, as a federally chartered corporation to provide a secondary market for the conventional mortgages written by savings and loans and other lenders and brokers. Over time, the mandates guiding the FNMA and FHLMC were liberalized, and the scope of their activity was expanded substantially to the point that they and the other federal housing finance programs now account for more than half the residential mortgage market in the United States.

Although structured as private companies, both the FNMA and the FHLMC operate with valuable federal privileges that give them a significant competitive advantage over other participants in the housing finance market. In particular, they are exempt from state and local income taxes; more important, they have exclusive access to lines of credit from the U.S. Treasury and the U.S. Federal Reserve System. Under current law, each is permitted to borrow up to $2.25 billion from the Treasury, and the Federal Reserve is authorized to purchase their debt as part of any "open market operation." Although neither of these privileges has ever been requested, the fact that the federal government is authorized to assist these GSEs is interpreted by investors as an implied federal guarantee of their debt, and this interpretation allows them to borrow at interest rates well below those paid by private companies with the best credit ratings and only slightly higher than what the Treasury pays on its own full faith and credit debt.

As quasi-private companies obligated to enrich their shareholders with ever-increasing earnings and dividends, and operating with an implicit federal interest rate subsidy as well as a federal mandate to promote homeownership, Fannie Mae and Freddie Mac had every reason and opportunity to grow rapidly. By the 1980s and early 1990s, they dominated the housing finance market. By parlaying their subsidized borrowing advantage into lower-rate mortgage lending, they gradually pushed life insurance companies and commercial banks out of the less profitable residential mortgage market and squeezed the earnings of the already wobbly savings and loans, which by law could invest only in residential mortgages. While homebuyers benefited from slightly lower borrowing costs, financial markets were put at greater risk as more and more of the housing finance system was concentrated in the hands of two highly leveraged, unsupervised, federally chartered financial institutions.

Concerns Met with Public Relations

Many policymakers soon recognized the risk to financial markets posed by such a concentration of market share. In the late 1970s and early 1980s, Fannie Mae made a bad bet on interest rate trends that left the institution technically insolvent as its net worth briefly turned negative, raising fears of a financial collapse. Fannie Mae later recovered when the Federal Reserve's monetary policy of the early 1980s led to dramatic declines in market interest rates, restoring the value of Fannie Mae's loan portfolio.

After implementing new financial controls and investment practices, Fannie Mae came out of its near-death experience as a better-managed operation. Nonetheless, the possibility that it might fail could disrupt financial markets in general and mortgage markets in particular. This, in turn, led to calls to limit its size, scope, and privileges.

In response to growing concern and criticism, Fannie Mae adopted an aggressive public relations program that was quickly copied by the Federal Home Loan Banks (FHLBs) and Freddie Mac, the other housing-related GSEs. With executive pay, bonuses, expense accounts, and other top management perks, and by promoting its stock to Wall Street analysts, Fannie Mae presents itself to investors as a hard-charging, profit-minded growth company.

Wall Street brokerage firms and investment banks earn more than $100 million in fees annually from the issuance of Fannie Mae and Freddie Mac debt instruments and mortgage-backed securities.[6] Wall Street returns the favor with enthusiastic

6. Bethany McLean, "The Fall of Fannie Mae," *Fortune*, January 10, 2005.

endorsements of their role in the economy and financial markets. However, when protecting itself against the few congressional reformers and marketplace competitors and selling its debt to foreign central banks at favorable interest rates, Fannie Mae poses as a public-purpose government entity that helps America's disadvantaged to become homeowners.

As part of this effort to garner influence, Fannie Mae has hired lobbyists by the score and created the Fannie Mae Foundation, which over the past five years has pumped $500 million into highly visible and heavily promoted local projects and grants.[7] In the process of spreading its message, every interest group is cultivated.

