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Fannie Mae and Freddie Mac: Avoiding the Next Big Mistake

David C. John

The biggest mistake that Congress and the next president could make about Fannie Mae and Freddie Mac is to leave them alone or let them get away with only minor changes. While both again seem temporarily stable after their stock took another sharp drop and failure seemed moments away, the calm is deceptive. The two have now seen the value of their stocks drop by about 90 percent since January.

More turmoil is almost inevitable, and the markets, knowledgeable analysts, and the press have sent a clear message that it is time for Fannie and Freddie to go. It is time for the Treasury Department and Fannie and Freddie's new regulator, the Federal Housing Finance Agency, to use their new and existing powers to put Fannie and Freddie into a receivership and break them up.

Background. Both entities are clearly undercapitalized and face yet more losses as the value of their housing portfolio continues to drop. While the management of Freddie Mac promises to raise more capital, a promise that they have been making for months, its stock is so low that it has very few hopes of raising the needed funds. Another option might be preferred stock, with its guaranteed dividend, but a major U.S. bank's action of writing down its investments in Freddie and Fannie preferred stock by 50 percent probably makes that approach infeasible.

Meanwhile, Fannie Mae has reshuffled its management, but given the fact that it merely promoted insiders at the company who were part of the team that created the current mess, such a move is unlikely to restore confidence. Similarly, a major

investment bank's estimate that Fannie and Freddie have enough capital to last through the end of the year should be taken to show the timing of their failure and not that either can or should survive.

This is a situation that political leaders had hoped to avoid by putting in place the mechanism for a government bailout of both companies. They expected that the markets would react so positively to the news that the government stood behind Freddie and Fannie that they would never have to actually bail them out. An actual bailout would be both expensive and politically tricky, since both Fannie and Freddie have deep connections and histories of political intrigue. In fact, the recent bailout provisions actually require the approval of the current management before the government could act. It would be naïve to believe the management would agree to any significant restrictions in any but the most extreme situation.

The answer should be to give them no choice by recognizing the inevitable and placing both Fannie and Freddie into receivership. It is now clear that both entities cause a significant risk that taxpayers will have to spend billions of dollars to deal with. As AEI's Peter Wallison points out, now that the gov-

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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ernment explicitly backs Fannie and Freddie, it is impossible to deny that any profits the two make go to the management and stockholders and that any losses will be picked up by the taxpayers.¹

What Not to Do. While the political establishment may prefer to do nothing and hope that they can survive, this would be a huge mistake. The one clear lesson of the past several months is that the basic structure of Fannie and Freddie is fatally flawed. While both may have made significant contributions to housing ownership in the past, they are remnants of the 1960s Great Society and no longer reflect today's realities. Doing nothing is likely to both increase the eventual cost to the taxpayer and delay the creation of a more modern housing finance system that can meet the needs of homebuyers without the risk posed by Fannie and Freddie.

If doing nothing is the worst option, then nationalizing Fannie and Freddie is the second worst. Such a move would do nothing to either reduce the potential cost to taxpayers or to change their dominance of the housing finance market. Instead, it would make housing finance even more subject to political pressures than it is today, while at the same time stifling efforts to create other types of housing finance tools, such as covered bonds. The only possible value to taxpayers would be that they (rather than management and shareholders) would receive the profits from Fannie and Freddie's activities. However, even here there is the danger that Congress would divert some or all of any profits to pay for politically valuable projects. As an example, the very legislation that authorized a bailout for Fannie and Freddie also imposed a new fee upon them to pay for low-income housing projects.

What to Do Instead. The best way to deal with Fannie and Freddie would be for a receiver to take over and then to sell the remaining good quality assets either as several newly chartered entities or to other financial services firms. These new entities would not retain any type of taxpayer backing—either explicitly or implicitly. Bad assets would be liquidated over time in a way that would

recoup to the maximum feasible extent any costs to the taxpayers.

Some have suggested that the return to the taxpayer would be greater if the good assets of Fannie and Freddie were sold off without breaking them up first. While this may be true if only the current return to taxpayers is considered, such a move would do nothing about the current market dominance of the existing firms. The new entities would still have the ability to stifle innovation or the creation of competitors. Leaving them in one piece would also make it much easier for them to regain their current political pull and conceivably to be seen as successors to the implicit government guarantee that both institutions had until it became explicit.

Thus, while breaking up the good assets of Fannie and Freddie might somewhat reduce the amount that taxpayers receive now, it could end up costing them much more in the future if the current situation reappears at some date. Rather than allowing some future Fannie and Freddie to claim that it is the heir to today's entities, it would be far better to explicitly and finally close this chapter once and for all.

Avoiding the Big Fannie and Freddie Mistake. Politically, Fannie and Freddie's financial woes are coming at the worst possible time. The second Bush term ends in just a few months, and Congress is intent on getting out of town for the 2008 elections. This is no time for any legislation to pass, especially in the face of Fannie and Freddie's lobbying muscle. However, strong leadership within the Treasury Department and the new regulator, the Federal Housing Finance Agency, could provide a lasting positive legacy by using their new and existing powers to bring Fannie and Freddie into a receivership that will break them up and allow the new era of housing finance to begin.

—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

1. Peter J. Wallison, "Fannie and Freddie by Twilight," *AEI Online*, August 26, 2008, at http://www.aei.org/publications/filter.all,pubID.28517/pub_detail.asp (September 4, 2008).