Even America's college professors became objects of Fannie Mae's affection when it created and financed two academic journals—*Housing Policy Debate* and *Journal of Housing Research*—that focus (with a notable exception) on a wide range of housing issues. The exception is that both journals generally avoid discussing the GSEs' role in the mortgage market and whether they make much of a difference. With many professors still confronting a publish-or-perish environment in pursuit of tenure and promotion, common sense argues against irritating a wealthy and influential publisher. As a result, academia has not been a reliable source of dispassionate inquiry into the GSEs' role in America's housing market.

Is Fannie Mae Really Needed?

However, independent analysts have looked into the matter and have found little evidence that the FNMA, FMLMC, and FHLB make much of a difference in how many new homes are built or how many Americans become homeowners. In fact, a broad review of the evidence accumulated in the postwar era suggests that their impact on homeownership is inconsequential.

Specifically, in 1965, when the GSE presence in the mortgage market was slightly above 6 percent, America's homeownership rate was 63.3 percent. In 1990, after outstanding residential mortgage credit had expanded more than tenfold from $220.8 billion in 1965 to $2.6 trillion in 1990 and after the federal and GSE presence in the residential mortgage market had grown from 6 percent in 1965 to 48 percent in 1990, America's homeownership rate was at 63.9 percent—virtually identical to the rate 25 years earlier. Expressed another way, the $1.24 trillion increase in federal and GSE involvement in the mortgage market was associated with an increase of less than 0.6 percentage points in the homeownership rate.[8]

In this regard, it is worth noting that America's greatest surge in homeownership took place between 1946 and 1960, when homeownership jumped from the mid-40 percent range at the end of World War II to 62 percent in 1960, when the FNMA's activity was still limited and the FHLMC did not yet exist.

From 1990 to 2003, GSE involvement in outstanding mortgage credit expanded substantially, from $1.0 trillion in mortgages in 1990 to $3.4 trillion in 2003. During the same 13 years, total outstanding residential mortgage loans increased almost threefold, from $2.6 trillion to $7.3 trillion,[9] and the homeownership rate increased from almost 64 percent in 1990 to 68 percent in 2003.

However, this does not mean the GSEs finally made a difference. Credit instead goes to the Federal Reserve's anti-inflation, pro-growth monetary policies, which drove down the AAA corporate bond rate from 9.32 percent in 1990 to 5.67 percent in 2003 and the home mortgage rate from 10.05 percent in 1990 to 5.80 percent in 2003. With the mortgage rate falling to half of its peak level, housing demand soared as monthly mortgage

7. *Ibid.*

8. Council of Economic Advisers, *Economic Report of the President*, pp. 366–367, and U.S. Bureau of the Census, "Housing Vacancies and Homeownership (CPS/HVS), Annual Statistics: 2004," revised February 17, 2005, Table 12, at *www.census.gov/hhes/www/housing/hvs/annual04/ann04t12.html* (June 8, 2005).

9. U.S. Bureau of the Census, *Statistical Abstract of the United States: 2004–2005* (Washington, D.C.: U.S. Government Printing Office, 2004), p. 744, Table 1177.

payments fell accordingly. Housing markets in the 1990s also benefited from the significant rise in employment and incomes over the decade, which allowed more families to accumulate the money for a down payment and qualify for a mortgage. As a consequence of these favorable macroeconomic developments, homeownership rose to record levels, independent of anything Fannie Mae and Freddie Mac did over the same period.

While these anecdotes are less than perfect proof of FNMA ineffectiveness, more comprehensive studies by the Federal Reserve Board and the Congressional Budget Office have come to similar conclusions. In 2003, Wayne Passmore, a Federal Reserve economist, wrote that "the GSE's implicit subsidy does not appear to have substantially increased home-ownership or homebuilding" and argued that the GSE's activity slightly lowered mortgage rates for some homeowners.[10] More recently, an article in the prestigious *Journal of Economic Perspectives* contends that "it does not appear that the companies' activities have appreciably affected the rate of homeownership in the United States" and cites several other studies that support that view.[11]

One reason for the tenuous connection between a *general* increase in mortgage credit and increased homeownership is that beyond some point, an increase in mortgage credit availability mostly makes itself felt in higher loan-to-value ratios (lower down payments), higher home prices, and/or a diversion of mortgage credit to non-housing investments. As the early postwar record indicates, existing private credit markets were perfectly capable of driving the homeownership rate into the mid-60 percent range. However, as more credit is forced into the system through the creation and expansion of subsidized GSEs, mortgage interest rates may fall somewhat, but this encourages private financial institutions that provide housing credit to look elsewhere for investments with better yields. While the slightly lower interest rates encourage and/or allow some moderate-income borrowers on the margin of eligibility to become homeowners, this stimulative effect may be partly or wholly offset by a credit-induced rise in home prices in excess of the growth in personal incomes.

While finding ways to assist the marginal buyer to become a homeowner has been one of the federal government's important public policy goals for much of the postwar era, relying on the GSEs to help achieve that goal is not an effective way to boost homeownership. As currently configured, the GSEs do not target the loans of marginal buyers but rather provide secondary market support to qualifying or conforming mortgages, most of which are secured by property owned by middle-income and higher-income households that are capable of buying and borrowing without federally sponsored support.

Despite its claims to the contrary, Fannie Mae's basic operating procedures do not target any particular type of buyer/borrower. Indeed, evidence from the federal government indicates that Fannie Mae and Freddie Mac are in fact neglecting first-time homebuyers in comparison to the entire private conventional mortgage market. Between 1999 and 2003, 9.0 percent of the conventional conforming loans (the type the GSEs are authorized to buy) made by the private mortgage market were to first-time minority homebuyers. By contrast, only 4.7 percent of Fannie Mae loans and 3.5 percent of Freddie Mac loans over the same period were to first-time minority homebuyers.[12]

Although one could give Fannie Mae the benefit of the doubt and view this failing as simply one of neglect, other actions by Fannie Mae in late 2004 and early 2005 suggest both that the neglect may be willful and that it reflects the company's bias against

10. Wayne Passmore, "The GSE Implicit Subsidy and Value of Government Ambiguity," Federal Reserve Board of Governors, Washington, D.C., preliminary draft, 2003.
11. W. Scott Frame and Lawrence J. White, "Fussing and Fuming over Fannie and Freddie: How Much Smoke, How Much Fire?" *Journal of Economic Perspectives*, Vol. 19, No. 2 (Spring 2005), p 172.
12. U.S. Department of Housing and Urban Development, "New Housing Goals for Fannie Mae & Freddie Mac in 2005–2008," briefing on HUD's Final Rule, December 9, 2004, Slide 18.

prospective lower-income, entry-level homebuyers. In January 2005, coalitions of low-income housing advocacy groups[13] published reports that challenged the value of policies promoting and encouraging homeownership among poor and moderate-income neighborhoods, arguing that homeowner "benefits may have been overstated" and that "rentals, public housing and other options may make better economic sense."[14] Although these organizations had previously published a number of papers and reports expressing skepticism about the value of homeownership, the two most recent reports, published in January 2005, were funded by the Fannie Mae Foundation.[15]

Suspiciously, the release of these anti-homeownership reports by the Fannie Mae-assisted advocacy groups was followed one month later by the release of a new rule from the Department of Housing and Urban Development (HUD) requiring Fannie Mae and Freddie Mac to improve mortgage availability to minority and moderate-income-buyers. In effect, while Fannie Mae was conducting a massive and costly public relations campaign to present itself as the benefactor of moderate-income and minority homebuyers, it was funding studies that undermined that very goal. In a town awash with insincerity, the ambidexterity of Fannie Mae's principles is in a class by itself.

As for the GSEs' ultimate value, competitive improvements in the residential mortgage market have further undermined the connection between mortgage credit and homeownership as the availability of second mortgages on attractive terms and the refinancing of existing first mortgages, combined with the provisions of federal tax law, have encouraged the redirection of mortgage credit to non–real estate purchases. With mortgage interest payments still deductible from income for state and federal tax purposes, more and more households use mortgage credit obtained through a mortgage refinancing to buy a car, conduct home improvements, consolidate personal debt, or pay for a college education because the interest payment that would otherwise be incurred on debt accumulated *directly* for these reasons—such as a car loan from a dealer or a student loan from a bank—is not tax-deductible. In part, this privileged use of debt, combined with substantial home price inflation, explains why outstanding residential mortgage credit has nearly tripled since 1990 while housing production and homeownership have expanded at a much slower pace.

Understanding the Real Problem

With little compelling evidence to indicate that four and a half decades of intrusive GSE activity has made much of a difference in homeownership rates, housing production, or helping the marginal buyer to become a homeowner, one has to wonder whether the costs and risks associated with these enterprises are justified.

Regrettably, from the extensive discussions, hearings, proposals, and counterproposals, it appears that Congress and the White House gave little thought to asking whether these entities should exist in the first place or why these for-profit entities should continue to enjoy the extraordinary federal privileges that allow them to maintain their monopoly status at the potential expense of the taxpayers.

The evidence reveals that Fannie Mae's management team appears to be the chief beneficiary of the federal privileges and the accounting irregularities that were recently uncovered. For example, in 2003, 749 members of Fannie Mae's management

13. Center for Community Change, Center for Economic and Policy Research, Children's Defense Fund, Community Learning Project, and National Low Income Housing Coalition.

14. Dushaw Hockett, Patrick McElwee, Danilo Pelletiere, Diane Schwartz, and Mark Treskon, "The Crisis in America's Housing: Confronting Myths and Promoting a Balanced Housing Policy," Center for Community Change, Center for Economic and Policy Research, Children's Defense Fund, Community Learning Project, and National Low Income Housing Coalition, January 2005, pp. 7 and 13, at *www.nlihc.org/research/housingmyths.pdf* (June 8, 2005). See also Dean Baker, "Who's Dreaming? Homeownership Among Low Income Families," Center for Economic and Policy Research *Briefing Paper*, January 11, 2005, at *www.cepr.net/publications/housing_2005_01.pdf* (June 8, 2005).

15. Hockett *et al.*, "The Crisis in America's Housing," and Baker, "Who's Dreaming?"

team received a staggering $65.1 million in bonuses, a portion of which was attributable to the overstated earnings that followed from the accounting irregularities.[16] Over the past five years, the top 20 Fannie Mae executives reportedly received combined bonuses of $245 million.[17] This disconnect between reward and mission suggests that any reconciliation with the Securities and Exchange Commission should also require that the FNMA's management return their bonuses to a fund administered by a *bona fide* not-for-profit entity, such as Habitat for Humanity, for the purpose of assisting prospective homebuyers of modest means.

Although management's unearned bonuses have generated most of the headlines, the real cost to the nation is not the tawdry looting of the company by its top management team. The real problem is the concentration of risk in the hands of two massive and privileged companies that now dominate America's housing finance markets.

Ironically, Fannie Mae's management has attempted to use the prospect of such risk to protect itself from better government oversight. In response to the U.S. Treasury's effort to improve oversight, former FNMA President Frank Raines admitted in a letter to U.S. Treasury Secretary John Snow that financial market instability could occur if even the slightest concern about the FNMA's operations were openly discussed: "From the beginning of our discussions, you and I have agreed to avoid disrupting the capital markets by indicating a wish to change Fannie Mae's charter, status, or mission."[18]

Lest one think that such an occurrence would be a distant possibility, the record reveals that federally sponsored financial institutions, including those that the federal government closely regulates and insures, have a knack of frequently exploding in hugely horrific and costly ways. Since the mid-1980s, massive losses have occurred in the federal Farm Credit System, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation. Worse, the heavily regulated and supposedly closely supervised savings and loan industry collapsed more than a decade ago, and repairing the residual damage cost the U.S. taxpayers $130 billion.

What Should Be Done

Ideas have consequences, as the saying goes, but the process is seldom instantaneous. In June 1990, echoing earlier HUD recommendations, a Heritage Foundation research fellow recommended that Fannie Mae "[c]ease payment of dividends to shareholders, so that all earnings can be applied to reserve accumulation."[19] In January 2005, nearly a decade and a half later, amidst the worst financial scandal in the company's history, Fannie Mae announced that it would cut its dividend in half.

To date, the Bush Administration, through the leadership at the U.S. Treasury and OFHEO, has done an excellent job of exposing the corruption in the GSEs and setting in motion an effective process of improvement. In both the FHLMC and the FNMA, problematic leadership has been forced to resign and the companies' boards of directors have been required to make overdue changes in corporate governance. The January 2005 FNMA agreement to cut its dividend to build reserves will add stability to the system.

But much more needs to be done, and most of the responsibility will fall on Congress because the laws governing the GSEs are flawed and need to be changed. The proposals endorsed by the House Committee on Financial Services do not go nearly far enough, and the White House has expressed concern with the timid reform package under consideration.

Enhanced regulations have attracted the most support, and the House Committee on Financial Services has proposed changes in how the GSEs are

16. David S. Hilzenrath and Kathleen Day, "After Scandals, Someone Must Pay," *The Washington Post*, January 20, 2005, p. B1.

17. McLean, "The Fall of Fannie Mae."

18. *Ibid.*

19. Ronald D. Utt, "The Six Trillion Dollar Debt Iceberg: A Review of the Government's Risk Exposure," Heritage Foundation *Backgrounder* No. 774, June 28, 1990, p. 12.

regulated, but a regulatory approach to GSE problems could easily become useless and counterproductive. With substantial evidence suggesting that the GSEs provide little or no benefit to society, trying to prop them up with new regulations makes little sense. The latest congressional strategy essentially compels taxpayers to bear the risk of a new regulatory regime that would perpetuate the commanding market position of these ineffective co-monopolists.

However, the greater risk is not that additional regulation of the GSEs will render them merely useless, but that it will render them both useless and dangerous. As past practices reveal, it is likely that Fannie Mae and Freddie Mac will soon co-opt the regulators as they have done so adeptly in the past. The Fannie Mae Foundation's $500 million of goodwill spending will buy the company helpful and influential supporters by the trainload. One merely needs to read the transcript of a recent congressional hearing for a sense of the loyal following that Fannie Mae has assembled in Congress.[20]

To correct the situation, Congress should:

- **End all of Fannie Mae's and Freddie Mac's federal privileges.** It would be better for all if the government began an orderly process of severing all of its ties with the GSEs invested in the residential mortgage market.
- **Immediately eliminate the Federal Reserve's authority to buy their debt** as part of its open market operations.
- **Phase out their U.S. Treasury credit lines over five years.** Phasing out Fannie Mae's and Freddie Mac's $2.25 billion credit lines with the U.S. Treasury in annual increments of $500 million would give them the opportunity to reduce their holdings of residential mortgages in an orderly manner. The profits from these investments depend largely on their ability to borrow at subsidized rates. This plan would also leave them with skilled workforces that could then concentrate on securing residential mortgages in fair and open competition with new entrants from the private sector, which would be attracted to the market by the level playing field.
- **Limit diversification until privatization is complete.** In the event that the GSEs choose to use the opportunity to reform themselves by diversifying their investment portfolios beyond the residential mortgage market, such diversification should be contingent upon the immediate termination of these privileges to avoid the cross-subsidization of new lines of business by federally supported profits, as occurred during the recent de-federalization of Sallie Mae (the Student Loan Marketing Corporation).

Conclusion

Congress has an opportunity to reduce financial market risk and taxpayer exposure and to restore competition in the residential mortgage market. At the same time, the housing industry and homeownership opportunity will remain unaffected.

—Ronald D. Utt, Ph.D., is Herbert and Joyce Morgan Senior Research Fellow in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

20. See hearing, *The OFHEO Report: Allegations of Accounting and Management Failure at Fannie Mae*, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, U.S. House of Representatives, 108th Cong., 2nd Sess., October 6, 2004, at *financialservices.house.gov/media/pdf/108-115.pdf* (June 9, 2005).